

LSI LOGIC CORP
Form 10-Q
August 13, 2004

LSI LOGIC CORPORATION
Form 10-Q
For the Quarter Ended June 30, 2004
INDEX

| | | Page No. |
|---|--|---------------------|
| <u>PART I. FINANCIAL INFORMATION</u> | | |
| <u>Item 1</u> | <u>Financial Statements</u> | |
| | <u>Consolidated Balance Sheets June 30, 2004 (unaudited) and December 31, 2003</u> | 3 |
| | <u>Consolidated Statements of Operations Three and Six Months Ended June 30, 2004 and 2003 (unaudited)</u> | 4 |
| | <u>Consolidated Statements of Cash Flows Six Months Ended June 30, 2004 and 2003 (unaudited)</u> | 5 |
| | <u>Notes to Unaudited Consolidated Financial Statements</u> | 6 |
| <u>Item 2</u> | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 19 |
| <u>Item 3</u> | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 34 |
| <u>Item 4</u> | <u>Controls and Procedures</u> | 34 |
| <u>PART II. OTHER INFORMATION</u> | | |
| <u>Item 1</u> | <u>Legal Proceedings</u> | 34 |
| <u>Item 2</u> | <u>Changes in Securities, Use of Proceeds</u> | 34 |
| <u>Item 4</u> | <u>Submission of Matters to a Vote of Security Holders</u> | 34 |
| <u>Item 6</u> | <u>Exhibits and Reports on Form 8-K</u> | 35 |
| | <u>Signatures</u> | 37 |
| | <u>Index to Exhibits</u> | |
| | <u>EXHIBIT 31.1</u> | |
| | <u>EXHIBIT 31.2</u> | |
| | <u>EXHIBIT 32.1</u> | |
| | <u>EXHIBIT 32.2</u> | |

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****LSI LOGIC CORPORATION****CONSOLIDATED BALANCE SHEETS
(UNAUDITED)**

| | June 30, 2004 | December 31, 2003 |
|---|---|------------------------------|
| | <hr/> | <hr/> |
| | (In thousands, except per-share amounts) | |
| Assets | | |
| Cash and cash equivalents | \$ 198,403 | \$ 269,682 |
| Short-term investments | 649,008 | 544,007 |
| Accounts receivable, less allowances of \$5,911 and \$7,415 | 288,957 | 231,184 |
| Inventories | 209,941 | 198,517 |
| Deferred tax assets | 7,642 | 8,116 |
| Prepaid expenses and other current assets | 125,115 | 138,531 |
| | <hr/> | <hr/> |
| Total current assets | 1,479,066 | 1,390,037 |
| Property and equipment, net | 451,511 | 481,489 |
| Intangibles, net | 152,124 | 161,236 |
| Goodwill | 973,014 | 968,483 |
| Deferred tax assets | 7,333 | 7,484 |
| Non-current assets and deposits | 285,378 | 318,176 |
| Investment in equity securities | 20,826 | 35,455 |
| Other assets | 87,463 | 85,541 |
| | <hr/> | <hr/> |
| Total assets | \$ 3,456,715 | \$ 3,447,901 |
| | <hr/> | <hr/> |
| Liabilities and Stockholders Equity | | |
| Accounts payable | \$ 111,870 | \$ 102,632 |
| Accrued salaries, wages and benefits | 75,815 | 75,968 |
| Other accrued liabilities | 145,826 | 153,857 |
| Income taxes payable | 62,471 | 58,417 |
| Current portion of long-term obligations | 351 | 377 |
| | <hr/> | <hr/> |
| Total current liabilities | 396,333 | 391,251 |
| | <hr/> | <hr/> |

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| | | |
|---|-------------------|-------------------|
| Long-term debt and capital lease obligations | 858,232 | 865,606 |
| Other non-current liabilities | 135,547 | 141,096 |
| | <u> </u> | <u> </u> |
| Total long-term obligations and other liabilities | 993,779 | 1,006,702 |
| | <u> </u> | <u> </u> |
| Commitments and contingencies (Note 14 and Note 15) | | |
| Minority interest in subsidiary | 763 | 7,498 |
| | <u> </u> | <u> </u> |
| Stockholders' equity: | | |
| Preferred shares; \$.01 par value; 2,000 shares authorized; none outstanding | | |
| Common stock; \$.01 par value; 1,300,000 shares authorized; 384,864 and 381,491 shares outstanding | 3,849 | 3,815 |
| Additional paid-in capital | 2,958,324 | 2,950,051 |
| Deferred stock compensation | (11,661) | (24,839) |
| Accumulated deficit | (904,463) | (920,790) |
| Accumulated other comprehensive income | 19,791 | 34,213 |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 2,065,840 | 2,042,450 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 3,456,715 | \$ 3,447,901 |
| | <u> </u> | <u> </u> |

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

Table of Contents**LSI LOGIC CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|---|---------------------|--------------------------------------|---------------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands, except per share amounts) | | | |
| Revenues | \$447,897 | \$ 407,213 | \$900,254 | \$ 779,998 |
| Cost of revenues | 239,081 | 238,469 | 490,006 | 486,537 |
| Gross profit | 208,816 | 168,744 | 410,248 | 293,461 |
| Research and development | 110,098 | 111,326 | 219,039 | 226,453 |
| Selling, general and administrative | 63,757 | 56,870 | 124,915 | 114,499 |
| Restructuring of operations and other items, net | 3,029 | 124,527 | 2,431 | 160,193 |
| Amortization of non-cash deferred stock compensation (*) | 2,003 | 8,884 | 3,829 | 19,427 |
| Amortization of intangibles | 19,398 | 19,267 | 37,672 | 39,392 |
| Income/ (loss) from operations | 10,531 | (152,130) | 22,362 | (266,503) |
| Interest expense | (6,067) | (7,314) | (11,979) | (16,145) |
| Interest income and other, net | 8,778 | 3,360 | 17,944 | 10,139 |
| Income/ (loss) before income taxes | 13,242 | (156,084) | 28,327 | (272,509) |
| Provision for income taxes | 6,000 | 6,000 | 12,000 | 12,000 |
| Net income/(loss) | <u>\$ 7,242</u> | <u>\$ (162,084)</u> | <u>\$ 16,327</u> | <u>\$ (284,509)</u> |
| Net income/(loss) per share: | | | | |
| Basic | <u>\$ 0.02</u> | <u>\$ (0.43)</u> | <u>\$ 0.04</u> | <u>\$ (0.76)</u> |
| Dilutive | <u>\$ 0.02</u> | <u>\$ (0.43)</u> | <u>\$ 0.04</u> | <u>\$ (0.76)</u> |
| Shares used in computing per share amounts: | | | | |
| Basic | <u>383,522</u> | <u>376,619</u> | <u>382,571</u> | <u>375,745</u> |

| | | | | |
|----------|----------------|----------------|----------------|----------------|
| Dilutive | <u>388,586</u> | <u>376,619</u> | <u>389,102</u> | <u>375,745</u> |
|----------|----------------|----------------|----------------|----------------|

(*) Amortization of non-cash deferred stock compensation recorded in connection with acquisitions, if not shown separately, would have been included in cost of revenues, research and development and selling, general and administrative expenses, as shown below:

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|-------------------------------------|--|----------------|--------------------------------------|------------------|
| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
| | (In thousands) | | | |
| Cost of revenues | \$ 46 | \$ 88 | \$ 96 | \$ 270 |
| Research and development | 1,530 | 7,391 | 2,711 | 15,541 |
| Selling, general and administrative | <u>427</u> | <u>1,405</u> | <u>1,022</u> | <u>3,616</u> |
| Total | <u>\$2,003</u> | <u>\$8,884</u> | <u>\$ 3,829</u> | <u>\$ 19,427</u> |

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

Table of Contents

LSI LOGIC CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | Six Months Ended June 30, | |
|---|--------------------------------------|--------------|
| | 2004 | 2003 |
| | (In thousands) | |
| Operating activities: | | |
| Net income/(loss) | \$ 16,327 | \$ (284,509) |
| Adjustments: | | |
| Depreciation and amortization | 92,441 | 152,111 |
| Amortization of non-cash deferred stock compensation | 3,829 | 19,427 |
| Non-cash restructuring and other items | 6,385 | 127,323 |
| Gain on sale and exchange of equity securities, loss on write down | (8,104) | 9,074 |
| Loss on repurchase of Convertible Subordinated Notes | | 2,029 |
| Gain on sale of property and equipment | (3,937) | (2,560) |
| Changes in deferred tax assets and liabilities | 625 | 37 |
| Changes in assets and liabilities, net of assets acquired and liabilities assumed in acquisition: | | |
| Accounts receivable | (56,980) | 8,500 |
| Inventories | (11,701) | (10,040) |
| Prepaid expenses and other assets | (5,777) | 52,440 |
| Accounts payable | 10,263 | 12,028 |
| Accrued and other liabilities | (5,178) | 18,205 |
| | 38,193 | 104,065 |
| Investing activities: | | |
| Purchase of debt securities available-for-sale | (454,756) | (1,409,529) |
| Maturities and sales of debt securities available-for-sale | 339,458 | 1,455,927 |
| Purchases of equity securities | (2,250) | |
| Proceeds from sales of equity securities | 10,518 | |
| Purchases of property and equipment | (25,218) | (31,518) |
| Proceeds from sale of property and equipment | 5,836 | 11,855 |
| Proceeds from the sale-lease back of equipment | | 160,000 |
| Increase in non-current assets and deposits | (40) | (389,393) |
| Decrease in non-current assets and deposits | 39,633 | 243,625 |
| Acquisition of companies, net of cash acquired | (32,025) | |
| | (118,844) | 40,967 |

| | | |
|--|-------------------|-------------------|
| Financing activities: | | |
| Repayment of debt obligations | (216) | (174) |
| Purchase of minority interest in subsidiary | (7,453) | |
| Issuance of common stock | 17,810 | 15,890 |
| Proceeds from borrowings | | 350,000 |
| Repurchase of Convertible Subordinated Notes | | (288,587) |
| Cash paid for call spread options | | (28,000) |
| Debt issuance costs | | (10,566) |
| | <u> </u> | <u> </u> |
| Net cash provided by financing activities | <u>10,141</u> | <u>38,563</u> |
| Effect of exchange rate changes on cash and cash equivalents | <u>(769)</u> | <u>3,722</u> |
| (Decrease)/increase in cash and cash equivalents | <u>(71,279)</u> | <u>187,317</u> |
| Cash and cash equivalents at beginning of period | <u>269,682</u> | <u>448,847</u> |
| Cash and cash equivalents at end of period | <u>\$ 198,403</u> | <u>\$ 636,164</u> |

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

Table of Contents

LSI LOGIC CORPORATION

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

In the opinion of LSI Logic Corporation (the Company or LSI), the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments and restructuring and other items, net as discussed in Note 5 to the Unaudited Consolidated Financial Statements, hereafter referred to as the Notes), necessary to present fairly the financial information included herein. While the Company believes that the disclosures are adequate to make the information not misleading, it is suggested that these financial statements 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, 2003.

For financial reporting purposes, the Company reports on a 13 or 14-week quarter with a year ending December 31. The current quarter ended July 4, 2004. For presentation purposes, the consolidated financial statements refer to the calendar quarters for convenience. The results of operations for the quarter ended July 4, 2004, are not necessarily indicative of the results to be expected for the full year. The first six months of 2004 ended on July 4, 2004, and consisted of approximately 27 weeks, while the first six months of 2003 ended on June 29, 2003, and consisted of approximately 26 weeks. The second quarter of 2004 and 2003 both consisted of 13 weeks.

The preparation of financial statements in conformity with accounting principles generally accepted 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

Certain items previously reported in specific financial statement captions have been reclassified to conform to the current period presentation.

Recent Accounting Pronouncements

In July 2004, the Emerging Issues Task Force (EITF) issued EITF Issue No. 02-14, Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock. This issue addresses the determination of whether an investment is in-substance common stock and when to perform that evaluation, but does not address the determination of whether an investor has the ability to exercise significant influence over the operating and financial policies of the investee. The pronouncement is effective for fiscal periods beginning after September 15, 2004. For existing investments, the investor should make an initial determination as to whether the investment is in-substance common stock based on the circumstances existing as of the date of first application of this issue. The Company does not believe that the adoption of this standard will have a material impact on its consolidated balance sheet or statement of operations.

In March 2004, the EITF issued EITF Issue No. 03-06, Participating Securities and the Two-class Method Under FASB Statement No. 128, Earnings Per Share. EITF Issue No. 03-06 addresses a number of questions regarding the computation of earnings per share (EPS) by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company when, and if, it declares dividends on its common stock. The issue also provides further guidance in applying the two-class method of calculating EPS. It clarifies what constitutes a participating security and how to apply the two-class method of computing EPS once it is determined that a security is participating, including how to allocate undistributed earnings

to such a security. This pronouncement is effective for fiscal periods beginning after March 31, 2004. The adoption of this standard did not have a material impact on the Company's computation of EPS.

In March 2004, the EITF reached a consensus on Issue No. 03-01, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." EITF No. 03-01 provides guidance on recording other-than-temporary impairments of cost method investments and requires additional disclosures for those investments. The recognition and measurement guidance in EITF No. 03-01 should be applied to other-than-temporary impairment evaluations in reporting periods beginning after June 15, 2004. The disclosure requirements are effective for fiscal years ending after June 15, 2004, and are required only for annual periods. The Company does not believe that the adoption of this standard will have a material impact on its consolidated balance sheet or statement of operations.

Table of Contents

In December 2003, the Financial Accounting Standards Board (FASB) released a revision to FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. A public entity shall apply the provisions of the FIN 46 revision no later than the end of the first reporting period that ends after March 15, 2004. However, a public entity shall apply FIN 46 to entities considered to be special-purpose entities no later than as of the end of the first reporting period that ends after December 15, 2003. The adoption of this standard did not have a material impact on the consolidated balance sheet or statement of operations.

NOTE 2 SEPARATION OF LSI LOGIC STORAGE SYSTEMS, INC.

On November 13, 2003, the Company announced its intention to separate its wholly-owned subsidiary, Engenio Information Technologies, Inc. (Engenio or Storage Systems segment), and create an independent storage systems company. Engenio was formerly referred to as LSI Logic Storage Systems, Inc. The Company has entered into agreements to implement this separation and to address various arrangements between Engenio and the Company. On February 19, 2004, Engenio filed a registration statement on Form S-1 (the Registration Statement) with the Securities and Exchange Commission (SEC). On July 27, 2004, Engenio filed Amendment No. 8 to the Registration Statement. On July 29, 2004, LSI announced jointly with Engenio the postponement of the initial public offering of its common stock due to market conditions. The Company has capitalized approximately \$1.5 million in professional services that are directly and solely related to the initial public offering of Engenio common stock. If the offering does not occur, the Company will record such expenses as selling, general and administrative (SG&A) expenses in the statement of operations.

The separation of Engenio from the Company, including the transfer of related assets, liabilities and intellectual property rights, was substantially completed in December 2003. At that time, the Company and Engenio entered into a Master Separation Agreement, General Assignment and Assumption Agreement, Intellectual Property Agreement, Employee Matters Agreement and an Indemnification and Insurance Matters Agreement as more fully described in the Company s Annual Report on Form 10-K. In March 2004, the Company and Engenio entered into the following additional agreements that further specify the terms of the separation.

Tax Sharing Agreement. The Tax Sharing Agreement sets forth the principal arrangements between the Company and Engenio regarding the filing of tax returns, the payment of taxes and the conduct of tax audits or disputes. The Tax Sharing Agreement provides that Engenio s stand-alone tax liability equals its taxable income multiplied by the highest corporate tax rate in effect for the year, modified by taking into account its losses and loss carryovers from prior years and, to the extent actually used, its credits. Engenio is obligated to pay the Company the amount of its stand-alone tax liability to the extent Engenio is included in any consolidated, combined or unitary tax return with the Company.

Under the Tax Sharing Agreement, the Company is required to prepare and file all consolidated, combined or unitary tax returns of the Company and Engenio through the date that Engenio ceases to be a member of the Company s consolidated or combined group, including the final consolidated federal income tax return. The Company has the right to review and consent to the federal and state income tax returns filed for the first tax year after Engenio ceases to be a member of the Company s consolidated group, which may not be withheld unreasonably. In addition, the Company has sole and complete authority to control and resolve all tax audits and other disputes relating to any consolidated, combined or unitary returns filed by the Company. However, the Company may not enter into any dispute settlement that would materially increase Engenio s liability under the Tax Sharing Agreement without Engenio s consent, which cannot be withheld unreasonably.

Transition Services Agreement. The Transition Services Agreement governs the provisions by the Company to Engenio of services such as finance, accounting and treasury, human resources, sales support, legal matters and information technology.

Real Estate Matters Agreement. The Real Estate Matters Agreement describes the manner in which the Company will transfer to or share with Engenio various properties leased and owned by the Company. The agreement provides that all reasonable costs required to effect the transfers, including landlord consent fees and landlord attorneys' fees, will be paid by the Company.

Investor Rights Agreement. The Investor Rights Agreement provides for specified registration and other rights relating to the Company's ownership of Engenio's shares of Class B common stock.

Table of Contents**NOTE 3 BUSINESS COMBINATIONS**

Acquisition of Accerant Inc. On May 11, 2004, the Company acquired Accerant Inc. (Accerant). The acquisition is anticipated to expand consumer product offerings within the Semiconductor segment. The acquisition was accounted for as a purchase of a business.

The Company paid approximately \$14.1 million in cash for the acquisition. The Company will also issue approximately 234,000 restricted common shares to certain Accerant employees hired as part of the transaction. Resulting deferred stock compensation will be amortized over a vesting period of two years using the straight-line method. The total purchase price was allocated to the estimated fair value of net assets acquired based on management estimates as follows:

| | (In thousands) |
|--|--|
| Fair value of tangible net assets acquired | \$ 31 |
| Current technology | 5,700 |
| Non-compete agreements | 400 |
| Goodwill | 7,972 |
| | <hr/> |
| Total purchase price excluding deferred stock compensation | 14,103 |
| Deferred stock compensation | 1,765 |
| | <hr/> |
| Total purchase price | \$15,868 |
| | <hr style="border-top: 3px solid black;"/> |

The Company may also pay additional cash of up to \$4.0 million if certain revenue targets are achieved over a period ending December 31, 2005. Such contingent consideration will represent additional purchase price and accordingly goodwill when and if such targets are met.

Useful lives of intangible assets. The amounts allocated to current technology and non-compete agreements are being amortized over their estimated useful lives of 5 and 2 years, respectively using the straight-line method.

Acquisition of Velio Communications. On April 2, 2004, the Company acquired Velio Communications, Inc. (Velio). The acquisition is anticipated to expand product offerings for high-speed interconnect and switch fabric application specific standard products (ASSPs) in the global communications market within the Semiconductor segment. The acquisition was accounted for as a purchase of a business.

The Company paid approximately \$19.8 million in cash for the acquisition. The Company will also issue approximately 100,000 restricted common shares to certain Velio employees hired as part of the transaction. Resulting deferred stock compensation will be amortized over a vesting period of two years using the straight-line method. The total purchase price was allocated to the estimated fair value of net assets acquired based on management estimates as follows:

| | (In thousands) |
|--|--|
| Fair value of tangible net assets acquired | \$ 1,529 |
| Current technology | 8,788 |
| Customer base | 8,788 |
| Non-compete agreements | 450 |
| Existing purchase orders | 200 |
| | <hr/> |
| Total purchase price excluding deferred stock compensation | 19,755 |
| Deferred stock compensation | 1,000 |
| | <hr/> |
| Total purchase price | \$20,755 |
| | <hr style="border-top: 3px solid black;"/> |

Useful lives of intangible assets. The amounts allocated to current technology, customer base, non-compete agreements and existing purchase orders are being amortized over their estimated useful lives of 9 months to 5.5 years using the straight-line method.

Pro forma statements of earnings information have not been presented because the effect of these acquisitions was not material either individually or on an aggregate basis.

Table of Contents**NOTE 4 STOCK-BASED COMPENSATION**

The following table provides pro forma disclosures as if the Company had recorded compensation costs based on the estimated grant date fair value, as defined by the Statement of Financial Accounting Standards (SFAS) No. 123, for awards granted under its stock option and stock purchase plans. The estimated weighted-average grant date fair value, as defined by SFAS No. 123, was calculated using the Black-Scholes model. The Black-Scholes model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated grant date fair value.

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|--|--|---------------------|----------------------------------|---------------------|
| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
| | (In thousands, except per share amounts) | | | |
| Net income/(loss), as reported | \$ 7,242 | \$ (162,084) | \$ 16,327 | \$ (284,509) |
| Add: Amortization of non-cash deferred stock compensation determined under the intrinsic value method as reported in net income/(loss), net of related tax effects * | 748 | 2,228 | 2,022 | 6,129 |
| Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects | <u>(32,756)</u> | <u>(52,385)</u> | <u>(70,597)</u> | <u>(108,191)</u> |
| Pro forma net loss ** | <u>\$ (24,766)</u> | <u>\$ (212,241)</u> | <u>\$ (52,248)</u> | <u>\$ (386,571)</u> |
| Income/(loss) per share: | | | | |
| Basic-as reported | \$ 0.02 | \$ (0.43) | \$ 0.04 | \$ (0.76) |
| Basic-pro forma | \$ (0.06) | \$ (0.56) | \$ (0.14) | \$ (1.03) |
| Diluted-as reported | \$ 0.02 | \$ (0.43) | \$ 0.04 | \$ (0.76) |
| Diluted-pro forma | \$ (0.06) | \$ (0.56) | \$ (0.14) | \$ (1.03) |

* This amount excludes amortization of non-cash deferred stock compensation on restricted stock awards.

** The amounts for the three and six months ended June 30, 2003 have been adjusted to reflect higher calculated fair values for the Employee Stock Purchase Plan, which resulted in a 1% increase in the pro forma net loss for the three

months and six months ended June 30, 2003, respectively.

NOTE 5 RESTRUCTURING AND OTHER ITEMS

The Company recorded charges of \$3.0 million and \$2.4 million in restructuring of operations and other items for the three and six months ended June 30, 2004, respectively primarily in the Semiconductor segment. The Company recorded a charge of \$125 million and \$160 million in restructuring of operations and other items for the three and six months ended June 30, 2003, respectively. For a complete discussion of the 2003 restructuring actions, please refer to the Company's Annual Report on Form 10-K.

Restructuring and impairment of long-lived assets:

First quarter of 2004:

The Company recorded a gain of \$3.3 million on the sale of fixed assets that had previously been held for sale and an expense of \$1.1 million for the abandonment of fixed assets that had previously been held for sale. In addition, an expense of \$1.1 million was recorded for the write-down of fixed assets due to impairment.

An expense of \$0.3 million was recorded to reflect the change in time value of accruals for facility lease termination costs, net of adjustments for changes in sublease assumptions for certain previously accrued facility lease termination costs. An expense of \$0.2 million was recorded primarily for severance and termination benefits for four employees involved in research and development.

Table of Contents

Second quarter of 2004:

The Company recorded a gain of \$1.0 million on the sale of fixed assets that had previously been held for sale and an expense of \$4.0 million primarily for the write-down of the Colorado Springs fabrication facility to reflect a decline in fair market value and to write down certain spare parts for fixed assets.

An expense of \$0.4 million was recorded to reflect the change in time value of accruals for facility lease termination costs, net of adjustments for changes in sublease assumptions for certain previously accrued facility lease termination costs. Previously accrued contract termination fees of \$0.4 million were reversed as the result of more favorable than expected negotiations to terminate those contracts.

The fair values of impaired equipment and facilities were estimated by management. Given that current market conditions for the sale of older fabrication facilities and related equipment may fluctuate, there can be no assurance that the Company will realize the current net carrying value of the assets held for sale. The Company reassesses the realizability of the carrying value of these assets at the end of each quarter until the assets are sold or otherwise disposed of and additional adjustments may be necessary. Assets held for sale of \$25 million and \$30 million were included as a component of prepaid expenses and other current assets as of June 30, 2004 and December 31, 2003, respectively. Assets classified as held for sale are not depreciated.

The following table sets forth the Company's restructuring reserves as of June 30, 2004, which are included in other accrued liabilities on the balance sheet:

| | Balance at December 31, 2003 | Restructuring Expense Q1 2004 | Utilized during Q1 2004 | Balance at March 31, 2004 | Restructuring Expense Q2 2004 | Release reserves Q2 2004 | Utilized during Q2 2004 | Balance at June 30, 2004 |
|--|---|--|--|--|--|---|--|---|
| | (in thousands) | | | | | | | |
| Write-down of excess assets (a) | \$ 2,661 | \$(1,118) | \$ 718 | \$ 2,261 | \$ 3,203 | \$(160) | \$(3,414) | \$ 1,890 |
| Lease terminations and maintenance contracts (b) | 21,021 | 252 | (1,886) | 19,387 | 379 | (375) | (2,312) | 17,079 |
| Facility closure and other exit costs (c) | 2,136 | 64 | (782) | 1,418 | | | (369) | 1,049 |
| Payments to employees for severance (d) | 874 | 204 | (767) | 311 | | (18) | (227) | 66 |
| Total | \$26,692 | \$ (598) | \$(2,717) | \$23,377 | \$ 3,582 | \$(553) | \$(6,322) | \$20,084 |

- (a) The amounts utilized in 2004 reflect \$6.3 million of non-cash write-downs of long-lived assets in the U.S. due to impairment and \$0.6 million in cash payments to decommission and sell assets, offset by \$4.3 million realized gain on the sale of fixed assets previously held for sale. The write-downs of long-lived assets were accounted for as a reduction of the assets and did not result in a liability. The \$1.9 million balance as of June 30, 2004, relates to machinery and equipment decommissioning costs in the U.S. and estimates of selling costs for assets held for sale and is expected to be utilized during 2004.
- (b) Amounts utilized represent cash payments. The balance remaining for primarily real estate lease terminations and maintenance contracts will be paid during the remaining terms of these contracts, which extend through 2011.
- (c) Amounts utilized represent cash payments. The balance remaining for facility closure and other exit costs will be paid during 2004.
- (d) Amounts utilized represent cash severance payments to twenty employees during the six months ended June 30, 2004. The balance remaining for severance is expected to be paid during 2004.

Other Items

During the second quarter of 2004, the Company reclassified a parcel of land in Colorado with a book value of \$1.4 million from a long-term asset to a current asset held for sale. The land is part of total assets in the Semiconductor segment. The Company expects to sell the property within the next 12 months for an amount in excess of book value.

Table of Contents**NOTE 6 INVESTMENTS**

| | June 30, 2004 | December 31, 2003 |
|---|--------------------------|------------------------------|
| | (In thousands) | |
| Available-for-sale debt securities | | |
| Asset and mortgage-backed securities | \$332,012 | \$345,625 |
| U.S. government and agency securities | 242,962 | 104,173 |
| Corporate and municipal debt securities | 74,034 | 90,730 |
| Auction rate preferred stock | | 3,150 |
| Foreign debt securities | | 329 |
| | <hr/> | <hr/> |
| Total short-term investments | \$649,008 | \$544,007 |
| | <hr/> | <hr/> |
| Long-term investment in equity securities | \$ 20,826 | \$ 35,455 |
| | <hr/> | <hr/> |

An unrealized gain on available-for-sale securities of \$4 million, net of the related tax effect of \$2 million, and \$8 million, net of the related tax effect of \$4 million, was included in accumulated other comprehensive income as of June 30, 2004 and December 31, 2003, respectively. Net realized losses on sales of available-for-sale debt securities were \$0.3 million for the three months ended June 30, 2004. Net realized gains on sales of available-for-sale debt securities were \$0.6 million for the six months ended June 30, 2004. Net realized gains on sales of available-for-sale debt securities were \$2 million and \$9 million for the three and six months ended June 30, 2003, respectively.

The Company realized pre-tax gains of \$8 million related to the following for the six months ended June 30, 2004:

A \$5 million pre-tax gain related to the sales of certain marketable available-for-sale equity securities in the second quarter of 2004; and

A \$3 million pre-tax gain associated with marketable available-for-sale equity securities of a certain technology company that was acquired by another technology company in the first quarter of 2004.

The following table includes the details of pre-tax losses related to investments in equity securities that the Company has recorded during the first six months of 2004 and 2003. Management believed that the declines in value were other than temporary.

| | Non-marketable equity investments | Marketable equity investments |
|---------------|--|--|
| | (in millions) | |
| Pre-tax loss: | | |

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| | | |
|---|-------|------------------|
| Three months ended June 30, 2004 | \$0.1 | \$ |
| Six months ended June 30, 2004 | 1.0 | |
| Pre-tax loss: | | |
| Three months ended June 30, 2003 | \$3.0 | |
| Six months ended June 30, 2003 | 7.4 | 2.7 |
| Total carrying value of impaired investments as of June 30, 2004 | \$4.0 | Sold during 2004 |

Table of Contents**NOTE 7 DERIVATIVE FINANCIAL INSTRUMENTS***Foreign currency risk*

The Company enters into forward contracts that are designated as foreign currency cash-flow hedges of forecasted payments in Euros. Changes in the fair value of the forward contracts due to changes in time value are excluded from the assessment of effectiveness and are recognized in interest income and other, net. As of June 30, 2004 and December 31, 2003, the Company held forward contracts designated as foreign currency cash flow hedges of forecasted Euro payment transactions that were set to expire over six-month and twelve-month periods, respectively. For the three months and six months ended June 30, 2004 and 2003, the change in time value of these forward contracts was not significant. As of June 30, 2004, unrealized losses included in accumulated other comprehensive income, which will be recorded in the income statement over the next six months, were not significant. There were no unrealized gains or losses included in accumulated other comprehensive income as of December 31, 2003. The expense for the three months and six months ended June 30, 2004 and the benefit for three months and six months ended June 30, 2003 recorded in the income statement was not significant. The Company did not record any gains or losses due to hedge ineffectiveness for the three months and six months ended June 30, 2004 and 2003.

Forward exchange contracts and options are also used to hedge certain foreign currency-denominated assets or liabilities. These derivatives do not qualify for SFAS No. 133 hedge accounting treatment. Accordingly, changes in the fair value of these hedges are recorded immediately in earnings to offset the changes in fair value of the assets or liabilities being hedged. The related gains and losses included in interest income and other, net were not significant.

Interest rate risk

With the objective of protecting cash flows and earnings of the Company from the impact of fluctuations in interest rates, while minimizing the cost of capital, the Company may enter into or terminate interest rate swaps, such as the below mentioned transactions.

In the second quarter of 2003, the Company entered into an interest rate swap transaction to effectively convert the LIBOR-based floating rate interest payments on the equipment operating leases discussed in Note 14 of the Notes, with an initial notional amount of \$395 million, to a fixed interest rate (the Lease Swap). The Lease Swap qualifies to be accounted for as a cash flow hedge of the forecasted interest payments attributable to the benchmark interest rate on the equipment operating leases through September 2006. The unrealized gains or losses included in accumulated other comprehensive income will be recorded in cost of revenues on a quarterly basis as lease payments are made. An unrealized gain as of June 30, 2004, which is expected to be recorded in cost of revenues within the next 12 months, was not significant. An unrealized loss of approximately \$1 million, net of tax of \$1 million was included in accumulated other comprehensive income as of December 31, 2003, and is expected to be recorded in cost of revenues within the next 12 months. The gain due to ineffectiveness recorded in interest income and other, net during the three months and six months ended June 30, 2004 was not significant. The loss due to ineffectiveness recorded in interest income and other, net during the three months ended June 30, 2003 was not significant. Under the terms of the Lease Swap, the Company must provide collateral to match any mark-to-market exposure on the swap. As of June 30, 2004 and December 31, 2003, collateral of approximately \$8 million was included in other long-term assets.

Table of Contents**NOTE 8 BALANCE SHEET DETAIL**

| | June 30, 2004 | December 31, 2003 |
|---|--------------------------|----------------------------------|
| | (In thousands) | |
| Cash and cash equivalents: | | |
| Cash in financial institutions | \$ 55,073 | \$ 108,989 |
| Cash equivalents | 143,330 | 160,693 |
| | <u> </u> | <u> </u> |
| | \$ 198,403 | \$ 269,682 |
| | <u> </u> | <u> </u> |
| Inventories: | | |
| Raw materials | \$ 17,703 | \$ 15,352 |
| Work-in-process | 138,873 | 116,340 |
| Finished goods | 53,365 | 66,825 |
| | <u> </u> | <u> </u> |
| | \$ 209,941 | \$ 198,517 |
| | <u> </u> | <u> </u> |
| Intangible assets, net of accumulated amortization: | | |
| Semiconductor segment | \$ 134,453 | \$ 137,230 |
| Storage Systems segment | 17,671 | 24,006 |
| | <u> </u> | <u> </u> |
| | \$ 152,124 | \$ 161,236 |
| | <u> </u> | <u> </u> |

The changes in the carrying amount of goodwill for the six months ended June 30, 2004 are as follows (in thousands):

| | Semiconductor segment | Storage Systems segment | Total |
|---|----------------------------------|--|-------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Balance as of January 1, 2004 | \$ 887,992 | \$ 80,491 | \$ 968,483 |
| Goodwill acquired during the year | 8,045 | | 8,045 |
| Adjustment to goodwill acquired in a prior year for the resolution of a pre-acquisition income tax contingency | (4,463) | | (4,463) |

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| | | | |
|--|-------------------|-------------------|-------------------|
| Adjustment to goodwill acquired in prior periods | | 142 | 142 |
| Purchase of minority interest | 807 | | 807 |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance as of June 30, 2004 | \$892,381 | \$ 80,633 | \$973,014 |
| | <u> </u> | <u> </u> | <u> </u> |

The Company monitors the recoverability of goodwill recorded in connection with acquisitions annually, or sooner if events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment, if any, would be determined in accordance with SFAS No. 142, which uses a fair value model for determining the carrying value of goodwill. See the Company's Annual Report on Form 10-K for further discussion.

Table of Contents**NOTE 9 DEBT**

| | | | | <u>June 30,</u> | <u>December</u> |
|---|-----------------|-----------------|-------------------|-----------------------|------------------|
| | | | | <u>2004</u> | <u>31,</u> |
| | <u>Maturity</u> | <u>Interest</u> | <u>Conversion</u> | | <u>2003</u> |
| | | <u>Rate *</u> | <u>Price</u> | | |
| | | | | (In thousands) | |
| 2003 Convertible Subordinated Notes | 2010 | 4.00% | \$13.4200 | \$350,000 | \$350,000 |
| 2001 Convertible Subordinated Notes | 2006 | 4.00% | \$26.3390 | 490,000 | 490,000 |
| Deferred gain on terminated swap | | | | 18,232 | 25,416 |
| Capital lease obligations | | | | 351 | 567 |
| | | | | <u>858,583</u> | <u>865,983</u> |
| Current portion of long-term debt and capital lease obligations | | | | (351) | (377) |
| | | | | <u>\$858,232</u> | <u>\$865,606</u> |

* The interest rate on a portion of the Convertible Subordinated Notes (Convertible Notes) was converted to floating rates through interest rate swaps. Interest rate swaps with a notional amount of \$740 million were terminated in the second quarter of 2003. The weighted average interest rate on the Convertible Subordinated Notes, after adjusting for the impact of the interest rate swaps, for the three months ended June 30, 2004 and 2003, was 4.00% and 2.94%, respectively and 4.00% and 2.54% for the six months ended June 30, 2004 and 2003, respectively.

NOTE 10 COMMON STOCK

Stock purchase plans. In May 2004, the stockholders approved an increase in the number of shares of common stock reserved for issuance under the Company's Employee Stock Purchase Plan by 10 million shares. As of June 30, 2004 there were approximately 19 million shares of common stock reserved for issuance under the Employee Stock Purchase Plan.

NOTE 11 RECONCILIATION OF BASIC AND DILUTED INCOME/(LOSS) PER SHARE

A reconciliation of the numerators and denominators of the basic and diluted income/(loss) per share computations is as follows:

Three Months Ended June 30,

| | 2004 | | | 2003 | | |
|--|---|---------|------------------|-------------|---------|------------------|
| | Income* | Shares+ | Per-Share Amount | Loss* | Shares+ | Per-Share Amount |
| | (In thousands except per share amounts) | | | | | |
| Basic EPS: | | | | | | |
| Net income/(loss) available to common stockholders | \$7,242 | 383,522 | \$ 0.02 | \$(162,084) | 376,619 | \$(0.43) |
| Stock options and restricted stock awards | | 5,064 | | | | |
| Diluted EPS: | | | | | | |
| Net income/(loss) available to common stockholders | \$7,242 | 388,586 | \$ 0.02 | \$(162,084) | 376,619 | \$(0.43) |

Six Months Ended June 30,

| | 2004 | | | 2003 | | |
|--|---|---------|------------------|-------------|---------|------------------|
| | Income* | Shares+ | Per-Share Amount | Loss* | Shares+ | Per-Share Amount |
| | (In thousands except per share amounts) | | | | | |
| Basic EPS: | | | | | | |
| Net income/(loss) available to common stockholders | \$16,327 | 382,571 | \$ 0.04 | \$(284,509) | 375,745 | \$(0.76) |
| Stock options and restricted stock awards | | 6,531 | | | | |
| Diluted EPS: | | | | | | |
| Net income/(loss) available to common stockholders | \$16,327 | 389,102 | \$ 0.04 | \$(284,509) | 375,745 | \$(0.76) |

* Numerator

+ Denominator

Table of Contents

Weighted average options to purchase 53,566,120 and 50,709,797 shares were outstanding during the three and six months ended June 30, 2004, respectively, but were not included in the computation of diluted shares because the exercise prices of these options were greater than the average market price of common shares for the above period. The exercise price of these options ranged from \$8.24 to \$72.25 and from \$9.12 to \$72.25 as of June 30, 2004, respectively. Weighted average options to purchase 54,111,587 and 55,140,797 shares were outstanding during the three and six months ended June 30, 2003, respectively, but were not included in the computation of diluted shares because the exercise prices of these options were greater than the average market price of common shares for the above period. The exercise price of these options ranged from \$5.86 to \$72.25 and from \$5.38 to \$72.25 as of June 30, 2004, respectively.

For the three months and six months ended June 30, 2004, weighted average potentially dilutive shares of 44,684,052 shares associated with the 2003 and 2001 Convertible Notes were excluded from the calculation of diluted shares because of their antidilutive effect on net income per share. For the three and six months ended June 30, 2003, weighted average potentially dilutive shares of 54,720,989 and 49,819,986, respectively, associated with the 2003, 2001, 2000 and 1999 Convertible Notes were excluded from the calculation of diluted shares because of their antidilutive effect on loss per share.

NOTE 12 COMPREHENSIVE INCOME/(LOSS)

Comprehensive income/(loss) is defined as a change in equity of a company during a period from transactions and other events and circumstances, excluding transactions resulting from investments by owners and distributions to owners. Comprehensive income/(loss), net of taxes for the current reporting period and comparable period in the prior year is as follows:

| | Three Months Ended June | | Six Months Ended June 30, | |
|---|--------------------------------|---------------------|----------------------------------|--------------------|
| | 30, | | | |
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands) | | | |
| Net income/(loss) | \$ 7,242 | \$(162,084) | \$ 16,327 | \$(284,509) |
| Change in unrealized gain/loss on derivative instruments designated as and qualifying as cash-flow hedges | 2,373 | (16) | 1,470 | 464 |
| Change in unrealized gain/loss on available-for-sale securities | (10,716) | 1,454 | (11,412) | 1,711 |
| Change in foreign currency translation adjustments | (9,653) | 6,178 | (4,480) | 8,422 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Comprehensive income/(loss) | <u>\$ (10,754)</u> | <u>\$ (154,468)</u> | <u>\$ 1,905</u> | <u>\$(273,912)</u> |

NOTE 13 SEGMENT REPORTING

The Company operates in two reportable segments: the Semiconductor segment and the Storage Systems segment.

The Storage Systems segment may also be referred to as Engenio. In the Semiconductor segment, the Company uses advanced process technology and comprehensive design methodologies to design, develop, manufacture and market highly complex integrated circuits. These system-on-a-chip solutions include application specific integrated circuits, commonly referred to as ASICs, RapidChip Platform ASICs and application specific standard products in silicon, or ASSPs. Semiconductor segment product offerings also include RAID host bus adapters and related products, and services. In the Storage Systems segment, the Company provides modular, high-performance, disk storage systems and sub-assemblies to server and storage original equipment manufacturers. The products of the Storage Systems segment are sold as complete storage systems or sub-assemblies configured from modular components, including storage controller modules, disk drive enclosure modules and related management software.

Table of Contents

The following is a summary of operations by segment for the three months and six months ended June 30, 2004 and 2003:

| | Three months ended June 30, | | Six months ended June 30, | |
|---------------------------------------|------------------------------------|-------------|----------------------------------|-------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands) | | | |
| Revenues: | | | | |
| Semiconductor | \$335,626 | \$ 306,150 | \$672,524 | \$ 579,214 |
| Storage Systems | 112,271 | 101,063 | 227,730 | 200,784 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Total | \$447,897 | \$ 407,213 | \$900,254 | \$ 779,998 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Income/(loss) from operations: | | | | |
| Semiconductor | \$ 3,992 | \$(160,532) | \$ 5,166 | \$(268,426) |
| Storage Systems | 6,539 | 8,402 | 17,196 | 1,923 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Total | \$ 10,531 | \$(152,130) | \$ 22,362 | \$(266,503) |
| | <hr/> | <hr/> | <hr/> | <hr/> |

Intersegment revenues for the periods presented above were not significant. For the three and six months ended June 30, 2004, restructuring of operations and other items, net of \$3 million and \$2.4 million, respectively were primarily included in the Semiconductor segment. For the three months ended June 30, 2003, restructuring of operations and other items, net of \$125 million primarily impacted the Semiconductor segment. For the six months ended June 30, 2003, restructuring of operations and other items, net of \$145 million and \$15 million were included in the Semiconductor segment and the Storage Systems segment, respectively.

Significant Customers. The following table summarizes the number of the Company's significant customers, each of whom accounted for 10% or more of the Company's revenues, along with the percentage of revenues they individually represent on a consolidated basis and by segment:

| | Three months ended June 30, | | Six months ended June 30, | |
|---------------------------------|------------------------------------|-------------|----------------------------------|-------------|
| | 2004 | 2003 | 2004 | 2003 |
| Semiconductor segment: | | | | |
| Number of significant customers | | 2 | | 2 |
| | | 14%, 11% | | 13%, 10% |

| | | | | |
|---|----------|---------------|---------------|---------------|
| Percentage of segment revenues Storage Systems segment: | | | | |
| Number of significant customers | 2 | 3 | 3 | 3 |
| Percentage of segment revenues Consolidated: | 55%, 14% | 50%, 13%, 11% | 53%, 14%, 11% | 45%, 14%, 12% |
| Number of significant customers | 1 | 2 | 1 | 1 |
| Percentage of consolidated revenues | 16% | 14%, 11% | 15% | 14% |

The following is a summary of total assets by segment as of June 30, 2004 and December 31, 2003:

| | June 30, 2004 | December 31, 2003 |
|----------------------|-----------------------------|------------------------------|
| | (In thousands) | |
| Total assets: | | |
| Semiconductor | \$3,068,814 | \$3,115,610 |
| Storage Systems | 387,901 | 332,291 |
| | <u> </u> | <u> </u> |
| Total | <u>\$3,456,715</u> | <u>\$3,447,901</u> |

Revenues from domestic operations were \$243 million, representing 54% of consolidated revenues for the second quarter of 2004 compared to \$217 million, representing 53% of consolidated revenues for the same period of 2003.

Table of Contents

Revenues from domestic operations were \$488 million, representing 54% of consolidated revenues, for the first six months of 2004 compared to \$424 million, representing 54% of consolidated revenues, for the same period of 2003.

NOTE 14 COMMITMENTS AND CONTINGENCIES

On March 28, 2003, the Company entered into two lease and security agreements, each with Bank of America, National Association (BANA), acting as the Lessor, and Wells Fargo Bank Northwest, as the Agent, for a total of \$395 million for certain wafer fabrication equipment (the Equipment). The leases qualify for operating lease accounting treatment. As of March 31, 2004, the amount under both leases was fully drawn. Each lease has a term of 3.5 years with no option for renewal. The Company may, at the end of the lease term, return or purchase, at a pre-determined amount, all of the Equipment. The first lease was for \$235 million and was for equipment that was previously on lease immediately prior to closing this transaction. In October 2003, BANA, with the Company's approval, assigned its rights as Lessor on the first lease to Bank of the West. The second lease was for \$160 million and was for Equipment that was sold to BANA and then immediately leased back in a transaction commonly referred to as a sale-leaseback. The Equipment sold had a book value of approximately \$103 million. The resulting \$57 million gain on the sale of the Equipment will be deferred until the end of the lease term and has been recorded as a non-current liability as of June 30, 2004. The Company has \$328 million in cash that is posted as collateral for the leases as of June 30, 2004. The lessor has access to the Company's cash collateral only in the event of a default. Of this cash collateral, \$51 million, representing the amount of cash collateral to be released in the next 12 months, is reflected in other current assets and the remaining cash collateral of \$277 million is recorded in other non-current assets. In addition, the Company is required to maintain unrestricted cash and short-term investments reserves in an amount no less than \$350 million. The Company was in compliance with this requirement as of June 30, 2004.

The Company guarantees residual values related to leased equipment. As of June 30, 2004, its maximum potential exposure to residual value guarantees was approximately \$163 million and the Company does not expect to have a loss on such guarantees. The fair value of the guarantee of the residual value of the equipment was determined using management estimates and was recorded as a non-current asset and liability each in the amount of \$7 million as of June 30, 2004.

In connection with the equipment operating leases described above, the Company entered into standby letters of credit for \$63 million to expire at the end of the lease term. These instruments are off-balance sheet commitments to extend financial guarantees. The fair value of the letters of credit approximates the contract amount.

No officer or employee of the Company has any financial interest in these leasing arrangements. The minimum lease payments, excluding the residual value guarantees, under the two lease agreements are \$32 million, \$62 million and \$45 million in 2004, 2005 and 2006, respectively.

The Company leases the majority of its facilities under non-cancelable operating leases, which expire through 2014. The facility lease agreements typically provide for base rental rates that are increased at various times during the terms of the lease and for renewal options at the fair market rental value. During the first six months of 2004, the Company renegotiated the existing lease agreements for six buildings located in California. The future minimum payments for these renegotiated building leases will be \$2 million, \$3 million, \$4 million, \$5 million, \$5 million and \$21 million for the years ending December 31, 2004, 2005, 2006, 2007, 2008 and thereafter, respectively.

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or 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 agreement with a refund to the other party), duration and/or amounts. In some instances, the Company may have recourse against third parties and/or insurance covering certain payments made by the Company.

Table of Contents**NOTE 15 LEGAL MATTERS**

In February 1999, a lawsuit alleging patent infringement was filed in the United States District Court for the District of Arizona by the Lemelson Medical, Education & Research Foundation, Limited Partnership (Lemelson) against 88 electronics industry companies, including us. The case number is CIV990377PHXRGs. The patents involved in this lawsuit are alleged to relate to semiconductor manufacturing and computer imaging, including the use of bar coding for automatic identification of articles. The plaintiff has sought a judgment of infringement, an injunction, treble damages, attorneys' fees and further relief as the court may provide. In September 1999, the Company filed an answer denying infringement and raising affirmative defenses. In addition, the Company asserted a counterclaim for declaratory judgment of non-infringement, invalidity and unenforceability of Lemelson's patents. As of June 30, 2004, a claim construction hearing has been set to be held in November of 2004, but no trial date has been set. While the Company cannot make any assurance regarding the eventual resolution of this matter, the Company does not believe it will have a material adverse effect on the consolidated results of operations or financial condition.

On June 14, 2002, Plasma Physics Corporation (Plasma Physics) filed suit against the Company in the United States District Court for the Eastern District of New York, alleging that the Company is willfully and deliberately infringing two U.S. patents. LSI was served with the lawsuit in December of 2002. The case is number CV 02-3462 (LDW) (WDW). The two Plasma Physics patents at issue are numbered 5,470,784 and 6,245,648. No specific Company products were identified in the complaint. The plaintiff has sought a judgment of infringement, an injunction, treble damages, attorneys' fees and further relief as the court may provide. Similar lawsuits were also filed at the same time against several other corporations. In January of 2003, the Company answered the complaint denying infringement and asserting affirmative defenses. In addition, the Company asserted counterclaims seeking declaratory judgments of patent non-infringement, patent invalidity, and that the patents are unenforceable. In June of 2004, the parties agreed to submit to the Court a Voluntary Notice of Dismissal with Prejudice. Although the terms of the agreement are confidential, the agreement did not have a material adverse effect on the consolidated results of operations or financial condition.

The Company is a party to other litigation matters and claims that are normal in the course of its operations, and while the results of such litigation and claims cannot be predicted with certainty, the Company believes that the final outcome of such matters is not expected to have a material adverse effect on the Company's consolidated results of operations and financial condition.

NOTE 16 SUBSEQUENT EVENTS***Restructuring of operations:***

In July of 2004, the Company continued to consolidate non-manufacturing facilities and recorded \$4.7 million for costs associated with exiting certain operating leases for real estate as the facilities ceased being used. In addition, the Company recorded severance and termination benefits of \$0.5 million for 38 employees involved in manufacturing operations and research and development activities.

Commitments and Contingencies:

On August 6, 2004, the Company entered into two lease and security agreements, each with Wells Fargo Bank Northwest, acting as the Agent. One lease for \$134 million is with Bank of the West acting as the Lessor, and the second lease for \$201 million is with BTM Capital Corporation acting as the Lessor. The leases are for wafer fabrication equipment (the Equipment) that was previously on lease immediately prior to closing this transaction. See Note 14 for a discussion of these former leases entered into on March 28, 2003. The new leases qualify for operating lease accounting treatment. Each lease has a term of 3 years. The Company may, at the end of the lease term, return or

purchase, at a pre-determined amount, all of the Equipment. The Company has \$313 million in cash that is posted as collateral for the leases as of August 6, 2004. The Company is required to maintain unrestricted cash and short-term investments reserves in an amount no less than the higher of a) the sum of \$100 million plus the principal amount of the Company's 2001 Convertible Subordinated Notes due in 2006 or b) \$350 million. The Company was in compliance with this requirement as of August 6, 2004.

The Company guarantees residual values related to the leased equipment. As of August 6, 2004, its maximum potential exposure to residual value guarantees was approximately \$142 million and the Company does not expect to have a loss on such guarantees.

Separation of LSI Logic Storage Systems, Inc. or Engenio:

On July 29, 2004, LSI announced jointly with Engenio the postponement of the initial public offering of its common stock due to market conditions.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****SAFE HARBOR REGARDING FORWARD-LOOKING STATEMENTS**

This Form 10-Q contains forward-looking statements. In many cases you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential, continue, or the negative of such terms and other comparable terminology. In addition, forward-looking statements in this document include, but are not limited to, those regarding: our expectation that revenues will be in the \$435 million to \$465 million range for the third quarter of 2004; our expectation that our consolidated gross profit margin will be in the range of 44% to 46% in the third quarter of 2004; our expectation that products utilizing RapidChip technology will have performance comparable to cell-based ASICs at a cost significantly lower than Field Programmable Gate Arrays; our expectation that we will sell a parcel of land in Colorado within the next 12 months; our expectation that capital expenditures will be approximately \$100 million in 2004; our belief that our existing liquid resources and funds generated from operations, combined with funds from such financing and our ability to borrow funds, will be adequate to meet our operating and capital requirements and obligations for the foreseeable future; our belief that if our convertible notes do not convert to equity, that our current cash position and expected future operating cash flows will be adequate to meet these obligations as they mature; and the impact regarding the adoption of new accounting standards on our consolidated balance sheet or statement of operations. We assume no obligation to update any such forward-looking statements, and these statements involve risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. For a summary of such risks and uncertainties, please see the paragraphs located at the end of this Item 2 entitled "Factors that May Affect Future Operating Results" and please also see the risk factors located in the Form 10-K for our fiscal year ended December 31, 2003.

OVERVIEW

Revenues for the second quarter ended June 30, 2004 were \$448 million representing a 10% increase over the second quarter of 2003 and a 1% decrease from the first quarter of 2004. Cash, cash equivalents and short-term investments totaled \$847 million as of June 30, 2004. We generated positive operating cash flows for the ninth consecutive quarter. Late in the second quarter of 2004, we experienced some slowing of the overall business that will carry over into the third quarter of 2004. Accordingly, we expect revenues to be in the \$435 million to \$465 million range for the third quarter of 2004.

Design wins and product shipments for RapidChip platform products continued to increase in the second quarter of 2004, and we expect steady growth in this area leading to higher volumes in 2005.

Separation of our Storage Systems business. On November 13, 2003, we announced our intention to separate our storage systems operations (Engenio Information Technologies, Inc. (Engenio or Storage Systems segment)) and create an independent storage systems company. Engenio was formerly referred to as LSI Logic Storage Systems, Inc. We have entered into agreements to implement this separation and to address various arrangements between Engenio and us. A more comprehensive discussion of the separation agreements is set forth in Note 2 of the Notes. On February 19, 2004, Engenio filed a Registration Statement on Form S-1, (the Registration Statement) with the Securities and Exchange Commission (SEC). On July 27, 2004, Engenio filed Amendment No. 8 to the Registration Statement. On July 29, 2004, we announced jointly with Engenio the postponement of the initial public offering of its common stock due to market conditions.

Significant acquisitions. We are continually exploring strategic acquisitions that build upon our existing library of intellectual property, human capital and engineering talent, and increase our leadership position in the markets in which we operate. We acquired Velio Communications, Inc. (Velio) during the first quarter of 2004 and Accerant Inc.

(Accerant) during the second quarter of 2004. Both were accounted for as purchases of businesses and, accordingly, the estimated fair value of assets acquired and liabilities assumed and the results of operations were included in our Consolidated Financial Statements as of the effective date of the acquisitions. The transactions are summarized in the table below. There were no significant differences between our accounting policies and those of the companies acquired. (See Note 3 of the Notes.)

Table of Contents

| Entity Name; Segment Included in; Description of Acquired Business | Total Purchase Acquisition Date | Type of Consideration | Fair Value of Tangible Net Assets/ (Liabilities) Acquired | Goodwill | Amortizable Intangible Assets | Deferred Stock IPR&C Compensation |
|---|--|----------------------------------|--|-----------------|--|--|
| (in millions) | | | | | | |
| Accerant Inc.; | | | | | | |
| Semiconductor segment; | | | \$14.1 cash; | | | |
| | May | | and 0.2 | | | |
| Consumer product | 11, | | million | | | |
| applications | 2004 | \$ 15.9 | restricted | \$ 8.0 | \$ 6.1 | \$ 1.8 |
| | | | common | | | |
| | | | shares | | | |
| Velio Communications, Inc.; | | | | | | |
| Semiconductor segment; | | | \$19.8 cash; | | | |
| High-speed interconnect | | | and | | | |
| and switch fabric | | | 0.1 million | | | |
| | April | | restricted | | | |
| application specific | 2, | | common | | | |
| standard products | 2004 | \$ 20.8 | shares | \$ 1.5 | \$ 18.3 | \$ 1.0 |

Where more than one significant factor contributed to changes in results from year to year, we have quantified such factors throughout the Management's Discussion & Analysis, where practicable.

RESULTS OF OPERATIONS**Revenues:**

| | Three months ended | | | Six months ended | |
|-------------------------|---------------------------|---------------------------|--------------------------|--------------------------|--------------------------|
| | June 30, 2004 | March 31, 2004 | June 30, 2003 | June 30, 2004 | June 30, 2003 |
| (in millions) | | | | | |
| Semiconductor segment | \$335.6 | \$ 336.9 | \$ 306.2 | \$672.5 | \$ 579.2 |
| Storage Systems segment | 112.3 | 115.5 | 101.0 | 227.8 | 200.8 |

| | | | | | |
|--------------|---------|----------|----------|---------|----------|
| | _____ | _____ | _____ | _____ | _____ |
| Consolidated | \$447.9 | \$ 452.4 | \$ 407.2 | \$900.3 | \$ 780.0 |
| | _____ | _____ | _____ | _____ | _____ |

There were no significant intersegment revenues during the periods presented.

Second quarter of 2004 compared to the first quarter of 2004

Total consolidated revenues for the second quarter of 2004 decreased \$4.5 million or 1% from the first quarter of 2004.

Revenues for the Semiconductor segment decreased slightly by \$1.3 million in the second quarter of 2004 as compared to the first quarter of 2004. The decrease in the Semiconductor segment was primarily attributable to a decrease in demand for semiconductors used in storage component applications, such as storage ASICs products, partially offset by an increase in demand for semiconductors used in consumer product applications, such as DVD-recordable.

Revenues for the Storage Systems segment decreased \$3.2 million or 3% from the first quarter of 2004. The decrease is primarily attributable to a \$7.0 million decline in revenues from the Teradata division of NCR. This decline was due to the timing of two large customer shipments for our controllers and disk enclosure related products in the first quarter of 2004 and led to strong sales to the Teradata division of NCR in that quarter. The decline was partially offset by a \$2.2 million increase in revenues from IBM and a net increase of \$1.6 million in revenues from our other customers.

Table of Contents**Three and six months ended June 30, 2004 compared to the same periods of 2003**

Total consolidated revenues for the second quarter of 2004 increased \$40.7 million or 10% as compared to the second quarter of 2003. For the six months ended June 30, 2004, revenues increased \$120.3 million or 15% as compared to the same period of the prior year.

Revenues for the Semiconductor segment increased \$29.4 million or 10% for the second quarter of 2004 and increased \$93.3 million or 16% for the first six months of 2004 as compared to the same periods of the previous year. The increase in revenues in the Semiconductor segment in the second quarter and first six months of 2004 as compared to the same periods of 2003 is attributable to an increased demand for semiconductors used in storage component applications, communications ASIC applications such as routers and switches and certain consumer product applications, such as DVD-recordable. These increases were partially offset by lower demand for semiconductors used in other consumer product applications such as video games platforms.

Revenues for the Storage Systems segment increased \$11.3 million or 11% for the second quarter of 2004 and increased \$27.0 million or 13% for the first six months of 2004 as compared to the same periods of 2003. The increase in revenues in the Storage Systems segment for the second quarter and first six months of 2004 as compared to the same periods of 2003, is primarily due to a significant increase in demand from IBM, StorageTek and SGI for new controller products that were introduced in late April 2003 and increased demand for our other controller and disk enclosure related products. Although revenues from the Teradata division of NCR declined to less than 10% of Storage Systems revenues in the second quarter of 2004, this decline was primarily the result of the timing of two large customer shipments for our high-end controllers and disk enclosure related products, which occurred in the first quarter of 2004 and led to strong sales to the Teradata division of NCR in that quarter. Revenues from this customer represented 11% of Storage Systems revenues in the six months ended June 30, 2004. As a percentage of total Storage Systems revenues, revenues from IBM increased from 50% in the second quarter of 2003 to 55% in the second quarter of 2004 and from 45% to 53% during the six months ended June 30, 2003 and 2004, respectively.

Significant Customers. The following table summarizes the number of our significant customers, each of whom accounted for 10% or more of our revenues, along with the percentage of revenues they individually represent on a consolidated basis and by segment:

| | Three months ended June 30, | | Six months ended June 30, | |
|---------------------------------|-----------------------------|---------------|---------------------------|---------------|
| | 2004 | 2003 | 2004 | 2003 |
| Semiconductor segment: | | | | |
| Number of significant customers | | 2 | | 2 |
| Percentage of segment revenues | | 14%, 11% | | 13%, 10% |
| Storage Systems segment: | | | | |
| Number of significant customers | 2 | 3 | 3 | 3 |
| Percentage of segment revenues | 55%, 14% | 50%, 13%, 11% | 53%, 14%, 11% | 45%, 14%, 12% |
| Consolidated: | | | | |

| | | | | |
|-------------------------------------|-----|----------|-----|-----|
| Number of significant customers | 1 | 2 | 1 | 1 |
| Percentage of consolidated revenues | 16% | 14%, 11% | 15% | 14% |

Revenues by geography. The following table summarizes our revenues by geography:

| | Three months ended | | | Six months ended | |
|-----------------------|--------------------|----------------|---------------|------------------|---------------|
| | June 30, 2004 | March 31, 2004 | June 30, 2003 | June 30, 2004 | June 30, 2003 |
| | (in millions) | | | | |
| Revenues: | | | | | |
| North America | \$243.3 | \$ 244.8 | \$ 216.7 | \$488.1 | \$ 423.6 |
| Asia, including Japan | 164.9 | 164.7 | 154.6 | 329.6 | 279.6 |
| Europe | 39.7 | 42.9 | 35.9 | 82.6 | 76.8 |
| | | | | | |
| Total | \$447.9 | \$ 452.4 | \$ 407.2 | \$900.3 | \$ 780.0 |
| | | | | | |

Table of Contents**Second quarter of 2004 compared to the first quarter of 2004**

In the second quarter of 2004, revenues remained relatively flat in North America and Asia, including Japan, as compared to the first quarter of 2004. Revenues decreased in Europe in the second quarter of 2004 as compared to the first quarter of 2004 due mainly to a decline in demand for semiconductors used in communication ASIC applications, such as routers and switches.

Three and six months ended June 30, 2004 compared to the same periods of 2003

Revenues in North America and Asia, including Japan and Europe increased in the second quarter of 2004 as compared to the second quarter of 2003. The growth in North America is mainly due to an increase in demand for semiconductors used in communication ASIC applications, such as routers and switches, and modular storage products associated with Engenio. The increase in revenues from Asia is primarily due to increased demand for semiconductors used in consumer and storage standard product applications, such as DVD-recordable and disk drive solutions. The majority of the increase from Europe was attributable to an increase in demand for semiconductors used in storage and communication ASIC applications, such as routers, switches and disk drive solutions.

In the first six months of 2004, revenues increased in all geographic regions as compared to the same period in 2003. Demand for semiconductors used in consumer products, such as DVD-recorders, increased, although demand decreased for semiconductors used in video games platforms.

Operating costs and expenses. Key elements of the consolidated statements of operations for the respective segments are as follows:

Gross profit margin:

| | Three months ended | | | Six months ended | |
|-------------------------|--------------------|-------------------|------------------|------------------|------------------|
| | June 30, 2004 | March 31, 2004 | June 30, 2003 | June 30, 2004 | June 30, 2003 |
| | (in millions) | | | | |
| Semiconductor segment | \$ 166.5 | \$ 156.2 | \$ 130.2 | \$ 322.7 | \$ 218.8 |
| Percentage of revenues | 50% | 46% | 43% | 48% | 38% |
| Storage Systems segment | \$ 42.3 | \$ 45.2 | \$ 38.5 | \$ 87.5 | \$ 74.7 |
| Percentage of revenues | 38% | 39% | 38% | 38% | 37% |
| Consolidated | \$ 208.8 | \$ 201.4 | \$ 168.7 | \$ 410.2 | \$ 293.5 |
| Percentage of revenues | 47% | 45% | 41% | 46% | 38% |

Second quarter of 2004 compared to the first quarter of 2004

The consolidated gross profit margin as a percentage of revenues increased to 47% in the second quarter of 2004 from 45% in the first quarter of 2004.

The gross profit margin as a percentage of revenues for the Semiconductor segment increased to 50% in the second quarter of 2004 from 46% in the first quarter of 2004. The improvement in gross profit margin for the semiconductor segment was primarily attributable to the following factors:

A favorable shift in product mix to selling products with relatively higher margins;

Improved efficiencies and higher utilization in the Gresham manufacturing facility; and

Lower compensation-related costs.

The favorable impacts on gross profit margin in the Semiconductor segment were partially offset by the following factors:

Slightly lower sales of previously reserved inventory in the second quarter of 2004, as compared to the first quarter of 2004; and

Table of Contents

Slightly higher inventory charges for excess and obsolescence in the second quarter of 2004 as compared to the first quarter of 2004.

The gross profit margin as a percentage of revenues for the Storage Systems segment decreased to 38% in the second quarter of 2004 from 39% in the first quarter of 2004. The decrease is mainly a result of an unfavorable change in the mix of products sold and higher charges for warranties.

We expect our consolidated gross profit margin to be in the range of 44% to 46% in the third quarter of 2004.

Three and six months ended June 30, 2004 compared to the same periods of 2003

The consolidated gross profit margin as a percentage of revenues increased to 47% in the second quarter of 2004 from 41% in the second quarter of 2003. The consolidated gross profit margin as a percentage of revenues increased to 46% in the first six months of 2004 as compared to 38% in the same period of 2003.

The gross profit margin as a percentage of revenues for the Semiconductor segment increased to 50% in the second quarter of 2004 from 43% in the second quarter of 2003. The gross profit margin as a percentage of revenues for the Semiconductor segment increased to 48% in the first six months of 2004 as compared to 38% in the same period of 2003. The improvement in gross profit margin for the Semiconductor segment was primarily attributable to the following factors:

Higher revenues and a favorable shift in product mix to selling products with higher margins in the second quarter and first six months of 2004 as compared to the same periods of 2003;

Lower manufacturing variances in the Gresham manufacturing facility associated with yield improvements, improved operating efficiencies and better utilization;

A reduction in cost of revenues as a result of the sale of our Japanese manufacturing facility in the fourth quarter of 2003;

Lower compensation-related costs; and

Lower inventory charges for non-marketable inventory for the six month period ended June 30, 2004 compared to the same period of 2003.

The favorable impacts on gross margin in the Semiconductor segment were partially offset by a one percentage point decrease in gross margin due to lower sales of previously reserved inventory in the second quarter and first six months of 2004 as compared to the same periods of 2003.

The gross profit margin as a percentage of revenues for the Storage Systems segment remained flat at 38% in the second quarter of 2004 as compared with the second quarter of 2003. The gross profit margin as a percentage of revenues for the Storage Systems segment increased to 38% in the first six months of 2004 from 37% in the first six months of 2003. The improvement in gross profit margin as a percentage of Storage Systems segment revenues is primarily a result of a reduction in the amortization of capitalized software due to the restructuring actions taken during the first quarter of 2003, lower charges for excess and obsolete inventory, a favorable mix of products sold, and lower freight charges. The improvements noted above were offset in part by higher compensation costs due to increased headcount, and higher expenses for outside services related to production line modifications to meet new customer requirements.

Factors that may affect gross profit margins

We have advanced wafer-manufacturing operations in Gresham, Oregon, which is our primary manufacturing site. We also acquire wafers from foundries in other locations. Utilizing a diversity of manufacturing locations allows us to better manage potential disruption in the manufacturing process due to economic and geographic risks associated with each location.

Our operating environment, combined with the resources required to operate in the Semiconductor and Storage Systems industries, requires that we manage a variety of factors which impact gross margin. These factors include, among other things:

Competitive pricing pressures;

Table of Contents

Product mix;

Factory capacity and utilization;

Manufacturing yields;

Availability of certain raw materials;

Terms negotiated with third-party subcontractors; and

Foreign currency fluctuations.

These and other factors could have a significant effect on our gross profit margin in future periods.

Research and development:

| | Three months ended | | | Six months ended | |
|-------------------------|--------------------|-------------------|------------------|------------------|------------------|
| | June 30, 2004 | March 31, 2004 | June 30, 2003 | June 30, 2004 | June 30, 2003 |
| | (in millions) | | | | |
| Semiconductor segment | \$ 96.1 | \$ 94.8 | \$ 100.4 | \$ 190.9 | \$ 205.6 |
| Percentage of revenues | 29% | 28% | 33% | 28% | 35% |
| Storage Systems segment | \$ 14.0 | \$ 14.1 | \$ 10.9 | \$ 28.1 | \$ 20.9 |
| Percentage of revenues | 12% | 12% | 11% | 12% | 10% |
| Consolidated | \$ 110.1 | \$ 108.9 | \$ 111.3 | \$ 219.0 | \$ 226.5 |
| Percentage of revenues | 25% | 24% | 27% | 24% | 29% |

Second quarter of 2004 compared to the first quarter of 2004

Research and development (R&D) expenses increased \$1.2 million or 1% in the second quarter of 2004 as compared to the first quarter of 2004 on a consolidated basis. As a percentage of revenues, consolidated R&D expenses increased to 25% in the second quarter of 2004 from 24% in the first quarter of 2004.

R&D expenses in the Semiconductor segment increased \$1.3 million or 1% in the second quarter of 2004 as compared to the first quarter of 2004. The increase in R&D expenses for the Semiconductor segment is primarily related to continued research and development spending associated with the acquisitions in the first six months of 2004 (see Note 3 of the Notes). R&D expenses for the Semiconductor segment increased to 29% of revenues in the second quarter of 2004 from 28% in the first quarter of 2004.

We continued the build-out of the RapidChip platform infrastructure in the second quarter of 2004. Products utilizing RapidChip technology combine the high-density, high-performance and proven intellectual property benefits of cell-based ASICs with the advantages of lower development costs and faster time to market. We expect products utilizing RapidChip technology to have performance comparable to cell-based ASICs at a cost significantly lower than

Field Programmable Gate Arrays (FPGAs). Markets for our RapidChip platform ASIC solutions will include communications, storage, consumer, industrial and others. Our customer base for RapidChip technology encompasses a range from small start-up companies to major system OEMs throughout all of our geographic markets. We shipped our first RapidChip platform products in the fourth quarter of 2003. Design wins and product shipments for RapidChip platform products continued to increase in the second quarter of 2004.

R&D expenses in the Storage Systems segment remained relatively flat in the second quarter of 2004 as compared to the first quarter of 2004. R&D expenses as a percentage of revenues for the Storage Systems segment remained unchanged at 12% in the first and second quarters of 2004.

Table of Contents**Three and six months ended June 30, 2004 compared to the same periods of 2003**

R&D expenses, on a consolidated basis, decreased \$1.2 million or 1% during the second quarter of 2004 as compared to the second quarter of 2003. R&D expenses for the first six months of 2004 decreased by \$7.5 million or 3% as compared to the first six months of 2003 on a consolidated basis.

R&D expenses for the Semiconductor segment decreased \$4.3 million or 4% in the second quarter of 2004 and \$14.7 million or 7% for the first six months of 2004 as compared to the same periods of 2003. The decrease in R&D expenses for the Semiconductor segment is primarily a result of benefits from the cost-cutting measures implemented as part of the restructuring actions in 2003 (see Note 5 of the Notes), partially offset by increased spending for RapidChip technology development.

R&D expenses as a percentage of revenues for the Semiconductor segment decreased to 29% in the second quarter of 2004 compared to 33% in the same quarter of 2003. R&D expenses as a percentage of revenues for the Semiconductor segment decreased to 28% in the first six months of 2004 as compared to 35% in the same period of 2003.

R&D expenses for the Storage Systems segment increased by \$3.1 million or 28% in the second quarter of 2004 and \$7.2 million or 34% in the first six months of 2004 as compared to the same periods of 2003 primarily as a result of increased compensation costs due to higher headcount and related expenses, higher expenses for outside service providers related to development programs and higher depreciation related to new assets purchased for product development.

R&D expenses as a percentage of revenues for the Storage Systems segment increased to 12% in the second quarter of 2004 from 11% in the same quarter of 2003. R&D expenses as a percentage of revenues for the Storage Systems segment increased to 12% in the first six months of 2004 as compared to 10% in the same period of 2003.

Selling, general and administrative:

| | Three months ended | | | Six months ended | |
|-------------------------|--------------------|-------------------|------------------|------------------|------------------|
| | June 30, 2004 | March 31, 2004 | June 30, 2003 | June 30, 2004 | June 30, 2003 |
| | | | (in millions) | | |
| Semiconductor segment | \$45.2 | \$ 43.9 | \$ 40.8 | \$ 89.1 | \$ 83.8 |
| Percentage of revenue | 13% | 13% | 13% | 13% | 14% |
| Storage Systems segment | \$18.6 | \$ 17.3 | \$ 16.1 | \$ 35.9 | \$ 30.7 |
| Percentage of revenue | 17% | 15% | 16% | 16% | 15% |
| Consolidated | \$63.8 | \$ 61.2 | \$ 56.9 | \$125.0 | \$ 114.5 |
| Percentage of revenue | 14% | 14% | 14% | 14% | 15% |

Second quarter of 2004 compared to the first quarter of 2004

Selling, general and administrative (SG&A) expenses increased \$2.6 million or 4% during the second quarter of 2004 from the first quarter of 2004 on a consolidated basis. As a percentage of revenues, consolidated SG&A expenses remained unchanged at 14% in the second quarter of 2004 as compared with the first quarter of 2004.

SG&A expenses for the Semiconductor segment increased \$1.3 million or 3% in the second quarter of 2004 as compared to the first quarter of 2004. This increase is mainly due to higher spending for professional services, such as legal services. For the Semiconductor segment, SG&A expenses, as a percentage of revenues, remained unchanged at 13% in the second quarter of 2004 as compared with the first quarter of 2004.

SG&A expenses for the Storage Systems segment increased \$1.3 million or 8% in the second quarter of 2004 as compared to the first quarter of 2004. The increase is primarily a result of \$1.0 million in expenses associated with the proposed initial public offering and the separation from LSI. On July 29, 2004, we announced jointly with Engenio the postponement of the initial public offering of its common stock due to market conditions. We capitalized \$1.5 million of professional fees that were directly and solely related to the initial public offering of Engenio s common stock. If the offering does not occur, we will record such fees as SG&A expenses in the statement of operations.

Table of Contents

For the Storage Systems segment, SG&A expenses, as a percentage of revenues increased to 17% in the second quarter of 2004 as compared with 15% in the first quarter of 2004.

Three and six months ended June 30, 2004 compared to the same periods of 2003

Consolidated SG&A expenses increased \$6.9 million or 12% during the second quarter of 2004 and \$10.5 million or 9% during the first six months of 2004 as compared to the same periods of 2003. As a percentage of revenues, SG&A expenses remained unchanged at 14% in the second quarter of 2004 as compared with the second quarter of 2003. As a percentage of revenues, SG&A expenses decreased to 14% in the first six months of 2004 as compared with 15% during the first six months of 2003.

SG&A expenses for the Semiconductor segment increased \$4.4 million or 11% for the second quarter of 2004 and \$5.3 million or 6% for the first six months of 2004, as compared to the same periods of 2003. The increase for the Semiconductor segment was primarily attributable to compensation-related costs and higher spending on professional services such as legal services, partially offset by lower depreciation expense.

SG&A expenses as a percentage of revenues for the Semiconductor segment remained unchanged at 13% in the second quarter of 2004 as compared to the same quarter of 2003. SG&A expenses as a percentage of revenues for the Semiconductor segment decreased to 13% in the first six months of 2004 as compared with 14% during the first six months of 2003. The decrease is a result of higher revenues, offset in part by an increase in SG&A expenses in the first six months of 2004 as compared to the same period of 2003.

SG&A expenses for the Storage Systems segment increased by \$2.5 million or 16% in the second quarter of 2004 and \$5.2 million or 17% in the first six months of 2004 as compared to the same periods of 2003 primarily as a result of higher compensation related costs. These increases are the result of employees hired for customer training and customer engineering support, as well as administrative employees hired and other expenses incurred in anticipation of the potential initial public offering of Engenio's common stock. During the second quarter of 2004, we also recorded \$1.0 million in expenses associated with the proposed initial public offering and the separation from LSI. These increases were offset in part by higher reimbursements of selling expenses related to the master distributor agreement with StorageTek due to the timing of billings and the underlying level of revenues.

SG&A expenses as a percentage of revenues for the Storage Systems segment increased to 17% in the second quarter of 2004 from 16% in the same quarter of 2003. SG&A expenses as a percentage of revenues for the Storage Systems segment increased to 16% in the first six months of 2004 as compared to 15% in the same period of 2003.

Restructuring of operations and other items: We recorded charges of \$3.0 million and \$2.4 million in restructuring of operations and other items for the three and six months ended June 30, 2004, respectively, which was primarily associated with the Semiconductor segment. We recorded a charge of \$124.5 million and \$160.2 million in restructuring of operations and other items for the three and six months ended June 30, 2003, respectively. For a complete discussion of the 2003 restructuring actions, please refer to our Annual Report on Form 10-K.

Restructuring and impairment of long-lived assets:

First quarter of 2004:

We recorded a gain of \$3.3 million on the sale of fixed assets that had previously been held for sale and an expense of \$1.1 million for the abandonment of fixed assets that had previously been held for sale. In addition, an expense of \$1.1 million was recorded for the write-down of fixed assets due to impairment.

An expense of \$0.3 million was recorded to reflect the change in time value of accruals for facility lease termination costs, net of adjustments for changes in sublease assumptions for certain previously accrued facility lease termination costs. An expense of \$0.2 million was recorded primarily for severance and termination benefits for four employees involved in research and development.

Second quarter of 2004:

We recorded a gain of \$1.0 million on the sale of fixed assets that had previously been held for sale and an expense of \$4.0 million primarily for the write-down of the Colorado Springs fabrication facility to reflect a decline in fair market value and to write down certain spare parts for fixed assets.

Table of Contents

An expense of \$0.4 million was recorded to reflect the change in time value of accruals for facility lease termination costs, net of adjustments for changes in sublease assumptions for certain previously accrued facility lease termination costs. Previously accrued contract termination fees of \$0.4 million were reversed as the result of favorable negotiations to terminate those contracts.

Subsequent to the end of our second quarter of 2004, we continued to consolidate non-manufacturing facilities and recorded \$4.7 million for costs associated with exiting certain operating leases for real estate as the facilities ceased being used and the impairment of related leasehold improvements. We also recorded severance and termination benefits of \$0.5 million for 38 employees involved in manufacturing operations and research and development activities in July of 2004.

The fair values of impaired equipment and facilities were estimated by management. Given that current market conditions for the sale of older fabrication facilities and related equipment may fluctuate, there can be no assurance that we will realize the current net carrying value of the assets held for sale. We reassess the realizability of the carrying value of these assets at the end of each quarter until the assets are sold or otherwise disposed of and additional adjustments may be necessary. Assets held for sale of \$25 million and \$30 million were included as a component of prepaid expenses and other current assets as of June 30, 2004 and December 31, 2003, respectively. Assets classified as held for sale are not depreciated.

The following table sets forth our restructuring reserves as of June 30, 2004, which are included in other accrued liabilities on the balance sheet:

| | Balance at December 31, 2003 | Restructuring Expense Q1 2004 | Utilized during Q1 2004 | Balance at March 31, 2004 | Restructuring Expense Q2 2004 | Release of reserves Q2 2004 | Utilized during Q2 2004 | Balance at June 30, 2004 |
|--|---------------------------------------|-------------------------------------|----------------------------------|---------------------------------------|-------------------------------------|--------------------------------------|-------------------------------|-----------------------------------|
| | (in thousands) | | | | | | | |
| Write-down of excess assets (a) | \$ 2,661 | \$(1,118) | \$ 718 | \$ 2,261 | \$ 3,203 | \$(160) | \$(3,414) | \$ 1,890 |
| Lease terminations and maintenance contracts (b) | 21,021 | 252 | (1,886) | 19,387 | 379 | (375) | (2,312) | 17,079 |
| Facility closure and other exit costs (c) | 2,136 | 64 | (782) | 1,418 | | | (369) | 1,049 |
| Payments to employees for severance (d) | 874 | 204 | (767) | 311 | | (18) | (227) | 66 |
| Total | \$26,692 | \$ (598) | \$(2,717) | \$23,377 | \$ 3,582 | \$(553) | \$(6,322) | \$20,084 |

(a)

The amounts utilized in 2004 reflect \$6.3 million of non-cash write-downs of long-lived assets in the U.S. due to impairment and \$0.6 million in cash payments to decommission and sell assets, offset by \$4.3 million realized gain on the sale of fixed assets previously held for sale. The write-downs of long-lived assets were accounted for as a reduction of the assets and did not result in a liability. The \$1.9 million balance as of June 30, 2004, relates to machinery and equipment decommissioning costs in the U.S. and estimates of selling costs for assets held for sale and is expected to be utilized during 2004.

- (b) Amounts utilized represent cash payments. The balance remaining for primarily real estate lease terminations and maintenance contracts will be paid during the remaining terms of these contracts, which extend through 2011.
- (c) Amounts utilized represent cash payments. The balance remaining for facility closure and other exit costs will be paid during 2004.
- (d) Amounts utilized represent cash severance payments to twenty employees during the six months ended June 30, 2004. The balance remaining for severance is expected to be paid during 2004.

Other Items

During the second quarter of 2004, we reclassified a parcel of land in Colorado with a book value of \$1.4 million from a long-term asset to a current asset held for sale. The land is part of total assets in the Semiconductor segment. We expect to sell the property within the next 12 months for an amount in excess of book value.

Table of Contents

Amortization of non-cash deferred stock compensation: Amortization of non-cash deferred stock compensation was \$2.0 million for the three months ended June 30, 2004, \$1.8 million for the three months ended March 31, 2004 and \$8.9 million for the three months ended June 30, 2003. For the six months ended June 30, 2004 and 2003, the amortization of non-cash deferred stock compensation was \$3.8 million and \$19.4 million, respectively. The acquisitions for which deferred stock compensation and related amortization were recorded consisted primarily of the Accerant transaction in the second quarter of 2004 and the Velio transaction in the first quarter of 2004 (see Note 3 of the Notes); an acquisition in the fourth quarter of 2002; the acquisitions of C-Cube, and the RAID business from AMI in 2001; and the acquisition of DataPath in 2000. We also recorded non-cash deferred stock compensation for restricted common shares issued to Engenio and our employees and non-employee directors of Engenio during the first and second quarters of 2004. We amortize deferred stock compensation ratably over the related vesting periods. Deferred stock compensation is adjusted to reflect the forfeitures prior to vesting.

Amortization of intangibles: Amortization of intangible assets was \$19.4 million for the second quarter of 2004 as compared to \$18.3 million for the first quarter of 2004. The slight increase over the prior quarter is due to amortization expense recorded in the second quarter of 2004 related to the intangible assets acquired from Accerant in the second quarter of 2004 and Velio in the first quarter of 2004 (see Note 3 of the Notes). No amortization expense was recorded in the first quarter of 2004 related to the intangible assets acquired from Velio as they were acquired on the last day of the first quarter of 2004.

Amortization of intangible assets for the second quarter of 2004 slightly increased from \$19.3 million for the same period in 2003. For the six months ended June 30, 2004 and 2003, amortization of intangible assets was \$37.7 million and \$39.4 million, respectively. The decrease is attributable to the write-down in the first quarter of 2003 of \$15.1 million of intangible assets in the Semiconductor segment and \$9.0 million of intangible assets in the Storage Systems segment. In the third quarter of 2003 we wrote-down an additional \$21.0 million of intangible assets originally acquired in connection with the acquisition of C-Cube, which was added to our Semiconductor segment in the second quarter of 2001. The charges were recorded in restructuring and other items, net in 2003. These decreases were more than offset by amortization of intangible assets acquired in the first and second quarter of 2004. As of June 30, 2004, we had approximately \$152.1 million of intangible assets, net of accumulated amortization that will continue to amortize.

We monitor the recoverability of goodwill recorded in connection with acquisitions annually, or sooner if events or changes in circumstances indicate that the carrying amount may not be recoverable. Impairment, if any, would be determined in accordance with SFAS No. 142, which uses a fair value model for determining the carrying value of goodwill. We plan to perform our annual impairment review in the fourth quarter of 2004.

Interest expense: Interest expense increased slightly to \$6.1 million in the second quarter of 2004 from \$5.9 million in the first quarter of 2004. Interest expense decreased by \$1.2 million during the three months ended June 30, 2004 from \$7.3 million during the same period in 2003. Interest expense decreased \$4.1 million to \$12.0 million in the first six months of 2004 from \$16.1 million in the same period of 2003. The decrease is due to the repurchase/redemption of \$710.0 million of Convertible Notes during 2003 and changes in the benefit received from the interest rate swaps before/after termination, offset by the issuance of \$350.0 million of Convertible Notes during the second quarter of 2003.

Interest income and other, net: Interest income and other, net, was \$8.8 million in the second quarter of 2004 as compared to \$9.2 million in the first quarter of 2004. Interest income decreased to \$3.5 million in the second quarter of 2004 from \$5.4 million in the first quarter of 2004. The decrease in interest income is mainly due to lower returns on our short-term investments. Other income, net of \$5.3 million in the second quarter of 2004 included a pre-tax gain of \$5.1 million on sales of certain marketable available-for-sale equity securities in the three months ended June 30, 2004, and other miscellaneous items. Other income, net of \$3.8 million in the first quarter of 2004 included a pre-tax

gain of \$3.0 million associated with our investment in marketable available-for-sale equity securities of a certain technology company that was acquired by another publicly traded technology company during the first quarter of 2004, and other miscellaneous items.

In the second quarter of 2003, interest income and other, net, was \$3.4 million. Interest income was \$7.1 million in the second quarter of 2003. The decrease in interest income for the second quarter of 2004 as compared to the second quarter of 2003 is mainly due to lower realized gains on the sale of short-term investments and lower returns. Other expense, net, of \$3.7 million in the second quarter of 2003 included a write-down of three investments in equity securities by \$2.1 million due to impairment considered to be other than temporary (see Note 6 of the Notes), a net loss on the repurchase of Convertible Notes of \$2.0 million, and currency option premium expenses, offset in part by net foreign exchange gains and gains on sale of assets.

Table of Contents

Interest income and other, net increased to \$17.9 million in the first six months of 2004 from \$10.1 million in the same period of 2003. Interest income decreased by \$10.5 million to \$8.9 million in the first six months of 2004 from \$19.4 million in the same period of 2003. The decrease in interest income is mainly due to lower realized gains on the sale of short-term investments and lower returns during the first six months of 2004. Other income, net of \$9.0 million in the first six months of 2004 included a pre-tax gain of \$3.0 million associated with our investment in marketable available-for-sale equity securities of a certain technology company that was acquired by another publicly traded technology company during the first quarter of 2004, a pre-tax gain of \$5.1 million on sales of certain marketable available-for-sale equity securities in the three months ended June 30, 2004, and other miscellaneous items. Other expense, net of \$9.3 million in the first six months of 2003 included write-downs of investments in equity securities by \$9.1 million due to impairment considered to be other than temporary (see Note 6 of the Notes), a net loss on the repurchase of Convertible Notes of \$2.0 million, and currency option premium expenses, offset in part by net foreign exchange gains, gains on sale of assets and other miscellaneous expenses that were individually insignificant.

Provision for income taxes: During the three and six months ended June 30, 2004, we recorded an income tax expense of \$6.0 million and \$12.0 million, respectively. The expense relates to foreign income taxes and U.S. alternative minimum taxes. Income taxes within the U.S. have been partially offset by the utilization of current foreign tax and research and development tax credits. For the three months and six months ended June 30, 2003, we recorded an income tax expense of \$6.0 million and \$12 million, respectively. The expense relates to foreign income taxes. Excluding certain foreign jurisdictions, the future benefit of temporary differences, including operating losses, is not being recognized.

FINANCIAL CONDITION, CAPITAL RESOURCES AND LIQUIDITY

Cash, cash equivalents and short-term investments increased to \$847.4 million at June 30, 2004, from \$813.7 million at December 31, 2003. As described below, the increase is mainly due to net cash inflows from operating and financing activities, and net cash inflows from investing activities excluding purchases of short-term investments in debt securities available for sale.

Working capital. Working capital increased by \$83.9 million to \$1.1 billion at June 30, 2004, from \$998.8 million at December 31, 2003. Working capital in the first six months of the current year was impacted by the following activities:

Cash, cash equivalents and short-term investments increased by \$33.7 million to \$847.4 million at June 30, 2004, as compared to \$813.7 million at December 31, 2003;

Accounts receivable increased by \$57.8 million to \$289.0 million at June 30, 2004 from \$231.2 million at December 31, 2003. The increase is mainly attributable to higher billings in the last month of the second quarter of 2004 as compared to the last month of the fourth quarter of 2003, and better cash collections in the fourth quarter of 2003 as compared to the second quarter of 2004;

Inventories increased by \$11.4 million to \$209.9 million as of June 30, 2004 from \$198.5 million as of December 31, 2003. This is mainly due to the purchase of raw materials during the second quarter of 2004 in anticipation of inventory to be required in the second half of 2004, part of which still remained as work-in-process inventories at the end of the second quarter of 2004; and

Other accrued liabilities decreased by \$8.0 million to \$145.8 million as of June 30, 2004 from \$153.8 million as of December 31, 2003. This is mainly due to utilization of our restructuring reserves.
The increase in working capital was offset, in part, by the following:

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Prepaid expenses and other current assets decreased by \$13.4 million primarily due to a \$6.8 million decrease in the current portion of collateral balance on the equipment operating leases (see Note 14 of the Notes), a \$4.6 million decrease in other receivables mainly due to a \$6.6 million income tax refund received in the first quarter of 2004, and a \$4.9 million decrease in assets held for sale due to sales and retirements (see Note 5 of the Notes), offset in part by other miscellaneous items;

Accounts payable increased by \$9.2 million primarily due to timing of invoice receipts and payments; and

29

Table of Contents

Income taxes payable increased by \$4.1 million primarily due to the timing of tax payments made and income tax provision recorded in the first six months of 2004.

Cash and cash equivalents generated from operating activities. During the first six months of 2004, we generated \$38.2 million of net cash and cash equivalents from operating activities compared to \$104.1 million generated in the same period of 2003. Cash and cash equivalents generated by operating activities for the six months ended June 30, 2004 were the result of the following:

Higher income (before depreciation and amortization, non-cash restructuring and other items, amortization of non-cash deferred stock compensation, gains on sale and exchange of equity securities, loss on write-down of equity securities, and gains on the sale of property and equipment) over the six months ended June 30, 2004 as compared to the same period in 2003, offset by lower net changes in assets and liabilities, net of assets acquired and liabilities assumed in business combinations. The non-cash items and other non-operating adjustments are quantified in our Consolidated Statements of Cash Flows included in this Current report on Form 10-Q; and

Changes in working capital components from December 31, 2003 to June 30, 2004 as discussed above.

Cash and cash equivalents used in investing activities. Cash and cash equivalents used in investing activities were \$118.8 million for the six months ended June 30, 2004, compared to \$41.0 million provided by investing activities in the same period in 2003. The primary investing activities during the six months ended June 30, 2004 were as follows:

Purchases of debt and equity securities available for sale, net of sales and maturities;

Purchases of property and equipment;

Proceeds from the sale of property and equipment;

Acquisition of companies (see Note 3 of the Notes); and

Lower non-current assets and deposits in the six months ended June 30, 2004, primarily as a result of the refund of collateral from the equipment operating lease during the first six months of 2004 (see Note 14 of the Notes) and a terminated letter of credit during the first quarter of 2004.

We believe that maintaining technological leadership in the highly competitive worldwide semiconductor manufacturing industry requires access to advanced manufacturing capacity. Our focus is on establishing strategic supplier alliances with foundry semiconductor manufacturers, which enables us to supplement internal manufacturing capability with additional external manufacturing capacity, and reduces our capital spending requirements. We expect capital expenditures to be approximately \$100 million in 2004.

Cash and cash equivalents provided by financing activities. Cash and cash equivalents provided by financing activities during the six months ended June 30, 2004 were \$10.1 million as compared to \$38.6 million in the same period in 2003. The primary financing activities during the six months ended June 30, 2004 were as follows:

Additional purchase of minority interests in subsidiary;

Issuance of common stock under our employee stock option and purchase plans; and

Repayment of debt obligations.

We may seek additional equity or debt financing from time to time. We believe that our existing liquid resources and funds generated from operations, combined with funds from such financing and our ability to borrow funds, will be adequate to meet our operating and capital requirements and obligations for the foreseeable future. However, we cannot be certain that additional financing will be available on favorable terms. Moreover, any future equity or

convertible debt financing will decrease the percentage of equity ownership of existing stockholders and may result in dilution, depending on the price at which the equity is sold or the debt is converted.

Table of Contents

On February 19, 2004, Engenio filed a registration statement on Form S-1 (the Registration Statement) with the Securities and Exchange Commission (SEC). On July 27, 2004, Engenio filed Amendment No. 8 to the Registration Statement. On July 29, 2004, we announced jointly with Engenio the postponement of the initial public offering of its common stock due to market conditions.

Contractual Obligations

The following table summarizes our contractual obligations at June 30, 2004, and the effect these obligations are expected to have on our liquidity and cash flow in future periods.

| | Payments due by period | | | | Total |
|--------------------------------|------------------------|-------------------|-------------------|-------------------|-------------------|
| | Less than 1 year | 1 3 years | 4 5 years | After 5 years | |
| | (in millions) | | | | |
| Convertible Subordinated Notes | \$ | \$490.0 | \$ | \$350.0 | \$ 840.0 |
| Operating lease obligations | 122.3 | 169.2 | 37.5 | 40.8 | 369.8 |
| Capital lease obligations | 0.4 | | | | 0.4 |
| Purchase commitment | 307.9 | 2.3 | | | 310.2 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total | \$430.6 | \$661.5 | \$37.5 | \$390.8 | \$1,520.4 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

Convertible Subordinated Notes

As of June 30, 2004, we have \$490 million of Convertible Subordinated Notes due in October 2006 (2001 Convertible Notes) and \$350 million of Convertible Subordinated Notes due in May 2010 (2003 Convertible Notes). All of the Convertible Notes are subordinated to all existing and future senior debt and are convertible at the holder's option, at any time prior to the maturity date of the Convertible Notes, into shares of our common stock. The 2001 and 2003 Convertible Notes have conversion prices of approximately \$26.34 per share and \$13.42 per share, respectively. The 2001 Convertible Notes are redeemable at our option, in whole or in part, on at least 30 days notice at any time on or after the call date, which is two years before the due date. We cannot elect to redeem the 2003 Convertible Notes prior to maturity. Each holder of the 2001 and 2003 Convertible Notes has the right to cause us to repurchase all of such holder's convertible notes at 100% of their principal amount plus accrued interest upon the occurrence of any fundamental change to us, which includes a transaction or event such as an exchange offer, liquidation, tender offer, consolidation, merger or combination. Interest is payable semiannually.

Fluctuations in our stock price impact the prices of our outstanding convertible securities and the likelihood of the convertible securities being converted into cash or equity. If we are required to redeem any of the Convertible Notes for cash, it may affect our liquidity position. However, in the event they do not convert to equity, we believe that our current cash position and expected future operating cash flows will be adequate to meet these obligations as they mature. From time to time, we may buy back Convertible Notes.

Operating Lease Obligations

As of June 30, 2004, we had operating leases financing certain wafer fabrication equipment (see Note 14 of the Notes). Under these leases, we are required to maintain unrestricted cash and short-term investment reserves in an amount no less than \$350 million. We were in compliance with this requirement as of June 30, 2004.

We guarantee residual values of equipment on these leases. As of June 30, 2004, we do not expect to realize a loss on the guarantee at the end of the lease term, and accordingly, no additional rent expense has been recognized (see Note 14 of the Notes).

In connection with the equipment operating leases described above, we entered into standby letters of credit for \$63 million to expire at the end of the lease term. These instruments are off-balance sheet commitments to extend financial guarantees. The fair value of the letters of credit approximates the contract amount (see Note 14 of the Notes).

We also lease real estate, certain other equipment and software under non-cancelable operating leases. We renegotiated the existing lease agreements for six buildings located in California in the first and second quarters of 2004. The future minimum

Table of Contents

payments for these renegotiated building leases will be \$2 million, \$3 million, \$4 million, \$5 million, \$5 million and \$21 million for the years ending December 31, 2004, 2005, 2006, 2007, 2008 and thereafter, respectively.

On August 6, 2004, we entered into two lease and security agreements, each with Wells Fargo Bank Northwest, acting as the Agent. One lease for \$134 million is with Bank of the West acting as the Lessor, and the second lease for \$201 million is with BTM Capital Corporation acting as the Lessor. The leases are for wafer fabrication equipment (the Equipment) that was previously on lease immediately prior to closing this transaction. See Note 14 of the Notes for a discussion of these former leases entered into on March 28, 2003. The new leases qualify for operating lease accounting treatment. Each lease has a term of 3 years. We may, at the end of the lease term, return or purchase, at a pre-determined amount, all of the Equipment. We have \$313 million in cash that is posted as collateral for the leases as of August 6, 2004. We are required to maintain unrestricted cash and short-term investments reserves in an amount no less than the higher of a) the sum of \$100 million plus the principal amount of our 2001 Convertible Subordinated Notes due in 2006 or b) \$350 million. We were in compliance with this requirement as of August 6, 2004.

We guarantee residual values related to the leased equipment. As of August 6, 2004, its maximum potential exposure to residual value guarantees was approximately \$142 million and we do expect to have a loss on such guarantees.

Purchase Commitments

We maintain certain purchase commitments primarily for raw materials with suppliers 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 forecast time-horizon can vary amongst different suppliers.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based on the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires estimates and assumptions that affect the reported amounts and disclosures. For a detailed discussion of our critical accounting policies, please see the Critical Accounting Policies contained in Part II, Item 7 of the Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2003.

Recent Accounting Pronouncements

In July 2004, the EITF issued EITF Issue No. 02-14, Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock. This issue addresses the determination of whether an investment is in-substance common stock and when to perform that evaluation, but does not address the determination of whether an investor has the ability to exercise significant influence over the operating and financial policies of the investee. The pronouncement is effective for fiscal periods beginning after September 15, 2004. For existing investments, the investor should make an initial determination as to whether the investment is in-substance common stock based on the circumstances existing as of the date of first application of this issue. We do not believe that the adoption of this standard will have a material impact on our consolidated balance sheet or statement of operations.

In March 2004, the Emerging Issues Task Force (EITF) issued EITF Issue No. 03-06, Participating Securities and the Two-class Method Under FASB Statement No. 128, Earnings Per Share. EITF Issue No. 03-06 addresses a number of questions regarding the computation of earnings per share (EPS) by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company

when, and if, it declares dividends on its common stock. The issue also provides further guidance in applying the two-class method of calculating EPS. It clarifies what constitutes a participating security and how to apply the two-class method of computing EPS once it is determined that a security is participating, including how to allocate undistributed earnings to such a security. This pronouncement is effective for fiscal periods beginning after March 31, 2004. The adoption of this standard did not have a material impact on our computation of EPS.

In March 2004, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF No. 03-01 provides guidance on recording other-than-temporary impairments of cost method investments and requires additional disclosures for those investments. The recognition and measurement guidance in EITF No. 03-01 should be applied to other-than-temporary impairment evaluations in reporting periods

Table of Contents

beginning after June 15, 2004. The disclosure requirements are effective for fiscal years ending after June 15, 2004 and are required only for annual periods. We do not believe that the adoption of this standard will have a material impact on our consolidated balance sheet or statement of operations.

In December 2003, the Financial Accounting Standards Board (FASB) released a revision to FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. A public entity shall apply the provisions of the FIN 46 revision no later than the end of the first reporting period that ends after March 15, 2004. However, a public entity shall apply FIN 46 to entities considered to be special-purpose entities no later than as of the end of the first reporting period that ends after December 15, 2003. The adoption of this standard did not have a material impact on our consolidated balance sheet or statement of operations.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

We believe that our future operating results will continue to be subject to quarterly variations based upon a wide variety of factors detailed in the Risk Factors in Part I of our Annual Report on Form 10-K for the year ended December 31, 2003, which information is incorporated by reference. Our actual results in future periods may be significantly different from any future performance suggested in this report. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Risks and uncertainties that may affect our results include, among others:

A general economic weakness may further reduce our revenues.

Engenio represents a significant portion of our business, and an initial public offering, sale or spin-off of Engenio, may cause our operating results to suffer and may cause net revenues and income to decline.

The separation and possible IPO, sale or spin-off of Engenio from us is a substantial undertaking that may disrupt our ongoing business and may increase expenses, which may adversely affect our results of operations and financial condition.

We operate in highly competitive markets.

Our new products may not achieve market acceptance.

We operate highly complex and costly manufacturing facilities.

We outsource a substantial portion of wafers manufactured.

We have significant capital requirements to maintain and grow our business.

We are exposed to fluctuations in foreign currency exchange rates.

We procure parts and raw materials from limited domestic and foreign sources.

We are dependent on a limited number of customers.

We utilize indirect channels of distribution over which we have limited control.

Our operations are affected by cyclical fluctuations.

We engage in acquisitions and alliances giving rise to economic and technological risks.

The price of our securities may be subject to wide fluctuations.

We may rely on capital and bank markets to provide liquidity.

We design and develop highly complex cell-based ASICs.

Our global operations expose us to numerous international business risks.

The high technology industry in which we operate is prone to intellectual property litigation.

Our manufacturing facilities may not achieve desired margins.

Our manufacturing facilities are subject to disruption.

Table of Contents

We must attract and retain key employees in a highly competitive environment.

Future changes in financial accounting standards or practices or existing taxation rules or practices may cause adverse unexpected fluctuations and affect our reported results of operations.

While management believes that the discussion and analysis in this report is adequate for a fair presentation of the information, we recommend that you read this discussion and analysis in conjunction with the Annual Report on Form 10-K.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no significant changes in the market risk disclosures during the six months ended June 30, 2004, as compared to the discussion in Part II of our Annual Report on Form 10-K for the year ended December 31, 2003.

Item 4. Controls and Procedures

Our management evaluated, with the participation of our chief executive officer and our chief financial officer, the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 promulgated under the Securities Exchange Act as of June 30, 2004. Based on this evaluation, our chief executive officer and our chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. We are aware that any system of control, however well designed and operated, can only provide reasonable, and not absolute, assurance that the objectives of this system are met, and that maintenance of disclosure controls and procedures is an ongoing process that may change over time.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

This information is included in Note 15 (Legal Matters) of the Notes to the Unaudited Consolidated Financial Statements, which information is incorporated herein by reference from Item 1 of Part I hereof.

Item 2. Changes of Securities, Use of Proceeds

On July 28, 2000, the Company's Board of Directors authorized a new stock repurchase program in which up to 5 million shares of the Company's common stock may be repurchased in the open market from time to time. There is no expiration date for the plan. No shares were repurchased under this plan during the first six months of 2004. There are 3.5 million shares available for repurchase under this plan as of June 30, 2004.

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

Our Annual Meeting of Stockholders was held on May 6, 2004 in San Jose, California. At the meeting, our stockholders voted on and approved the following proposals. The results of the voting were as follows:

Table of Contents

Proposal 1. To elect eight directors to serve for the ensuing year and until their successors are elected.

| Director | Votes For | Votes Withheld |
|---------------------|------------------|-----------------------|
| T.Z. Chu | 319,158,332 | 17,273,593 |
| Wilfred J. Corrigan | 321,046,627 | 15,385,298 |
| Malcolm R. Currie | 318,805,265 | 17,626,660 |
| James H. Keyes | 319,256,650 | 17,175,275 |
| R. Douglas Norby | 321,413,748 | 15,018,177 |
| Matthew J. O'Rourke | 320,120,581 | 16,311,344 |
| Gregorio Reyes | 323,868,137 | 12,563,788 |
| Larry W. Sonsini | 315,814,258 | 20,617,667 |

Proposal 2. To approve an amendment to the Company's Employee Stock Purchase Plan to increase the number of shares of common stock reserved for issuance thereunder by 9,000,000.

| Votes For | Votes Against | Abstentions | Broker Non-Votes |
|------------------|----------------------|--------------------|-------------------------|
| 114,129,095 | 86,275,334 | 2,569,478 | 0 |

Proposal 3. To approve an amendment to the Company's International Employee Stock Purchase Plan to increase the number of shares of common stock reserved for issuance thereunder by 1,000,000.

| Votes For | Votes Against | Abstentions | Broker Non-Votes |
|------------------|----------------------|--------------------|-------------------------|
| 175,334,835 | 24,997,535 | 2,640,738 | 0 |

Proposal 4. To approve the amendment and restatement of the Company's Incentive Plan.

| Votes For | Votes Against | Abstentions | Broker Non-Votes |
|------------------|----------------------|--------------------|-------------------------|
| 187,939,781 | 12,291,223 | 2,742,102 | 0 |

Proposal 5. To ratify the appointment of PricewaterhouseCoopers LLP as independent accountants of the Company for its 2004 fiscal year.

| Votes For | Votes Against | Abstentions | Broker Non-Votes |
|------------------|----------------------|--------------------|-------------------------|
| 324,030,110 | 10,221,668 | 2,180,146 | 0 |

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 31.1 Certification of the Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-1(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-1(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 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. *

Table of Contents

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. *

* Furnished not filed.

(b) Reports on Form 8-K

On April 28, 2004, the Company filed in part and furnished in part a Form 8-K pursuant to Items 5, 7 and 12 to report information regarding the financial results for the fiscal quarter ended March 31, 2004 set forth in the Registrant's news release dated April 28, 2004.

Table of Contents

SIGNATURES

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

LSI LOGIC CORPORATION
(Registrant)

Date: August 13, 2004

By /s/ Bryon Look

Bryon Look
*Executive Vice President &
Chief Financial Officer*

Table of Contents

INDEX TO EXHIBITS

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 - 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. *
- * Furnished not filed.