

LSI CORP
Form 10-Q
November 06, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2012

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: 1-10317

LSI CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

94-2712976
(I.R.S. Employer Identification Number)

1621 Barber Lane

Milpitas, California 95035

(Address of principal executive offices)

(Zip code)

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(408) 433-8000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company.)

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

As of November 1, 2012, there were 553,408,484 shares of the registrant's Common Stock, \$.01 par value, outstanding.

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FORWARD-LOOKING STATEMENTS

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words estimate, plan, intend, expect, anticipate, believe and similar words are intended to identify forward-looking statements. Although we believe our expectations are based on reasonable assumptions, our actual results could differ materially from those projected in the forward-looking statements. We have described in Part II, Item 1A- Risk Factors a number of factors that could cause our actual results to differ materially from our projections or estimates. Except where otherwise indicated, the statements made in this report are made as of the date we filed this report with the Securities and Exchange Commission and should not be relied upon as of any subsequent date. We expressly disclaim any obligation to update the information in this report, except as may otherwise be required by law.

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****LSI CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except per share amounts)****(Unaudited)**

	September 30, 2012	December 31, 2011
ASSETS		
Cash and cash equivalents	\$ 440,507	\$ 779,811
Short-term investments	202,520	155,644
Accounts receivable, less allowances of \$6,206 and \$6,950, respectively	256,492	246,539
Inventories	209,104	180,035
Prepaid expenses and other current assets	64,526	60,659
Total current assets	1,173,149	1,422,688
Property and equipment, net	250,206	180,589
Identified intangible assets, net	516,104	433,790
Goodwill	255,838	72,377
Other assets	108,074	122,604
Total assets	\$ 2,303,371	\$ 2,232,048
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	\$ 184,358	\$ 175,093
Accrued salaries, wages and benefits	131,853	106,948
Other accrued liabilities	160,622	178,830
Total current liabilities	476,833	460,871
Pension and post-retirement benefit obligations	512,545	597,183
Income taxes payable non-current	100,104	91,791
Other non-current liabilities	15,917	23,263
Total liabilities	1,105,399	1,173,108
Commitments and contingencies (Note 13)		
Stockholders' equity:		
Preferred stock, \$.01 par value: 2,000 shares authorized; none outstanding	0	0
Common stock, \$.01 par value: 1,300,000 shares authorized; 553,083 and 561,767 shares outstanding, respectively	5,531	5,618
Additional paid-in capital	5,574,076	5,623,581
Accumulated deficit	(3,863,456)	(4,037,031)
Accumulated other comprehensive loss	(518,179)	(533,228)
Total stockholders' equity	1,197,972	1,058,940
Total liabilities and stockholders' equity	\$ 2,303,371	\$ 2,232,048

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The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents**LSI CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)****(Unaudited)**

	Three Months Ended		Nine Months Ended	
	September 30, 2011	October 2, 2011	September 30, 2011	October 2, 2011
Revenues	\$ 623,962	\$ 546,910	\$ 1,905,959	\$ 1,520,818
Cost of revenues	311,311	283,065	974,508	795,179
Gross profit	312,651	263,845	931,451	725,639
Research and development	167,488	143,347	512,923	431,567
Selling, general and administrative	92,032	77,874	271,046	218,534
Restructuring of operations and other items, net	4,221	10,784	26,174	2,686
Income from operations	48,910	31,840	121,308	72,852
Interest income and other, net	5,855	7,610	30,105	18,348
Income from continuing operations before income taxes	54,765	39,450	151,413	91,200
Provision for/(benefit from) income taxes	15,100	7,800	(22,162)	12,596
Income from continuing operations	39,665	31,650	173,575	78,604
(Loss)/income from discontinued operations (including a gain on disposal of \$260,066 for the nine months ended October 2, 2011), net of taxes	0	(2,311)	0	254,673
Net income	\$ 39,665	\$ 29,339	\$ 173,575	\$ 333,277
Basic income per share:				
Income from continuing operations	\$ 0.07	\$ 0.05	\$ 0.31	\$ 0.13
(Loss)/income from discontinued operations	\$ 0	\$ (0.00)	\$ 0	\$ 0.43
Net income	\$ 0.07	\$ 0.05	\$ 0.31	\$ 0.56
Diluted income per share:				
Income from continuing operations	\$ 0.07	\$ 0.05	\$ 0.30	\$ 0.13
(Loss)/income from discontinued operations	\$ 0	\$ (0.00)	\$ 0	\$ 0.42
Net income	\$ 0.07	\$ 0.05	\$ 0.30	\$ 0.55
Shares used in computing per share amounts:				
Basic	555,197	567,790	561,708	592,898
Diluted	572,022	581,483	582,296	608,743

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents**LSI CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(In thousands)****(Unaudited)**

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2011	October 2, 2011
Net income	\$ 39,665	\$ 29,339	\$ 173,575	\$ 333,277
Other comprehensive income/(loss) before tax:				
Foreign currency translation adjustments	3,575	(3,107)	178	(1,516)
Unrealized gain/(loss) on investments for the period	754	(143)	1,998	1,278
Reclassification adjustments for gain on investments included in net income	(401)	(546)	(1,814)	(2,059)
Unrealized gain/(loss) on investments	353	(689)	184	(781)
Unrealized gain/(loss) on derivatives for the period	991	(2,183)	(358)	(1,162)
Reclassification adjustments for loss/(gain) on derivatives included in net income	770	(272)	2,778	(1,244)
Unrealized gain/(loss) on derivatives	1,761	(2,455)	2,420	(2,406)
Net actuarial loss	0	(1,855)	0	(1,855)
Amortization of transition asset, prior service cost and net actuarial loss	4,115	1,932	12,267	5,494
Defined benefit pension plans	4,115	77	12,267	3,639
Other comprehensive income/(loss) before tax	9,804	(6,174)	15,049	(1,064)
Income tax expense related to items of other comprehensive income/(loss)	0	0	0	0
Other comprehensive income/(loss), net of tax	9,804	(6,174)	15,049	(1,064)
Comprehensive income	\$ 49,469	\$ 23,165	\$ 188,624	\$ 332,213

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents**LSI CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	Nine Months Ended	
	September 30, 2010	October 2, 2011
Operating activities:		
Net income	\$ 173,575	\$ 333,277
Adjustments:		
Depreciation and amortization	136,318	145,843
Stock-based compensation expense	83,538	38,480
Non-cash restructuring of operations and other items, net	5,739	30,535
Gain on re-measurement of a pre-acquisition equity interest to fair value	(5,765)	0
Gain on sale of investments	(2,550)	0
Gain on sale of business	0	(260,066)
Loss/(gain) on sale of property and equipment	2,574	(543)
Unrealized foreign exchange (gain)/loss	(80)	200
Deferred taxes	(43,246)	(18,944)
Changes in assets and liabilities, net of assets acquired and liabilities assumed in business combination:		
Accounts receivable	931	78,215
Inventories	(4,864)	(60,203)
Prepaid expenses, assets held for sale and other assets	(720)	(10,256)
Accounts payable	4,335	(1,700)
Accrued and other liabilities	(70,481)	(83,479)
Net cash provided by operating activities	279,304	191,359
Investing activities:		
Purchases of debt securities available-for-sale	(94,456)	(38,683)
Proceeds from maturities and sales of debt securities available-for-sale	29,523	31,988
Purchases of other investments	0	(4,000)
Proceeds from sale of other investments	2,550	0
Purchases of property and equipment	(103,285)	(46,841)
Proceeds from sale of property and equipment	1,626	939
Acquisition of business, net of cash acquired	(319,231)	0
Proceeds from sale of business, net of transaction costs	0	475,150
Net cash (used in)/provided by investing activities	(483,273)	418,553
Financing activities:		
Issuances of common stock	90,643	66,060
Purchases of common stock under repurchase programs	(226,247)	(471,787)
Net cash used in financing activities	(135,604)	(405,727)
Effect of exchange rate changes on cash and cash equivalents	269	(821)
Net change in cash and cash equivalents	(339,304)	203,364

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Cash and cash equivalents at beginning of period	779,811	521,786
Cash and cash equivalents at end of period	\$ 440,507	\$ 725,150

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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LSI CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Basis of Presentation

For financial reporting purposes, LSI Corporation (LSI or the Company) reports on a 13- or 14-week quarter with the year ending December 31. The third quarters of 2012 and 2011 consisted of 13 weeks each and ended on September 30, 2012 and October 2, 2011, respectively. The results of operations for the quarter ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year.

On January 3, 2012, the Company completed the acquisition of SandForce, Inc. (SandForce) for total consideration of approximately \$346.4 million, net of cash acquired. SandForce was a provider of flash storage processors for enterprise and client flash solutions and solid state drives. The acquisition was accounted for under the purchase method of accounting. Accordingly, the results of operations of SandForce and the estimated fair value of the assets acquired and liabilities assumed were included in the Company s condensed consolidated financial statements from January 3, 2012.

On May 6, 2011, the Company completed the sale of substantially all of its external storage systems business to NetApp, Inc. (NetApp). The results of the external storage systems business are presented as discontinued operations in the Company s condensed consolidated statements of operations and, as such, have been excluded from all line items other than (Loss)/income from discontinued operations for all periods presented.

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

In management s opinion, the accompanying unaudited condensed consolidated financial statements contain all normal recurring adjustments necessary for a fair statement of the Company s financial position, results of operations, comprehensive income and cash flows for the interim periods presented. While the Company believes that the disclosures are adequate to make the information not misleading, these financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued additional guidance on fair value measurements and related disclosures. The new guidance clarifies the application of existing guidance on fair value measurement for non-financial assets and requires the disclosure of quantitative information about the unobservable inputs used in a fair value measurement. The Company adopted this guidance in the first quarter of 2012. The adoption did not impact the Company s results of operations or financial position.

In June 2011, the FASB issued amended guidance regarding the presentation of comprehensive income. The amended guidance gives an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amended guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity. The Company adopted this guidance in the first quarter of 2012. The adoption did not impact the Company s results of operations or financial position.

Note 2 Stock-Based Compensation Expense

In May 2012, the Company s 2003 Equity Incentive Plan was amended to increase the number of shares available for new awards to a total of 25 million, of which 15 million shares were available for restricted stock and/or restricted stock units (RSUs). In addition, the period during which incentive stock options can be granted was extended to February 9, 2022, and the maximum number of shares that may be issued upon exercise of incentive stock options was set at 25 million.

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Stock-based compensation expense included in continuing operations, net of estimated forfeitures, related to the Company's stock options, Employee Stock Purchase Plan (ESPP) and restricted stock unit awards by expense category was as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
	(In thousands)			
Cost of revenues	\$ 2,573	\$ 1,460	\$ 9,088	\$ 5,324
Research and development	11,170	5,410	35,451	18,286
Selling, general and administrative	13,643	4,883	38,999	15,462
Total stock-based compensation expense	\$ 27,386	\$ 11,753	\$ 83,538	\$ 39,072

In connection with the SandForce acquisition, the Company assumed stock options and RSUs originally granted by SandForce. Stock-based compensation expense for the nine months ended September 30, 2012 included \$4.5 million of expense related to the accelerated vesting of stock options and RSUs for certain SandForce employees in January 2012. Stock-based compensation expense for the three and nine months ended September 30, 2012 also includes \$3.1 million and \$8.8 million, respectively, related to assumed stock options and RSUs.

Stock Options

The fair value of each option grant is estimated as of the date of grant using a reduced-form calibrated binomial lattice model (lattice model). The following table summarizes the weighted-average assumptions that the Company applied in the lattice model:

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
Estimated grant date fair value per share	\$ 2.50	\$ 2.37	\$ 2.84	\$ 2.14
Expected life (years)	4.46	4.48	4.46	4.51
Risk-free interest rate	1%	1%	1%	2%
Volatility	52%	50%	47%	47%

The following table summarizes changes in stock options outstanding:

	Number of Shares (In thousands)	Weighted-Average Exercise Price Per Share	Weighted-Average	
			Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Options outstanding at December 31, 2011	64,245	\$ 6.19		
Assumed in SandForce acquisition	7,542	\$ 0.75		
Granted	5,389	\$ 8.40		
Exercised	(14,385)	\$ 5.32		
Canceled	(4,758)	\$ 8.69		
Options outstanding at September 30, 2012	58,033	\$ 5.70	3.91	\$ 102,654
Options exercisable at September 30, 2012	35,670	\$ 6.13	2.71	\$ 52,025

As of September 30, 2012, the total unrecognized compensation expense related to unvested stock options, net of estimated forfeitures, was \$40.9 million and is expected to be recognized over the next 2.2 years on a weighted-average basis. The options assumed in the SandForce acquisition vest over four years from the date of the grant and have ten year terms.

Restricted Stock Units

The cost of service-based and performance-based RSUs is determined using the fair value of the Company's common stock on the date of grant. For performance-based RSU expense, the Company also considers the probability that those RSUs will vest.

Service-based:

The vesting of service-based RSUs requires that the employees remain employed by the Company for a specified period of time.

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The following table summarizes changes in service-based RSUs outstanding:

	Number of Units (In thousands)	Weighted-Average Grant Date Fair Value per Share
Unvested service-based RSUs outstanding at December 31, 2011	12,085	\$ 5.94
Assumed in SandForce acquisition	1,576	\$ 6.17
Granted	7,921	\$ 8.23
Vested	(3,315)	\$ 5.87
Forfeited	(782)	\$ 6.53
Unvested service-based RSUs outstanding at September 30, 2012	17,485	\$ 6.98

As of September 30, 2012, the total unrecognized compensation expense related to service-based RSUs, net of estimated forfeitures, was \$94.6 million and will be recognized over the next 2.8 years on a weighted-average basis.

Performance-based:

The vesting of performance-based RSUs is contingent upon the Company meeting specified performance criteria and requires that the employees remain employed by the Company for a specified period of time.

The following table summarizes changes in performance-based RSUs outstanding:

	Number of Units (In thousands)	Weighted-Average Grant Date Fair Value per Share
Unvested performance-based RSUs outstanding at December 31, 2011	4,729	\$ 5.98
Granted	2,986	\$ 8.52
Vested	(1,446)	\$ 5.85
Forfeited	(593)	\$ 6.53
Unvested performance-based RSUs outstanding at September 30, 2012	5,676	\$ 7.29

As of September 30, 2012, the total unrecognized compensation expense related to performance-based RSUs, net of estimated forfeitures, was \$19.8 million and, if the performance conditions are fully met, will be recognized over the next 3 years.

Employee Stock Purchase Plan

Compensation expense for the ESPP is calculated using the fair value of the employees' purchase rights under the Black-Scholes model. Under the ESPP, rights to purchase shares are granted during the second and fourth quarters of each year. The Company issued 2.8 million and 2.9 million shares under the ESPP during the three months ended July 1, 2012 and July 3, 2011, respectively. No shares related to the ESPP were issued during the three months ended September 30, 2012 or October 2, 2011. The following table summarizes the weighted-average assumptions that the Company applied in the calculation of the fair value for the May 2012 and May 2011 grants:

	2012	2011
Estimated grant date fair value per share	\$ 2.19	\$ 2.10
Expected life (years)	0.8	0.8

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Risk-free interest rate	0.17%	0.02%
Volatility	41%	37%

Note 3 Common Stock Repurchases

The Company's board of directors authorized stock repurchases of up to \$750.0 million on March 9, 2011 and an additional \$500.0 million on August 1, 2012. As of September 30, 2012, \$525.0 million remained available for stock repurchases. The Company repurchased 6.6 million shares for \$50.1 million during the three months ended September 30, 2012 and 29.1 million shares for \$226.2 million during the nine months ended September 30, 2012. The Company repurchased 11.2 million shares for \$75.0 million during the three months ended October 2, 2011 and 67.5 million shares for \$471.8 million during the nine months ended October 2, 2011. Repurchased shares are retired immediately after the repurchases are completed. Retirement of repurchased shares is recorded as a reduction of common stock and additional paid-in capital.

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The following table summarizes items included in restructuring of operations and other items, net:

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
	(In thousands)			
Lease terminations (a)	\$ 901	\$ 311	\$ 3,716	\$ 3,864
Employee severance and benefits (b)	1,239	482	2,698	2,414
Asset impairment and other exit charges	3,515(c)	6,019(d)	3,515(c)	6,019(d)
Total restructuring expense	5,655	6,812	9,929	12,297
Other items, net	(1,434)(e)	3,972(f)	16,245(g)	(9,611)(h)
Total restructuring of operations and other items, net	\$ 4,221	\$ 10,784	\$ 26,174	\$ 2,686

- (a) Includes changes in estimates, changes in time value and on-going expenditures related to previously vacated facilities.
- (b) Relates to restructuring actions taken as the Company continued to streamline operations.
- (c) Consists of a \$2.7 million loss on the sale of a property in the U.S. and \$0.8 million of other asset impairment and exit costs.
- (d) Primarily relates to write-offs of intellectual property and software which are no longer in use.
- (e) Primarily consists of a \$1.7 million reversal of a sales and use tax liability as a result of concluding a state tax audit.
- (f) Primarily consists of costs related to the transition service agreement associated with the sale of the external storage systems business.
- (g) Primarily consists of \$8.4 million of SandForce acquisition-related costs and \$6.7 million of costs related to the transition service agreement associated with the sale of the external storage systems business, offset in part by a \$1.7 million reversal of a sales and use tax liability as a result of concluding a state tax audit.
- (h) Primarily consists of the reversal of a \$14.5 million sales and use tax related liability as a result of concluding various audits, partially offset by \$5.3 million of costs related to the transition service agreement associated with the sale of the external storage systems business.
- The following table summarizes the significant activity within, and components of, the Company's restructuring obligations:

Asset Impairment and Other Exit Charges	Lease Terminations	Employee Severance and Benefits	Total
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	(In thousands)			
Balance at December 31, 2011	\$ 0	\$ 11,752	\$ 10,444	\$ 22,196
Expense	3,515	3,716	2,698	9,929
Utilized	(3,515)	(7,199)(a)	(11,794)(a)	(22,508)
Balance at September 30, 2012 (b)	\$ 0	\$ 8,269	\$ 1,348	\$ 9,617

(a) Represents cash payments.

(b) The balance remaining for lease terminations is expected to be paid during the remaining terms of the leases, which extend through 2013. The balance remaining for employee severance and benefits is expected to be paid by the end of 2013.

Note 5 Business Combination

Acquisition of SandForce

On January 3, 2012, the Company completed the acquisition of SandForce. SandForce was a provider of flash storage processors for enterprise and client flash solutions and solid state drives. The Company acquired SandForce to enhance its position in storage technology solutions.

Total consideration consisted of the following (in thousands):

Cash paid, net of cash acquired	\$ 319,231
Fair value of partially vested equity awards	19,089
Fair value of LSI's previous investment in SandForce	8,120
Total	\$ 346,440

In connection with the SandForce acquisition, the Company assumed stock options and RSUs originally granted by SandForce and converted them into LSI stock options and RSUs. The portion of the fair value of partially vested equity awards associated with prior service of SandForce employees represents a component of the total consideration for the SandForce acquisition, as presented above. Stock options assumed were valued using a binomial lattice model calibrated to the exercise behavior of LSI's employees. RSUs were valued based on LSI's stock price as of the acquisition date.

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Prior to the acquisition, the Company held an equity interest in SandForce. The Company determined the fair value of this equity interest by applying the per share value of the contractual cash consideration to the SandForce shares held by the Company immediately prior to the acquisition. The fair value of the Company's pre-acquisition investment in SandForce represents a component of the total consideration, as presented above. As a result of re-measuring the pre-acquisition equity interest in SandForce to fair value, the Company recognized a gain of \$5.8 million, which was included in interest income and other, net, for the nine month period ended September 30, 2012.

The allocation of the purchase price to SandForce's tangible and identified intangible assets acquired and liabilities assumed was based on their estimated fair values.

The purchase price has been allocated as follows (in thousands):

Accounts receivable	\$ 10,711
Inventory	24,268
Identified intangible assets	172,400
Goodwill	183,461
Net deferred tax liabilities	(43,198)
Other, net	(1,202)
Total	\$ 346,440

The goodwill is primarily attributable to the assembled workforce of SandForce and synergies and economies of scale expected from combining the operations of LSI and SandForce. The goodwill recognized is not deductible for tax purposes.

Identified intangible assets consisted of the following:

	Fair Value (In thousands)	Weighted- Average Life (In years)
Current technology	\$ 73,400	4.0
Customer relationships	41,700	7.0
Order backlog	4,500	0.5
Trade names	1,500	3.0
Total identified intangible assets subject to amortization	121,100	4.9
In-process research and development	51,300	
Total identified intangible assets	\$ 172,400	

The allocation of the purchase price to identified intangible assets acquired was based on the Company's best estimate of the fair value of those assets. The fair value of acquired identified intangible assets is determined based on inputs that are unobservable and significant to the overall fair value measurement. As such, acquired intangible assets are classified as Level 3 assets.

The fair value of each of the acquired identified intangible assets was determined using a discounted cash flow methodology. The cash flows for each category of identified intangible assets represent the estimated incremental effect on the Company's cash flows directly attributable to that intangible asset over its estimated remaining life. Estimated cash flows represent expected incremental revenues, net of returns on contributory assets and after considering estimated incremental operating costs and income taxes. Discount rates ranging from 12.9% to 17.9% were used based on the cost of capital, adjusted to reflect the specific risk associated with each of the cash flows.

Current technology represents the fair value of SandForce products that had reached technological feasibility and were a part of its product offering. Customer relationships represents the fair values of SandForce's relationships with its customers.

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In-process research and development (IPR&D) represents the fair value of incomplete research and development projects that had not reached technological feasibility as of the date of the acquisition. At the time of acquisition, SandForce had IPR&D related to its next generation flash storage processor (the Griffin project). At September 30, 2012, expected costs to complete the Griffin project are approximately \$20.3 million through its anticipated completion date in 2013. Total revenues for the Griffin project are expected to extend through 2018. The acquisition date fair value of the Griffin project will be either amortized or impaired depending on whether the project is completed or abandoned.

From January 3, 2012 through September 30, 2012, the Company recognized approximately \$124.1 million of revenues related to the SandForce business. In addition, during the nine months ended September 30, 2012, the Company recognized \$8.4 million of acquisition-related costs included in restructuring of operations and other items, net related to SandForce. It is impracticable to

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determine the effect on net income resulting from the SandForce acquisition for the nine months ended September 30, 2012, as the Company immediately integrated SandForce into its ongoing operations. Historical pro forma results giving effect to the acquisition have not been presented because such effect is not material to the prior period financial results.

Note 6 Benefit Obligations

In 2007, the Company acquired Agere Systems Inc. (Agere). The Company has pension plans covering substantially all former Agere U.S. employees, excluding management employees hired after June 30, 2003. Retirement benefits are provided under defined benefit pension plans, which include a management plan and a represented plan. The payments under the management plan are based on an adjusted career-average-pay formula or a cash-balance program. The payments under the represented plan are based on a dollar-per-month formula. Since February 2009, there have been no active participants under the represented plan. The Company also has a non-qualified supplemental pension plan in the U.S. that principally provides benefits based on compensation in excess of amounts that can be considered under a tax qualified plan. The Company also provides post-retirement life insurance coverage under a group life insurance plan for former Agere employees excluding participants in the cash-balance program and management employees hired after June 30, 2003. The Company also has pension plans covering certain international employees.

Effective April 6, 2009, the Company froze the U.S. management defined benefit pension plan. Participants in the adjusted career-average-pay program will not earn any future service accruals after that date. Participants in the cash-balance program will not earn any future service accruals, but will continue to earn 4% interest per year on their cash-balance accounts.

The following table summarizes the components of the net periodic benefit cost or credit:

	Three Months Ended			
	September 30, 2012		October 2, 2011	
	Pension Benefits	Post-retirement Benefits	Pension Benefits	Post-retirement Benefits
	(In thousands)			
Service cost	\$ 96	\$ 22	\$ 141	\$ 19
Interest cost	15,355	657	16,891	702
Expected return on plan assets	(17,024)	(953)	(17,000)	(1,032)
Amortization of net actuarial loss, prior service cost and transition asset	3,592	523	1,695	237
Total benefit cost/(credit)	\$ 2,019	\$ 249	\$ 1,727	\$ (74)

	Nine Months Ended			
	September 30, 2012		October 2, 2011	
	Pension Benefits	Post-retirement Benefits	Pension Benefits	Post-retirement Benefits
	(In thousands)			
Service cost	\$ 321	\$ 67	\$ 416	\$ 57
Interest cost	46,090	1,950	50,670	1,948
Expected return on plan assets	(51,077)	(2,859)	(50,998)	(3,097)
Amortization of net actuarial loss, prior service cost and transition asset	10,754	1,513	5,080	414
Total benefit cost/(credit)	\$ 6,088	\$ 671	\$ 5,168	\$ (678)

During the nine months ended September 30, 2012, the Company contributed \$80.2 million to its pension plans. The Company expects to contribute an additional \$15.2 million to its pension plans during the remainder of 2012. The Company does not expect to contribute to its post-retirement benefit plan in 2012.

Table of Contents**Note 7 Cash Equivalents and Investments**

The following tables summarize the Company's cash equivalents and investments measured at fair value:

	Fair Value Measurements as of September 30, 2012		
	Level 1	Level 2 (In thousands)	Total
Cash equivalents:			
Money-market funds	\$ 338,690(a)	\$ 0	\$ 338,690
U.S. government and agency securities	0	1,000(b)	1,000
Total cash equivalents	\$ 338,690	\$ 1,000	\$ 339,690
Available-for-sale debt securities:			
Asset-backed and mortgage-backed securities:			
Agency securities	\$ 0	\$ 124,247(b)	\$ 124,247
Non-agency securities	0	2,336(b)	2,336
U.S. government and agency securities	13,276(a)	45,968(b)	59,244
Corporate debt securities	0	16,693(b)	16,693
Total short-term investments	\$ 13,276	\$ 189,244	\$ 202,520
Long-term investments in equity securities:			
Marketable available-for-sale equity securities	\$ 2,209(c)	\$ 0	\$ 2,209

	Fair Value Measurements as of December 31, 2011		
	Level 1	Level 2 (In thousands)	Total
Cash equivalents:			
Money-market funds	\$ 674,219(a)	\$ 0	\$ 674,219
Available-for-sale debt securities:			
Asset-backed and mortgage-backed securities:			
Agency securities	\$ 0	\$ 97,408(b)	\$ 97,408
Non-agency securities	0	9,989(b)	9,989
U.S. government and agency securities	5,403(a)	30,572(b)	35,975
Corporate debt securities	0	12,272(b)	12,272
Total short-term investments	\$ 5,403	\$ 150,241	\$ 155,644
Long-term investments in equity securities:			
Marketable available-for-sale equity securities	\$ 1,514(c)	\$ 0	\$ 1,514

- (a) The fair value of money-market funds is determined using unadjusted prices in active markets. The fair value of Level 1 U.S. government and agency securities is determined using quoted prices in active markets.
- (b) These investments are traded less frequently than Level 1 securities and are valued using inputs that include quoted prices for similar assets in active markets and inputs other than quoted prices that are observable for the asset, such as interest rates, yield curves, prepayment speeds, collateral performance, broker/dealer quotes and indices that are observable at commonly quoted intervals.
- (c) The fair value of marketable equity securities is determined using quoted market prices in active markets. These amounts are included within other assets in the condensed consolidated balance sheets.

As of September 30, 2012 and December 31, 2011, the aggregate carrying value of the Company's non-marketable securities was \$41.6 million and \$43.9 million, respectively.

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Upon the acquisition of SandForce in January 2012, the Company recognized a gain of \$5.8 million as a result of re-measuring its pre-acquisition equity interest in SandForce to estimated fair value. There were no other non-marketable securities fair-valued during the three and nine months ended September 30, 2012 or October 2, 2011.

The following tables summarize the Company's available-for-sale securities:

	Amortized Cost	September 30, 2012		Fair Value
		Gross Unrealized Gain	Gross Unrealized Loss	
(In thousands)				
Short-term debt securities:				
Asset-backed and mortgage-backed securities	\$ 120,326	\$ 6,730	\$ (473)	\$ 126,583
U.S. government and agency securities	58,350	895	(1)	59,244
Corporate debt securities	16,523	170	0	16,693
Total short-term debt securities	\$ 195,199	\$ 7,795	\$ (474)	\$ 202,520
Long-term marketable equity securities	\$ 669	\$ 1,541	\$ (1)	\$ 2,209

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	Amortized Cost	December 31, 2011		Fair Value
		Gross Unrealized Gain	Gross Unrealized Loss	
(In thousands)				
Short-term debt securities:				
Asset-backed and mortgage-backed securities	\$ 99,884	\$ 7,891	\$ (378)	\$ 107,397
U.S. government and agency securities	35,179	799	(3)	35,975
Corporate debt securities	12,146	153	(27)	12,272
Total short-term debt securities	\$ 147,209	\$ 8,843	\$ (408)	\$ 155,644

Long-term marketable equity securities \$ 669 \$ 846 \$ (1) \$ 1,514
As of September 30, 2012, there were 89 investments in an unrealized loss position. The following tables summarize the gross unrealized losses and fair values of the Company's short-term investments that have been in a continuous unrealized loss position for less than and greater than 12 months, aggregated by investment category:

	September 30, 2012			
	Less than 12 Months		Greater than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(In thousands)				
Asset-backed and mortgage-backed securities	\$ 29,041	\$ (424)	\$ 2,165	\$ (49)
U.S. government and agency securities	7,099	(1)	0	0
Total	\$ 36,140	\$ (425)	\$ 2,165	\$ (49)

	December 31, 2011			
	Less than 12 Months		Greater than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(In thousands)				
Asset-backed and mortgage-backed securities	\$ 10,645	\$ (286)	\$ 1,301	\$ (92)
U.S. government and agency securities	3,872	(3)	0	0
Corporate debt securities	2,375	(27)	505	0
Total	\$ 16,892	\$ (316)	\$ 1,806	\$ (92)

Net realized gains on sales of available-for-sale securities were not material for the three and nine months ended September 30, 2012 or October 2, 2011.

Contractual maturities of available-for-sale debt securities as of September 30, 2012 were as follows:

	Available-For-Sale Debt Securities (In thousands)
Due within one year	\$ 30,135
Due in 1-5 years	47,892
Due in 5-10 years	10,671
Due after 10 years	113,822
Total	\$ 202,520

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The maturities of asset-backed and mortgage-backed securities were allocated based on contractual principal maturities assuming no prepayments.

Note 8 Supplemental Financial Information

Inventories

	September 30, 2012	December 31, 2011
	(In thousands)	
Raw materials	\$ 176	\$ 236
Work-in-process	52,809	78,886
Finished goods	156,119	100,913
Total inventories	\$ 209,104	\$ 180,035

Table of Contents**Goodwill**

The following table summarizes goodwill activity for the nine months ended September 30, 2012:

	Goodwill (In thousands)
Balance as of December 31, 2011	\$ 72,377
Addition due to SandForce acquisition	183,461
Balance as of September 30, 2012	\$ 255,838

There was no impairment charge for goodwill during the nine months ended September 30, 2012 or October 2, 2011. The accumulated impairment loss as of September 30, 2012 was \$2.4 billion.

Accumulated Other Comprehensive Loss

The following table presents the components of, and changes in, accumulated other comprehensive loss, net of taxes:

	Balance at December 31, 2011	Other Comprehensive Income (In thousands)	Balance at September 30, 2012
Accumulated net foreign currency translation adjustments	\$ 42,138	\$ 178	\$ 42,316
Accumulated net unrealized gain on investments	5,942	184	6,126
Accumulated net unrealized loss on derivatives	(2,551)	2,420	(131)
Accumulated actuarial loss on pension and post-retirement plans	(578,757)	12,267	(566,490)
Total accumulated other comprehensive loss	\$ (533,228)	\$ 15,049	\$ (518,179)

There was no tax effect on any item of other comprehensive income presented in the condensed consolidated statements of comprehensive income for the three and nine months ended September 30, 2012 or October 2, 2011.

Reconciliation of Basic and Diluted Shares

The following table provides a reconciliation of basic and diluted shares:

	Three Months Ended		Nine Months Ended	
	September 30, 2011	October 2, 2011	September 30, 2011	October 2, 2011
	(In thousands)			
Basic shares	555,197	567,790	561,708	592,898
Dilutive effect of stock options, employee stock purchase rights and restricted stock unit awards	16,825	13,693	20,588	15,845
Diluted shares	572,022	581,483	582,296	608,743

The weighted-average common share equivalents that were excluded from the computation of diluted shares because their inclusion would have had an anti-dilutive effect on net income per share were as follows:

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	Three Months Ended		Nine Months Ended	
	September 30, 2010	October 2, 2010	September 30, 2010	October 2, 2011
	(In thousands)			

Anti-dilutive securities:				
Stock options	29,181	39,924	27,694	42,978
Restricted stock unit awards	9,871	1,491	6,621	182

Note 9 Derivative Instruments

The Company has foreign subsidiaries that operate and sell the Company's products in various markets around the world. As a result, the Company is exposed to changes in foreign-currency exchange rates. The Company utilizes forward contracts to manage its exposure associated with net asset and liability positions denominated in non-functional currencies and to reduce the volatility of earnings and cash flows related to forecasted foreign-currency transactions. The Company does not hold derivative financial instruments for speculative or trading purposes.

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Cash-Flow Hedges

The Company enters into forward contracts that are designated as foreign-currency cash-flow hedges of selected forecasted payments denominated in currencies other than U.S. dollars. These forward contracts generally mature within twelve months. The Company evaluates and calculates the effectiveness of each hedge at least quarterly. Changes in fair value attributable to changes in time value are excluded from the assessment of effectiveness and are recognized in interest income and other, net. The effective portion of the forward contracts' gain or loss is recorded in other comprehensive income and, when the hedged expense is recognized, is subsequently reclassified into earnings within the same line item in the statements of operations as the impact of the hedged transaction. The ineffective portion of the gain or loss is reported in earnings immediately. As of September 30, 2012 and December 31, 2011, the total notional value of the Company's outstanding forward contracts, designated as foreign-currency cash-flow hedges, was \$38.3 million and \$36.9 million, respectively.

Other Foreign-Currency Hedges

The Company enters into foreign-exchange forward contracts that are used to hedge certain foreign-currency-denominated assets or liabilities and that do not qualify for hedge accounting. These forward contracts generally mature within three months. Changes in the fair value of these forward contracts are recorded immediately in earnings to offset the changes in fair value of the assets or liabilities being hedged. As of September 30, 2012 and December 31, 2011, the total notional value of the Company's outstanding forward contracts, not designated as hedges under hedge accounting, was \$43.0 million and \$37.6 million, respectively. The Company recognized net gains on other foreign-currency hedges of \$2.7 million and \$1.0 million, respectively, during the three and nine months ended September 30, 2012, and net losses of \$2.5 million and \$0.5 million, respectively, during the three and nine months ended October 2, 2011. These amounts are included in interest income and other, net in the Company's condensed consolidated statements of operations and were substantially offset by the losses and gains on the underlying foreign-currency-denominated assets or liabilities.

Fair Value of Derivative Instruments

As of September 30, 2012 and December 31, 2011, the total fair value of derivative assets was immaterial and was recorded in prepaid expenses and other current assets in the condensed consolidated balance sheets. As of September 30, 2012 and December 31, 2011, the total fair value of derivative liabilities was \$0.9 million and \$3.0 million, respectively, and was recorded in other accrued liabilities in the condensed consolidated balance sheets.

Note 10 Segment, Geographic and Product Information

The Company operates in one reportable segment—the Semiconductor segment. The Company's chief executive officer is the chief operating decision maker (CODM). The Company's CODM bears ultimate responsibility for, and is actively engaged in, the allocation of resources and the evaluation of the Company's operating and financial results.

Information about Geographic Areas

The following table summarizes the Company's revenues by geography based on the ordering location of the customer. Because the Company sells its products primarily to other sellers of technology products and not to end users, the information in the table below may not accurately reflect geographic end-user demand for its products.

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
	(In thousands)			
North America*	\$ 164,111	\$ 136,849	\$ 477,548	\$ 380,648
Asia	414,409	360,238	1,292,419	993,239
Europe and the Middle East	45,442	49,823	135,992	146,931
Total	\$ 623,962	\$ 546,910	\$ 1,905,959	\$ 1,520,818

* Primarily the United States.

Table of Contents**Information about Product Groups**

The following table presents the Company's revenues by product groups:

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
	(In thousands)			
Storage products	\$ 492,600	\$ 403,125	\$ 1,515,766	\$ 1,098,473
Networking products	105,849	116,998	311,651	346,381
Other	25,513	26,787	78,542	75,964
Total	\$ 623,962	\$ 546,910	\$ 1,905,959	\$ 1,520,818

Note 11 Income Taxes

The Company recorded an income tax provision of \$15.1 million and an income tax benefit of \$22.2 million for the three and nine months ended September 30, 2012, respectively, and income tax provisions of \$7.8 million and \$12.6 million for the three and nine months ended October 2, 2011, respectively.

The income tax benefit for the nine months ended September 30, 2012 included a tax benefit of approximately \$43.2 million due to the release of valuation allowance resulting from the net deferred tax liabilities recorded as part of the SandForce purchase price allocation. The income tax benefit for the nine months ended September 30, 2012 also included a reversal of \$10.8 million in liabilities for uncertain tax positions, which included previously unrecognized tax benefits of \$5.7 million and interest and penalties of \$5.1 million, as a result of the expiration of statutes of limitations in multiple jurisdictions.

The income tax provision for the nine months ended October 2, 2011 included a reversal of \$9.6 million in liabilities for uncertain tax positions, which included previously unrecognized tax benefits of \$5.6 million and interest and penalties of \$4.0 million, as a result of the expiration of statutes of limitations in multiple jurisdictions.

The Company computes its tax provision using an estimated annual tax rate. The Company excludes certain loss jurisdictions from the computation of the estimated annual rate when no benefit can be realized on those losses. With the exception of certain foreign jurisdictions, the Company believes it is not more likely than not that the future benefit of the deferred tax assets will be realized.

As of September 30, 2012, the Company had \$188.4 million of unrecognized tax benefits, for which the Company is unable to make a reasonably reliable estimate as to when cash settlement with a taxing authority may occur. It is reasonably possible that the total amount of unrecognized tax benefits will increase or decrease in the next 12 months. Such changes could occur based on the normal expiration of statutes of limitations or the possible conclusion of ongoing tax audits in various jurisdictions around the world. If those events occur within the next 12 months, the Company estimates that the unrecognized tax benefits, plus accrued interest and penalties, could decrease by up to \$16.3 million.

Note 12 Related Party Transactions

A member of the Company's board of directors is also a member of the board of directors of Seagate Technology (Seagate). The Company sells semiconductors used in storage product applications to Seagate for prices comparable to those charged to an unrelated third party. Revenues from sales by the Company to Seagate were \$170.3 million and \$604.9 million for the three and nine months ended September 30, 2012, respectively. Revenues from sales by the Company to Seagate were \$157.9 million and \$375.4 million for the three and nine months ended October 2, 2011, respectively. The Company had accounts receivable from Seagate of \$93.9 million and \$90.3 million as of September 30, 2012 and December 31, 2011, respectively.

The Company has an equity interest in a joint venture, Silicon Manufacturing Partners Pte Ltd. (SMP), with GLOBALFOUNDRIES, a manufacturing foundry for integrated circuits. SMP operates an integrated circuit manufacturing facility in Singapore. The Company owns a 51% equity interest in this joint venture and accounts for its ownership position under the equity method of accounting. The Company is effectively precluded from unilaterally taking any significant action in the management of SMP due to GLOBALFOUNDRIES' significant participatory rights under the joint venture agreement. Because of GLOBALFOUNDRIES' approval rights, the Company cannot make any significant decisions regarding SMP without GLOBALFOUNDRIES' approval, despite the 51% equity interest. In addition, the General

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Manager, who is responsible for the day-to-day management of SMP, is appointed by GLOBALFOUNDRIES, and GLOBALFOUNDRIES provides day-to-day operational support to SMP.

The Company purchased \$11.6 million and \$35.5 million of inventory from SMP during the three and nine months ended September 30, 2012, respectively. The Company purchased \$12.9 million and \$38.5 million of inventory from SMP during the three and nine months ended October 2, 2011, respectively. As of September 30, 2012 and December 31, 2011, the amounts payable to SMP were \$7.7 million and \$5.0 million, respectively.

Table of Contents**Note 13 Commitments, Contingencies and Legal Matters****Purchase Commitments**

The Company maintains purchase commitments with certain suppliers, primarily for raw materials and manufacturing services and for some non-production items. Purchase commitments for inventory materials are generally restricted to a forecasted time horizon as mutually agreed upon between the parties. This forecasted time horizon can vary for different suppliers. As of September 30, 2012, the Company had purchase commitments of \$384.6 million, which are due through 2016.

The Company has a take-or-pay agreement with SMP under which it has agreed to purchase 51% of the managed wafer capacity from SMP's integrated circuit manufacturing facility, and GLOBALFOUNDRIES has agreed to purchase the remaining managed wafer capacity. SMP determines its managed wafer capacity each year based on forecasts provided by the Company and GLOBALFOUNDRIES. If the Company fails to purchase its required commitments, it will be required to pay SMP for the fixed costs associated with the unpurchased wafers. GLOBALFOUNDRIES is similarly obligated with respect to the wafers allotted to it. The agreement may be terminated by either party upon two years written notice. The agreement may also be terminated for material breach, bankruptcy or insolvency.

Guarantees***Product Warranties:***

The following table sets forth a summary of changes in product warranties:

	Accrued Warranties (In thousands)
Balance as of December 31, 2011	\$ 6,334
Accruals for warranties issued during the period	998
Adjustments to pre-existing accruals (including changes in estimates)	(470)
Warranty liabilities assumed in SandForce acquisition	426
Settlements made during the period (in cash or in kind)	(1,234)
Balance as of September 30, 2012	\$ 6,054

Standby Letters of Credit:

The Company had outstanding obligations relating to standby letters of credit of \$4.4 million and \$3.5 million, respectively, as of September 30, 2012 and December 31, 2011. Standby letters of credit are financial guarantees provided by third parties for leases, customs and certain self-insured risks. If the guarantees are called, the Company must reimburse the provider of the guarantee. The fair value of the letters of credit approximates the contract amounts. The standby letters of credit generally renew annually.

Indemnifications

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party. These obligations arise primarily in connection with sales contracts, license agreements or agreements for the sale of assets, under which the Company customarily agrees to hold the other party harmless against losses arising from a breach of warranties, representations and covenants related to such matters as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by the Company is typically subject to the other party making a claim to and cooperating with the Company pursuant to the procedures specified in the particular contract. This usually allows the Company to challenge the other party's claims or, in case of breach of intellectual property representations or covenants, to control the defense or settlement of any third-party claims brought against the other party. Further, the Company's obligations under these agreements may be limited in terms of activity (typically to replace or correct the products or terminate the agreement with a refund to the other party), duration and/or amounts. In some instances, the Company may have recourse against third parties covering certain payments made by the Company.

Legal Matters

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On December 6, 2006, Sony Ericsson Mobile Communications USA Inc. (Sony Ericsson) filed a lawsuit against Agere in Wake County Superior Court in North Carolina, alleging unfair and deceptive trade practices, fraud and negligent misrepresentation in connection with Agere's engagement with Sony Ericsson to develop a wireless data card for personal computers. The complaint claimed an unspecified amount of damages and sought compensatory damages, treble damages and attorneys' fees. In August, 2007, the case was dismissed for improper venue. On October 22, 2007, Sony Ericsson filed a lawsuit in the Supreme Court of the State of New York, New York County against LSI, raising substantially the same allegations and seeking substantially the same relief as the North Carolina proceeding. In January 2010, Sony Ericsson amended its complaint by adding claims for fraudulent concealment and gross negligence. On September 10, 2010, LSI filed a motion for summary judgment. On August 4, 2011, the court granted LSI's motion and ordered the dismissal of all of Sony Ericsson's claims. Sony Ericsson has appealed this decision. The Company is unable to estimate the possible loss or range of loss, if any, that may be incurred with respect to this matter.

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On March 23, 2007, CIF Licensing, LLC, d/b/a GE Licensing (GE) filed a lawsuit against Agere in the United States District Court for the District of Delaware, asserting that Agere products infringe patents in a portfolio of patents GE acquired from Motorola. GE has asserted that four of the patents cover inventions relating to modems. GE is seeking monetary damages. Agere believes it has a number of defenses to the infringement claims in this action, including laches, exhaustion and its belief that it has a license to the patents. The court postponed hearing motions based on these defenses until after the trial, and did not allow Agere to present evidence on these defenses at trial. On February 17, 2009, the jury in this case returned a verdict finding that three of the four patents were invalid and that Agere products infringed the one patent found to be valid and awarding GE \$7.6 million for infringement of that patent. The jury also found Agere's infringement was willful, which means that the judge could increase the amount of damages up to three times its original amount. The court has not scheduled hearings on Agere's post-trial motions related to its defenses. One of these motions seeks to have a mis-trial declared based on Agere's belief that GE withheld evidence in discovery, which affected Agere's ability to present evidence at trial. On October 6, 2010, a special master appointed by the court determined that GE's actions were not wrongful and that the evidence withheld by GE was not material to the jury's findings. Agere is challenging this determination. If the jury's verdict is entered by the court, Agere would also expect to be required to pay interest from the date of infringing sales. If the verdict is entered, Agere intends to appeal the matter. On February 17, 2010, the court issued an order granting GE's summary judgment motions seeking to bar Agere's defenses of laches, exhaustion, and license and denying Agere's summary judgment motions concerning the same defenses. On July 30, 2010, the court held that one of the patents found invalid by the jury was valid. The court also held that the February 17, 2010 order was not inconsistent with its previous ruling that Agere would be permitted to renew its laches, licensing, and exhaustion defenses, and that Agere has not been precluded from asserting them post-trial. The Company is unable to estimate the possible loss or range of loss, if any, that may be incurred with respect to this matter.

On December 1, 2010, Rambus Inc. (Rambus) filed a lawsuit against LSI in the United States District Court for the Northern District of California alleging that LSI products infringe one or more of 19 Rambus patents. These products contain either DDR-type memory controllers or certain high-speed SerDes peripheral interfaces, such as PCI Express interfaces and certain SATA and SAS interfaces. Rambus is seeking unspecified monetary damages, treble damages and costs, expenses and attorneys' fees due to alleged willfulness, interest and permanent injunctive relief in this action. In addition, on December 1, 2010, Rambus filed an action with the International Trade Commission (ITC) against LSI and five of its customers alleging that LSI products infringe six of the 19 patents in the California case. Rambus also named five other companies and a number of their customers in the ITC action. Rambus sought an exclusionary order against LSI and its customers in the ITC action, which, if granted, would preclude LSI and its customers from selling these products in the U.S. The ITC held a hearing on the matter in October 2011. On March 2, 2012, an administrative law judge (ALJ) found that LSI infringed Rambus' patents; however, the ALJ also found the patents invalid or unenforceable or both, and accordingly, found no violation of section 337 of the Tariff Act of 1930. On July 25, 2012, the ITC determined to terminate the investigation with a finding of no violation of section 337 of the Tariff Act of 1930. The ITC affirmed the ALJ's conclusion that all of the asserted patent claims are invalid under 35 U.S.C. §102 or 103, except for certain asserted claims, for which they found that Rambus has not demonstrated infringement. The ITC reversed the ALJ's determination that Rambus had demonstrated the existence of a domestic industry under 19 U.S.C. § 1337(a) for the asserted patents. The ITC affirmed the ALJ's determination that certain patents are unenforceable under the doctrine of unclean hands. Rambus has appealed the ITC's rulings. The lawsuit against LSI in the United States District Court for the Northern District of California is still pending. The Company is unable to estimate the possible loss or range of loss, if any, that may be incurred with respect to these proceedings.

In addition to the foregoing, the Company and its subsidiaries are parties to other litigation matters and claims in the normal course of business. The Company does not believe, based on currently available facts and circumstances, that the final outcome of these other matters, taken individually or as a whole, will have a material adverse effect on the Company's consolidated results of operations or financial position. However, the pending unsettled lawsuits may involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources to defend. From time to time, the Company may enter into confidential discussions regarding the potential settlement of such lawsuits. However, there can be no assurance that any such discussions will occur or will result in a settlement. Moreover, the settlement of any pending litigation could require the Company to incur substantial costs and, in the case of the settlement of any intellectual property proceeding against the Company, may require the Company to obtain a license to a third-party's intellectual property that could require royalty payments in the future and the Company to grant a license to certain of its intellectual property to a third party under a cross-license agreement. The results of litigation are inherently uncertain, and material adverse outcomes are possible.

The Company has not provided accruals for any legal matters in its financial statements as potential losses for such matters are not considered probable and reasonably estimable. However, because such matters are subject to many uncertainties, the ultimate outcomes are not predictable, and there can be no assurances that the actual amounts required to satisfy any liabilities arising from the matters described above will not have a material adverse effect on the Company's consolidated results of operations, financial position or cash flows.

Table of Contents**Note 14 Discontinued Operations**

On May 6, 2011, the Company completed the sale of substantially all of its external storage systems business to NetApp for \$480.0 million in cash. The strategic decision to exit the external storage systems business was based on the Company's expectation that long-term shareholder value could be maximized by becoming a pure-play semiconductor company. Under the terms of the agreement, NetApp purchased substantially all the assets of the Company's external storage systems business, which developed and delivered external storage systems products and technology to a wide range of partners who provide storage solutions to end customers. As part of the transaction, the Company provided transitional services to NetApp. The purpose of these services was to provide short-term assistance to the buyer in assuming the operations of the purchased business.

Following is selected financial information included in (loss)/income from discontinued operations for the three and nine months ended October 2, 2011:

	Three Months Ended October 2, 2011	Nine Months Ended October 2, 2011
	(In thousands)	
Revenues	\$ 2,860	\$ 210,225
Loss before gain on sale of external storage systems business and income taxes	\$ (2,366)	\$ (24,866)
Gain on sale of external storage systems business	0	260,066
Benefit from income taxes	(55)	(19,473)
(Loss)/income from discontinued operations	\$ (2,311)	\$ 254,673

There was no income or loss from discontinued operations for the three or nine months ended September 30, 2012.

During the three and nine months ended October 2, 2011, the Company recognized \$3.0 million and \$40.9 million, respectively, of restructuring expense as the Company terminated employees, closed several office locations, terminated certain contracts, discontinued various development projects and wrote off intangible assets and software due to the cancellation of development programs in connection with the exit of the external storage systems business. Further, the Company released \$19.7 million of deferred tax liabilities related to tax deductible goodwill in connection with the sale of the external storage systems business during the nine months ended October 2, 2011.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This management's discussion and analysis should be read in conjunction with the other sections of this Form 10-Q, including Part I, Item 1- Financial Statements.

Where more than one significant factor contributed to changes in results from year to year, we have quantified these factors throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where practicable and material to understanding the:10.0pt;">Customer segment that includes all the wireline and wireless wholesale business for the other businesses (e.g. directories) and all intercompany eliminations that are related to the Portuguese telecommunications businesses.

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3Generation. Third generation is a generic term, covering several technologies for mobile networks (UMTS, W-CDMA and EDGE), that integrate mobile multimedia services and allows a higher data transmission rates than GSM technology.

4G-LTE

4Generation. Fourth generation is a generic term, covering technologies for mobile access network (LTE/LTE Advanced) with high spectral efficiency, high peak data rates, short round trip time and frequency flexibility allowing enhanced broadband and multimedia services.

Additional Information

This information is also available on PT's IR website ir.telecom.pt and mobile website m.telecom.pt and on PT's IR&CSR app for iPad and Android tablets.

Conference Call details

Portuguese conference call

Date: 15 May 2014

Time: 13:00 (Portugal/UK), 14:00 (CET), 8:00 (US/NY)

Telephone number

+55 11 3127 4971 / +55 11 3728 5971

(Code: Oi)

If you are unable to attend the conference call a replay will be available for one week through the following number:

+55 11 3127 4999
(Replay code: 71948665)

English conference call

Date: 15 May 2014

Time: 15:00 (Portugal/UK), 16:00 (CET), 10:00 (US/NY)

Telephone numbers:

Outside US: +1 412 317 6776

US: +1 877 317 6776

(Code: Oi)

If you are unable to attend the conference call a replay will be available for one week through the following numbers:

Outside US callers: +1 412 317 0088
(Replay code: 10046122)

US callers: +1 877 344 7529
(Replay code: 10046122)

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Portugal Telecom is listed on the Euronext and New York Stock Exchanges. Information may be accessed on Reuters under the symbols PTC.LS and PT and on Bloomberg under the symbol PTC PL.

SIGNATURE

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

Date: May 15, 2014

PORTUGAL TELECOM, SGPS, S.A.

By: */s/ Nuno Vieira*
Nuno Vieira
Investor Relations Director

FORWARD-LOOKING STATEMENTS

This document may contain forward-looking statements. These statements are statements that are not historical facts, and are based on management's current view and estimates of future economic circumstances, industry conditions, company performance and financial results. The words anticipates, believes, estimates, expects, plans and similar expressions, as they relate to the company, are intended to identify forward-looking statements. Statements regarding the declaration or payment of dividends, the implementation of principal operating and financing strategies and capital expenditure plans, the direction of future operations and the factors or trends affecting financial condition, liquidity or results of operations are examples of forward-looking statements. Such statements reflect the current views of management and are subject to a number of risks and uncertainties. There is no guarantee that the expected events, trends or results will actually occur. The statements are based on many assumptions and factors, including general economic and market conditions, industry conditions, and operating factors. Any changes in such assumptions or factors could cause actual results to differ materially from current expectations.