

LSI LOGIC CORP
Form 10-K
March 01, 2007

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

Form 10-K

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal Year Ended December 31, 2006
- OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to .

**Commission File No. 1-10317
LSI LOGIC CORPORATION**
(Exact name of registrant as specified in its charter)

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

94-2712976
*(IRS Employer
Identification No.)*

**1621 Barber Lane
Milpitas, California 95035**
(Address of principal executive offices) (Zip Code)

**Registrant's telephone number, including area code:
(408) 433-8000**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, \$0.01 par value	New York Stock Exchange
Preferred Share Purchase Rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
NONE
(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

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Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act (check one):
Large accelerated Filer Accelerated Filer Non-accelerated Filer

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

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The aggregate market value of the voting and non-voting common stock held by non-affiliates of the Registrant as of July 2, 2006 (the last day of the Registrant's second quarter of 2006), based upon the closing price of the Common Stock on June 30, 2006, as reported on the New York Stock Exchange (the "NYSE"), was approximately \$2,852,702,182. Shares of Common Stock held by each executive officer and director and by each person who owns more than 5% of the outstanding Common Stock have been excluded in that such persons may be deemed affiliates. In determining the number of shares held by greater than 5% shareholders, the Registrant used the ownership as of December 31, 2005 shown on their Schedules 13G filed in February 2006. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 23, 2007, the Registrant had 404,414,200 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the following document are incorporated by reference into Part III of this Annual Report on Form 10-K: Registrant's Proxy Statement to be filed for Registrant's 2007 Annual Meeting of Stockholders to be held on May 10, 2007.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Actual results could differ materially from those projected in the forward-looking statements as a result of a number of risks and uncertainties, including the risk factors set forth in this Annual Report on Form 10-K. See "Risk Factors" in Part I, Item 1A. Statements made herein are as of the date of the filing of this Form 10-K with the Securities and Exchange Commission and should not be relied upon as of any subsequent date. We expressly disclaim any obligation to update information presented herein, except as may otherwise be required by law.

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PART I

Item 1. *Business*

General

LSI Logic Corporation (together with its subsidiaries collectively referred to as *LSI*, *LSI Logic* or the *Company* and referred to as *we*, *us* and *our*) designs, develops and markets complex, high-performance semiconductors and storage systems. We are a leading provider of silicon-to-system solutions that are used at the core of products that create, store and consume digital information. We offer a broad portfolio of semiconductors, including custom and standard product integrated circuits, for use in consumer applications, high-performance storage controllers, enterprise hard disk controllers and a wide range of communication devices. We also offer external storage systems and software applications for storage area networks.

In 2005, our operations were organized in four markets: communications, consumer products, storage components and storage systems. On March 6, 2006, we announced plans to focus our business growth opportunities in the information storage and consumer markets, increasing associated research and development investments, while redirecting investments from non-core areas and ceasing further development of our RapidChip® product platform. Consistent with our increased focus on storage, in March 2006 we also announced the cancellation of the previously announced initial public offering of our storage systems business, Engenio Information Technologies. In May 2006, we sold our Gresham, Oregon manufacturing facility as part of our strategy to transition to a fabless semiconductor manufacturing model. In November 2006, we acquired StoreAge Networking Technologies Ltd., a privately held company based in Neshar, Israel that provides SAN storage management and multi-tiered data protection software for enterprises. Also in November 2006, we acquired Metta Technology, a privately held company based in Pune, India that develops multimedia system-on-chip technology and related software for consumer electronics products. On December 4, 2006, we announced our proposed merger with Agere Systems Inc. (together with its subsidiaries collectively referred to as *Agere*), as further discussed in the *Recent Developments* section below. The proposed merger with Agere supports our strategy to increase our penetration of the information storage and consumer markets, and also provides us with complementary capabilities and products to more effectively address the enterprise networking market.

We operate in two segments—the Semiconductor segment and the Storage Systems segment—in which we offer products and services for a variety of electronic systems applications. Our products are marketed primarily to original equipment manufacturers (*OEMs*) that sell products to our target markets.

For the year ended December 31, 2006, revenues from the Semiconductor segment were \$1,223.1 million (approximately 62% of total consolidated revenues) and its income from operations was \$96.2 million. In the Semiconductor segment, we use advanced process technologies and comprehensive design methodologies to design, develop, manufacture and market highly complex integrated circuits (*ICs*). These system-on-a-chip solutions include both custom solutions and standard products. Custom solutions are designed for a specific application defined by the customer, whereas standard products are developed for market applications that we define and are sold to multiple customers. See also *Management's Discussion and Analysis of Financial Condition and Results of Operations* in Item 7 of Part II.

For the year ended December 31, 2006, revenues from the Storage Systems segment were \$759.0 million (approximately 38% of total consolidated revenues) and its income from operations was \$62.1 million. In the Storage Systems segment, we design, manufacture and sell enterprise storage systems. Our high-performance, highly scalable open storage area network systems and storage solutions are distributed through leading OEMs and directly to a few selected accounts. The Storage Systems segment product offerings also include host bus adapters, RAID adapters

(redundant array of independent disks), software and related products and services.

LSI Logic Corporation was incorporated in California on November 6, 1980, and was reincorporated in Delaware on June 11, 1987. Our principal offices are located at 1621 Barber Lane, Milpitas, California 95035, and our telephone number at that location is (408) 433-8000. Our home page on the Internet is www.lsi.com. The contents of this website are not incorporated in or otherwise to be regarded as part of this annual report on Form 10-K. Copies of this and other annual reports, quarterly reports on Form 10-Q, current reports on Form 8-K

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and all amendments to these reports are available free of charge on our website as soon as reasonably practicable after such documents are filed electronically with the Securities and Exchange Commission (SEC). Any materials that the Company files with the SEC can be read at the SEC s website on the Internet at <http://www.sec.gov> or read and copied at the SEC s Public Reference Room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at (800) 732-0330.

Recent Developments

Proposed Merger with Agere. On December 3, 2006, we entered into an Agreement and Plan of Merger with Agere and we publicly announced the signing of the merger agreement on December 4, 2006. Agere is a provider of integrated circuit solutions for a variety of computing and communications applications. Some of Agere s solutions include related software and reference designs. Agere s solutions are used in products such as hard disk drives, mobile phones, high-speed communications systems and personal computers. Agere also licenses its intellectual property to others.

Pursuant to the terms and subject to the conditions set forth in the merger agreement, Agere will become a wholly owned subsidiary of LSI. Upon completion of the merger, each share of Agere common stock that is outstanding at the effective time of the merger will be converted into the right to receive 2.16 shares of LSI common stock. Each outstanding option to purchase Agere common stock, whether or not then vested or exercisable, shall be assumed by LSI and will become exercisable for a number of shares of LSI common stock at an exercise price adjusted to reflect the exchange ratio in the merger.

The completion of the proposed merger with Agere is subject to various customary conditions, including (i) obtaining the approval of the LSI and Agere stockholders, (ii) absence of any applicable law prohibiting the merger, (iii) certain regulatory approvals, (iv) subject to certain exceptions, the accuracy of the representations and warranties of each party, and (v) performance in all material respects by each party of its obligations under the merger agreement. LSI has scheduled a special meeting of its stockholders for Thursday, March 29, 2007 to vote on a proposal to approve matters related to the proposed merger. Agere has scheduled its 2007 annual meeting of stockholders for Thursday, March 29, 2007, at which Agere stockholders will vote on a proposal to approve the proposed merger, among other things. Subject to obtaining the approval of the LSI and Agere stockholders at these meetings and the satisfaction of other closing conditions, we expect to complete the merger soon after the stockholder meetings.

We believe that the proposed merger with Agere presents a unique opportunity to create a combined entity that will offer a comprehensive set of building block solutions, including semiconductors, systems and related software for storage, networking and consumer electronics products, and that the merger should allow us to deliver significant benefits to our customers, stockholders and employees. We believe that the proposed merger offers the following strategic and financial benefits:

Complementary Businesses. The products and development capabilities of LSI and Agere are complementary, and should enable the combined company to compete more effectively in their target markets. The combined company should be stronger than either company on its own, with greater breadth and depth in storage and networking/communications product offerings and a greater ability to develop new product offerings in these market segments. In addition, the combined company is expected to benefit from access to large growth markets, such as those served by the mobile products business of Agere and the consumer products business of LSI.

Customers. The combined company is expected to have deep relationships with many of the market-leading customers in our chosen markets. We expect to improve our ability to expand current customer relationships, and expect to increase the penetration of new customer accounts. We believe that the combination of the two

companies' product lines and engineering resources should enable the combined company to meet customer needs more effectively and to deliver more complete solutions to our customers. In addition, we believe that the larger sales organization, greater marketing resources and financial strength of the combined company may lead to improved opportunities for marketing the combined company's products.

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Engineering Talent. The combined company will have over 4,200 engineers, including over 1,700 that hold masters or doctorate degrees, which should enable the combined company to compete more effectively by developing innovative products and delivering greater value to customers more rapidly than either company could do on a stand-alone basis.

Intellectual Property Portfolio. The combined company will have over 10,000 pending and issued U.S. patents, which will be one of the largest intellectual property portfolios in the semiconductor industry. This portfolio is expected to provide the combined company with additional licensing opportunities.

Reduction in Operating Costs. The combined company is expected to realize substantial cost savings beginning in 2007, with annual cost savings reaching at least \$125 million in 2008 from increased efficiencies in manufacturing and operating expenses. We expect the combined company to achieve benefits from exercising greater purchasing power with its suppliers, and consolidation and reduction of areas of overlap in operating expenses, including the expenses of maintaining two separate public companies.

Stronger Financial Position. The combined company will have greater scale and financial resources. We expect that this stronger financial position will improve the combined company's ability to support product development strategies; to respond more quickly and effectively to customer needs, technological change, increased competition and shifting market demand; and to pursue strategic growth opportunities in the future, including acquisitions.

Stock-for-Stock Transaction with Fixed Exchange Ratio. The stockholders of each of LSI and Agere will share in the benefits expected from the synergies and cost savings the combined company will generate. The fact that the merger consideration is based on a fixed exchange ratio provides certainty as to the number of shares of LSI common stock that will be issued to Agere stockholders.

In connection with the proposed merger with Agere, LSI has filed a Registration Statement on Form S-4 with the SEC, which registration statement includes a joint proxy statement/prospectus, dated February 5, 2007, and related materials to register the shares of LSI common stock to be issued in the merger. The registration statement and the joint proxy statement/prospectus contain important information about LSI, Agere, the proposed merger and related matters. Investors and security holders are urged to read the registration statement and the joint proxy statement/prospectus carefully. Investors and security holders can obtain free copies of the registration statement and the joint proxy statement/prospectus and other documents filed with the SEC by LSI and Agere through the website maintained by the SEC at www.sec.gov. In addition, free copies of the registration statement and the joint proxy statement/prospectus and other documents are also available on the Agere website at www.agere.com and on the LSI website at www.lsi.com. The registration statement, the joint proxy statement/prospectus and other relevant documents may also be obtained free of charge from Agere by directing such request to Investor Relations, Agere Systems Inc., 1110 American Parkway N.E., Allentown Pennsylvania 18109 and from LSI by directing such request to Investor Relations, LSI Logic Corporation, 1621 Barber Lane, Milpitas, California 95035. The contents of the websites referenced above are not deemed to be incorporated by reference into this Annual Report on Form 10-K, the registration statement or the joint proxy statement/prospectus. Agere, LSI and their respective officers, directors and employees may be deemed to be participants in the solicitation of proxies from their respective stockholders with respect to the proposed merger. Information regarding the interests of these officers, directors and employees in the proposed merger is included in the joint proxy statement/prospectus.

Announcement of Stock Repurchase Program. On December 4, 2006, we announced that our board of directors authorized a stock repurchase program of up to \$500 million worth of shares of our common stock. Our board of directors terminated the stock repurchase program previously authorized by the Board on July 28, 2000. The

repurchases are expected to be funded from available cash and short-term investments.

Pending Acquisition of SiliconStor, Inc. In February 2007, we entered into an agreement to acquire SiliconStor, Inc. (SiliconStor), a privately held company that provides silicon solutions for enterprise storage networks. SiliconStor is headquartered in Fremont, California and has approximately 30 employees. At the closing of the acquisition, we expect to pay approximately \$55 million in cash for SiliconStor. The closing of the acquisition is subject to the satisfaction of customary closing conditions and is expected to occur in the first quarter of 2007.

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Business Strategy

We focus our business growth opportunities in the information storage, enterprise connectivity and consumer electronics markets. Following completion of our proposed merger with Agere, we also expect to be in a position to address growth opportunities in semiconductor applications for the networking market and the wireless handset portion of the consumer market.

Semiconductor Business Strategy

Our objective is to continue our industry leadership in the design, development and marketing of highly complex integrated circuits, software and system-level solutions in the information storage and consumer electronics markets. To achieve this objective, our business strategy includes the following key elements:

Target Growth Markets and Customers. We concentrate our sales and marketing efforts on leading OEM customers in targeted growth markets. Our engineering expertise is focused on developing technologies that will meet the product and service needs of our customers in order to succeed in these market areas.

Promote Highly Integrated Design Technology. We use proprietary and leading third-party electronic design automation, or EDA, software design tools. We continually evaluate and, as appropriate, develop expertise with third-party EDA tools from leading and emerging suppliers of such products.

Provide Flexibility in Design Engineering. We engage with customers of our semiconductor products under various arrangements whereby the extent of the engineering support we provide will be determined in accordance with the customer's requirements. For example, a customer may primarily use its own engineers for substantial development of its product design and retain our support for silicon-specific engineering work. We also enter into engineering design projects, including those on a turn-key basis.

Deploy a Fabless Semiconductor Manufacturing Model. On September 13, 2005, we announced our intention to sell our Gresham, Oregon manufacturing facility as part of our strategy to transition to a fabless semiconductor manufacturing model. We completed the sale of this facility to Semiconductor Components Industries, LLC, a wholly owned subsidiary of ON Semiconductor Corporation (ON Semiconductor), on May 15, 2006. Since announcing our intention to sell this facility, our wafer manufacturing strategy has been to expand our working relationships with major foundry partners and to adopt a roadmap leading to the production of advanced semiconductors utilizing 65-nanometer and below process technology on 300-mm or 12-inch wafers. This model enables us to focus on developing innovative intellectual property and products, while reducing capital and operating infrastructure requirements. We perform substantially all of our packaging, assembly and final test operations through subcontractors in Asia. If we complete our proposed merger with Agere, we will acquire Agere's 51% equity interest in Silicon Manufacturing Partners, a joint venture with Chartered Semiconductor Manufacturing Ltd. that operates a semiconductor wafer manufacturing facility in Singapore, as well as Agere's assembly and test facilities in Asia.

Leverage Alliances with Key Partners. We are continually seeking to establish relationships with key partners in a diverse range of technologies to promote new products, services, operating standards and manufacturing capabilities and to avail ourselves of cost efficiencies that may be obtained through collaborative development.

Forge Successful Partnerships with Leading Distribution Partners. Our partner program is designed to effectively market our host bus adapter product families and integrated circuit products utilizing distribution and reseller partnerships. Such partnerships help us to provide an extended range of customers with the full

spectrum of product offerings, services and support needed to enable their success.

Develop and Drive Industry Standards to Achieve Market Advantage. We are a leader in developing and promoting important industry standard architectures, functions, protocols and interfaces. We believe that this leadership will enable us to quickly launch new standard-based products, allowing our customers to achieve time-to-market and other competitive advantages.

Operate Worldwide. We market our products and engage with our customers on a worldwide basis through direct sales, marketing and field technical staff and through independent sales representatives and

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distributors. Our network of design centers located in major markets allows us to provide customers with highly experienced engineers, to interact with customer engineering management and system architects, to develop designs for new products and to provide continuing after-sale customer support.

Storage Systems Business Strategy

Our objective is to be the leading provider to server and storage OEMs of modular disk storage systems and sub-assemblies. We intend to enhance our market position by:

Continuing to Innovate and Extend Our Product Offering. We intend to adopt and implement innovative storage system technologies, interfaces, features and customer requirements. In addition, we intend to define, design and develop products that enable our channel customers to offer a broad storage system product line, which incorporates their own intellectual property, to address multiple markets. In this manner, we intend to continue to expand our product offerings in the mid-range markets and further into the entry-level markets.

Adding Feature Functionality to Meet Expanding Enterprise Requirements. Implementation and management of storage systems within the enterprise is increasingly complex. To address this increasing complexity, we plan to develop or acquire additional premium software management and hardware system features to enhance reliability, data availability and serviceability of our products. For example, in November 2006, we acquired StoreAge Networking Technologies Ltd. (together with its subsidiaries collectively referred to as StoreAge), a privately held company based in Nesher, Israel that provides SAN storage management and multi-tiered data protection software for enterprises. We also intend to expand our LSI Storage Solutions program, which is designed to help our customers rapidly implement our products for specific business applications.

Enhancing Interoperability Among Our Products, Our Customers' Products and Other Leading Enterprise Products. We provide significant value to our channel customers and enterprises by testing and certifying our products with the products of other leading enterprise information technology vendors to ensure broad interoperability and compatibility. We intend to work closely with our channel customers and enterprises to extend and enhance the capabilities of our storage sub-assemblies and storage management software. We also seek to enhance our position in the storage industry by actively participating in a variety of organizations focused on developing standards for emerging technologies and facilitating industry-wide interoperability.

Obtaining New Channel Customers. Our channel customers sell storage solutions based on or incorporating our products and technology through their direct sales forces and other channels. We will continue to seek new customers in domestic and international markets in order to expand the total marketing and sales resources that are focused on our products. In this manner, we intend to increase the market addressable by our products.

Expanding Our Joint Marketing and Sales Efforts With Existing and New Channel Customers. We seek to add value to our customers' sales, marketing and support initiatives through the provision of extensive training, customized go-to-market campaigns, product positioning, marketing materials, competitive analysis and product support infrastructure. We maintain 16 Experience Centers worldwide, which allow our channel customers to demonstrate to enterprise users the performance and benefits of storage deployments incorporating our products. We plan to continue to add additional demonstration capabilities to reach a broader customer base in the future.

Promoting Our Brand. We believe that a strong association of our brand with innovation and integrity is valuable in achieving increased scale, market leadership and OEM acceptance within our industry. Furthermore, we believe that brand recognition and reputation will become more important as OEMs increasingly outsource their storage system offerings and their customers focus on the performance and

reliability of the storage systems or sub-assemblies integrated into OEM storage solutions. We intend to continue to promote our brand and build brand equity to establish and bolster our position in the disk storage systems and related storage management software markets.

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Products and Services

Semiconductor Products

In our semiconductor components business, we design and develop custom solutions and standard products to customers competing in global storage and consumer markets. The proposed merger with Agere would bring additional semiconductor products into our portfolio, including those targeting the networking market and the wireless handset portion of the consumer market.

Custom solutions are semiconductors that are designed for unique, customer-specified applications. Standard products are developed for market applications we define and are targeted to be sold to multiple customers. Both custom solutions and standard products are sold to customers for incorporation into system-level products and may incorporate our intellectual property building blocks.

Storage Components. Our custom solutions and standard product solutions offered to customers in worldwide storage component markets make possible data transmission and storage between a host computer and peripheral devices such as magnetic and optical disk drives, scanners, printers and disk and tape-based storage systems.

Storage Standard Products. Our standard product solutions include Fibre Channel, Serial-Attached SCSI (SAS), Serial ATA (SATA) and SCSI standard products, including host adapter ICs for motherboard and adapter applications, SCSI and SAS expander ICs, storage adapter boards and our own Fusion-MPT™ software drivers for these product families. We are an industry leader in the on-going development of new storage interface standards and products, including SAS. In February 2007, we entered into an agreement to acquire SiliconStor, a privately held company that provides storage technology focused on the SATA and SAS markets and is shipping patent-pending products that improve the performance, reliability, and manageability of SATA drives when used in a SAS environment.

Storage Custom Solutions. We also offer custom solutions to customers who develop Fibre Channel storage area network (SAN) switches and host adapters, storage systems, hard disk drives and tape peripherals. Through leveraging our extensive experience in providing solutions for these applications, we have developed a full portfolio of high-speed interface CoreWare® that is employed for custom solution platforms that provide a connection to the network, the SAN, memory and host buses. Using these pre-verified interfaces, our customers reduce development risk and achieve quicker time to market. Our CoreWare® offerings include the GigaBlaze® high performance SerDes Core supporting Fibre Channel, SATA, Gigabit Ethernet, Infiniband, SAS, Serial RapidIO and PCI-Express industry standards and a family of high-performance Fibre Channel, RapidIO, PCI-E, SAS and SATA protocol controllers.

Consumer Products. For the consumer market, we offer a broad array of semiconductor products, including both standard products and custom solutions.

Consumer Standard Products. We design, develop, manufacture and market semiconductor devices, along with enabling software and reference system designs to enable a variety of digital video and audio applications utilizing our core competency in media processing. We are focused on providing solutions for high-growth applications such as DVD recorders, digital set-top boxes, and a variety of combination products such as DVD recorder /VCR, DVD recorder/PVR and DVD recorder/digital set-top box as well as broadcast encoders. At the center of our standard product strategy is our industry leading DoMiNo® architecture. Products based on this flexible architecture provide software programmable, cost-effective solutions to our customers in our target markets.

Consumer Custom Solutions. We offer system-on-a-chip solutions for consumer applications. We focus on consumer market segments employing our intellectual property portfolio, media processing expertise, system level knowledge, design methodology and turn-key product offerings to provide customized solutions to our customers. We are focused on providing solutions to portable consumer appliances such as digital audio players, portable media players, global positioning systems, edutainment and electronic toys and other emerging multimedia applications utilizing in many cases our Zevio™ architecture.

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Communications Products. Our highly integrated, high-performance, system-on-a-chip silicon solutions are used in the design of communications equipment. We deliver custom semiconductor solutions to customers who develop devices used for wireless and broadband data networking applications. We have ceased further development of our RapidChip product platform. The proposed merger with Agere would bring additional semiconductor products into our portfolio, including those targeting the networking market and the wireless handset portion of the consumer market.

Storage Systems Products

We offer a broad line of open, modular storage products comprised of complete systems and sub-assemblies configured from modular components, such as our storage controller modules, disk drive enclosure modules and related management software. The modularity of our products provides channel customers with the flexibility to integrate either our sub-assemblies with third-party components, such as disk drives, or software to form their own storage system products. Our modular product approach allows channel customers to create highly customized storage systems that can then be integrated with value-added software and services and delivered as a complete, differentiated data storage solution to enterprises.

We design and develop storage systems, sub-assemblies and storage management software that operate within all major open operating systems, including Windows, UNIX and UNIX variants and Linux environments. We test and certify our products, both independently and jointly with our customers, with those of other hardware, networking and software storage vendors to ensure a high level of interoperability and performance. Our products are targeted at a wide variety of data storage applications, including Internet-based applications such as online transaction processing and e-commerce, data warehousing, video editing and post-production and high-performance computing.

In addition, we offer a wide spectrum of direct-attach RAID solutions, spanning from integrated RAID in our storage IC and adapter products and our software-based RAID products to our MegaRAID® product family. Our MegaRAID products include integrated single-chip RAID on motherboard solutions and a broad family of PCI and PCI Express RAID controller boards featuring ATA, SATA, SCSI and SAS interfaces, along with fully featured software and utilities for robust storage configuration and management.

In November 2006, we acquired StoreAge, which provides SAN storage management and multi-tiered data protection software for enterprises. This acquisition augmented our product offerings in the storage systems area.

Semiconductor Design Services

Our CoreWare design methodology offers a comprehensive design approach for creating custom solutions efficiently, predictably and rapidly. Our CoreWare libraries include high-level intellectual property building blocks created around industry standards. Our CoreWare cells are connected electronically with other memory and logic elements to form an entire system on a single chip.

Our software design tool environment supports and automatically performs key elements of the design process from circuit concept to physical layout of the circuit design. The design tool environment features a combination of internally developed proprietary software and third-party tools that are highly integrated with our manufacturing process requirements. The design environment includes expanded interface capabilities with a range of third-party tools from leading EDA vendors and features hardware/software co-verification capability. We provide a suite of MIPS cores and ARM processors, in addition to industry-standard interface cores such as USB, PCI-Express, DDR1&2, QDR, SPI4, SFI, XAUI, XGXS and others.

After completion of the custom design effort, we produce and test prototype circuits for shipment to the customer. We then begin volume production of integrated circuits that have been developed through one or more of the arrangements described above in accordance with the customer's quantity and delivery requirements.

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Marketing and Distribution

Semiconductor Marketing and Distribution

The highly competitive semiconductor industry is characterized by rapidly changing technology, short product cycles and emerging standards. Our marketing strategy requires that we forecast trends in the evolution of product and technology development. We must then act upon this knowledge in a timely manner to develop competitively priced products offering superior performance. As part of this strategy, we are active in the formulation and adoption of critical industry standards that influence the design specifications of our products. Offering products with superior price and performance characteristics is essential to satisfy the rapidly changing needs of our customers in the dynamic storage and consumer electronics markets.

Our semiconductor products and design services are primarily sold through our network of direct sales and marketing and field engineering offices located in North America, Europe, Japan and elsewhere in Asia. Our sites are interconnected by means of advanced computer networking systems that allow for the continuous, uninterrupted exchange of information that is vital to the proper execution of our sales and marketing activities. International sales are subject to risks common to export activities, including governmental regulations, geopolitical risks, tariff increases and other trade barriers, and currency fluctuations.

We rely primarily on direct sales and marketing, but we also work with independent component and commercial distributors and manufacturers' representatives or other channel partners in North America, Europe, Japan and elsewhere in Asia. Some of our distributors possess engineering capabilities, and design and purchase both custom solutions and standard products from us for resale to their customers. Other distributors focus solely on the sale of standard products. Our agreements with distributors generally grant limited rights to return standard product inventory and we defer revenue for such inventory until the distributor sells the product to a third party.

Storage Systems Marketing and Distribution

Our storage systems products are sold worldwide through our channel customers and, to a smaller degree, to a limited installed base of end-users. We closely develop and manage our channel customer relationships to meet the diverse needs and requirements of enterprises. By selling products through our channel customers, we are able to address more markets, reach a greater number of enterprises, and reduce our overall sales and marketing expenditures.

Our marketing efforts are designed to support our channel customers with programs targeted at developing differentiated go-to-market strategies and increasing sales effectiveness. Depending on the nature of our channel customer engagement, our marketing teams offer various levels of assistance in assessing and analyzing the competitive landscape, defining product strategy and roadmap, developing product positioning and pricing, creating product launch support materials and assisting in closing the sales process. These marketing teams carefully coordinate joint product development and marketing efforts between our customers and us to ensure that we address and effectively target enterprise requirements. We maintain sales and marketing organizations at our headquarters in Milpitas, and also in regional offices in Atlanta, Georgia; Boulder, Colorado; Dallas, Texas; Chicago, Illinois; Houston, Texas; Los Angeles and Irvine, California; New York, New York; Parsippany, New Jersey; Reston, Virginia; Wichita, Kansas; Westborough, Massachusetts; Raleigh, North Carolina; and Renton, Washington. We also market our products internationally in China, France, Germany, Italy, Japan, Singapore, Sweden and the United Kingdom.

Customers

In 2006, International Business Machines Corporation and Seagate Technology accounted for approximately 19% and 12%, respectively, of our consolidated revenues. No other customer accounted for more than 10% of our consolidated revenues in 2006. We currently have a highly concentrated customer base as a result of our strategy to focus our marketing and sales efforts on select, large-volume customers. We are therefore dependent on a limited number of customers for a substantial portion of our revenues. The loss of any of our significant customers, any substantial decline in sales to these customers, or any significant change in the timing or volume of purchases by our customers could result in lower revenues and could harm our business, financial condition or results of operations.

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We expect that we will continue to derive a substantial portion of our revenue from a highly concentrated customer base following completion of our proposed merger with Agere.

Semiconductor Customers

We seek to leverage our expertise in the fields of consumer and storage components by marketing our products and services predominantly to market leaders. Our current strategic account focus is on large, well-known companies that produce high-volume products incorporating our semiconductors. We recognize that this strategy may result in increased dependence on a limited number of customers for a substantial portion of our revenues. It is possible that we will not achieve anticipated sales volumes from one or more of the customers we focus on. While this could result in lower revenues, we believe this strategy provides us with an opportunity to drive further growth in sales and unit volumes.

Storage Systems Customers

We deliver our storage systems products to OEMs who independently resell or distribute OEM-branded or Engenio co-branded products. The products sold by our OEM partners may be integrated by the OEM with value-added services, hardware and software and delivered as differentiated complete storage solutions to enterprises. Our OEM partners receive basic training services to enhance their abilities to sell and support our products. After receiving our basic training services, most of our OEM partners independently market, sell and support our products, requiring limited ongoing product support from us. We also assist some of our OEM partners with additional resources that may provide tailored, account-specific education, training and sales and marketing assistance, allowing these OEM partners to leverage our storage products and industry expertise.

Manufacturing

Semiconductor Manufacturing

The semiconductor manufacturing cycle converts a product design from the development stage into an integrated circuit. Manufacturing begins with wafer fabrication, where the design is transferred to silicon wafers through a series of processes, including photolithography, ion implantation, deposition of numerous films and the etching of these various films and layers. Each circuit on the wafer is tested in the wafer sort operation. The good circuits are identified and the wafer is then separated into individual die. Each good die is then assembled into a package using different standards and advanced assembly technologies. This package encapsulates the circuit for protection and allows for electrical connection to the printed circuit board. The final step in the manufacturing process is final test, where the finished devices undergo stringent and comprehensive testing using computer systems.

The wafer fabrication operation is very complex and costly, and the industry trend has been towards outsourcing all or a portion of this operation to silicon foundries located throughout the world. Prior to 2006, our wafer manufacturing strategy included a combination of internal and external fabrication. Prior to the sale of our Gresham, Oregon semiconductor manufacturing facility in May 2006, the majority of our wafers were fabricated internally at the Gresham facility and the remainder of our wafer fabrication was outsourced to a variety of wafer foundries in Taiwan, Japan, China and Malaysia. For the more advanced deep sub-micron technologies, we use a combination of standard foundry process technologies and process technologies jointly developed with our foundry partners. These joint development agreements provide us access to leading edge technology and additional wafer capacity.

On September 13, 2005, we announced our intention to sell our Gresham facility as part of our strategy to transition to a fabless semiconductor manufacturing model. We completed the sale of this facility to ON Semiconductor on May 15, 2006. Since announcing our intention to sell this facility, our wafer manufacturing strategy has been to

expand our working relationships with major foundry partners and to adopt a roadmap leading to the production of advanced semiconductors utilizing 65-nanometer and below process technology on 300-mm or 12-inch wafers. If we complete our proposed merger with Agere, we will acquire Agere's 51% equity interest in Silicon Manufacturing Partners, a joint venture with Chartered Semiconductor Manufacturing Ltd. that operates a semiconductor wafer manufacturing facility in Singapore.

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Our final assembly and test operations are performed by independent subcontractors in South Korea, Taiwan, the Philippines, Malaysia, Thailand and China. We have a long history of outsourcing these operations and can offer a wide range of high-performance packaging solutions for system-on-a-chip designs, including flip chip technology. Upon completion of our proposed merger with Agere, we will acquire the assembly and test facilities in Asia that are owned by Agere.

Storage Systems Manufacturing

We use third-party suppliers for standard components, such as disk drives and standard computer processors, which are designed and incorporated into our products. Additionally, we outsource the manufacturing of the majority of our product components, such as printed circuit boards, in order to take advantage of quality and cost benefits afforded by using third-party manufacturing services. We believe that using outsourced manufacturing services allows us to focus on product development and increases operational flexibility, both in terms of adjusting manufacturing capacity in response to customer demand and rapidly introducing new products.

The assembly of our storage system products involves integrating supplied components and manufactured sub-assemblies into final products, which are configured and rigorously tested before being delivered to our customers. The highly modularized nature of our storage system products allows for flexible assembly and delivery models, which include build-to-order, configure-to-order, direct shipment, bulk shipment and local fulfillment services. We have implemented these models in an effort to reduce requisite lead times for delivery of our products and to provide channel customers with multiple manufacturing and delivery alternatives that best complement their operations.

We own a manufacturing facility in Wichita, Kansas at which we assemble and test complete storage systems and sub-assemblies configured from modular components, such as our storage controller modules and disk drive enclosure modules. We have maintained ISO-9001 certification at our Wichita, Kansas manufacturing facility since April 1992 and this facility has been certified as ISO-9001:2000 compliant since October 2001. Product quality is achieved through extensive employee training, exhaustive and automated testing and sample auditing. Quality control and measurement is extended through the subcomponent supplier and component manufacturer base with continuous reporting and ongoing qualification programs. We also use third party contract manufacturers for manufacturing in Mexico.

Backlog

Semiconductor Backlog

In the Semiconductor segment, we generally do not have long-term volume purchase contracts with our customers. Instead, customers place purchase orders that are subject to acceptance by us. The timing of the design activities for which we receive payment and the placement of orders included in our backlog at any particular time is generally within the control of the customer. For example, there could be a significant time lag between the commencement of design work and the receipt of a purchase order for the units of a developed product. Also, customers may from time to time revise delivery quantities or delivery schedules to reflect their changing needs. For these reasons, our backlog as of any particular date may not be a meaningful indicator of future annual sales.

Storage Systems Backlog

Due to the nature of our business, we maintain relatively low levels of backlog in the Storage Systems segment. Consequently, we believe that backlog is not a good indicator of future sales, and our quarterly revenues depend

largely on orders booked and shipped in that quarter. Because lead times for delivery of our products are relatively short, we must build in advance of orders. This subjects us to certain risks, most notably the possibility that expected sales will not materialize, leading to excess inventory, which we may be unable to sell to our customers.

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Competition

Semiconductor Competitors

The semiconductor industry is intensely competitive and characterized by constant technological change, rapid product obsolescence, evolving industry standards and price erosion. Many of our competitors are larger, diversified companies with substantially greater financial resources. Some of our competitors are also customers who have internal semiconductor design and manufacturing capacity. We also compete with smaller and emerging companies whose strategy is to sell products into specialized markets or to provide only a portion of the products and services that we offer, or, if so, only at reduced prices.

Our major competitors in the Semiconductor segment include large companies such as Agere Systems Inc., International Business Machines Corporation, Philips Electronics, N.V., STMicroelectronics, Texas Instruments, Inc. and Toshiba Corporation. Other competitors in strategic markets include Adaptec, Inc., Advanced Micro Devices Inc., Broadcom Corporation, Genesis Microchip, Inc., Intel Corporation, Marvell Technology Group, Ltd., MediaTek Incorporated, NEC Corporation, Sunplus Co. Technology Ltd., Samsung Semiconductor, Trident Microsystems, Inc. and Zoran Corporation.

The principal competitive factors in the semiconductor industry include:

- design capabilities;
- differentiating product features;
- product performance characteristics;
- time to market;
- price; and
- utilization of emerging industry standards.

It is possible that our competitors will develop design solutions that could have a material adverse impact on our competitive position. Our competitors may also decide from time to time to aggressively reduce prices of products that compete with our products in order to sell related products or achieve strategic goals. Due to their customized nature, custom solutions are not as susceptible to price fluctuations as standard products. However, strategic pricing by competitors can place strong pricing pressure on our products in certain transactions, resulting in lower selling prices and lower gross profit margins for those transactions.

The markets into which we sell our semiconductor products are subject to severe price competition. We expect to continue to experience declines in the selling prices of our semiconductor products over the life cycle of each product. In order to offset or partially offset declines in the selling prices of our products, we continue to reduce the costs of products through product design changes, manufacturing process changes, yield improvements and procurement of wafers from outsourced manufacturing partners.

Storage Systems Competitors

The market for our storage system products is highly competitive, rapidly evolving and subject to changing technology, customer needs and new product introductions. We compete with products from storage system and component providers such as Adaptec, Inc., Dot Hill Systems Corporation, Infortrend Technology Inc., XIOtech Corporation, Xyratex Group Limited. We also compete with the internal storage divisions of existing and potential channel customers as well as with large well-capitalized storage system companies such as EMC Corporation, Hitachi Data Systems and Network Appliance, Inc. with respect to sales to OEM customers.

The principal competitive factors affecting the market for our storage system products include:

features and functionality;

product performance and price;

reliability, scalability and data availability;

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interoperability with other networking devices;

support for emerging industry and customer standards;

levels of training, marketing and customer support;

level of easily customizable features;

quality and availability of supporting software;

quality of system integration; and

technical services and support.

Our ability to remain competitive will depend largely upon our ongoing performance in the areas of product development and customer support. To be successful in the future, we believe that we must respond promptly and effectively to the challenges of technological change and our competitors' innovations by continually enhancing our product offerings. We must also continue to aggressively recruit and retain employees highly qualified and technically experienced in hardware and software development in order to achieve industry leadership in product development and support.

Patents, Trademarks and Licenses

We maintain a patent program, and believe that our patents and other intellectual property rights add value to our business. We currently have more than 4,500 pending and issued U.S. patents and additional pending and issued foreign patents, some of which are in the Semiconductor segment and some of which are in the Storage Systems segment. In both segments, we also maintain trademarks for our products and services and claim copyright protection for certain proprietary software and documentation. Patents, trademarks and other forms of protection for our intellectual property are important, but we believe our future success principally depends upon the technical competence and creative skills of our employees. Upon completion of our proposed merger with Agere, we will substantially increase the size and breadth of our intellectual property portfolio. We expect that the combined company will have more than 10,000 issued and pending U.S. patents. Agere also derives revenue and income from licensing its intellectual property to other companies, and we expect the combined company to continue this intellectual property licensing business in the future.

We continue to expand our portfolio of patents and trademarks. We offer a staged incentive to employees to identify, document and submit invention disclosures. We have developed an internal review procedure to maintain a high level of disclosure quality and to establish criteria, priorities and plans for filings both in the U.S. and abroad. The review process is based solely on engineering, business, legal and management judgment, with no assurance that a specific filing will issue or, if issued, will deliver any lasting value to us. There is no assurance that the rights granted under any patent will provide competitive advantages to us or will be adequate to protect our innovations, products or services. Moreover, the laws of certain countries in which our products are or may be manufactured or sold may not protect our products and intellectual property rights to the same extent as the U.S. legal system.

As is typical in the high technology industry, from time to time, we have received communications from other parties asserting that certain of our products or processes infringe upon their patent rights, copyrights, trademark rights or other intellectual property rights. We regularly evaluate such assertions. In light of industry practice, we believe that, with respect to existing or future claims, any licenses or other rights that may be necessary may generally be obtained

on commercially reasonable terms. Nevertheless, there is no assurance that licenses will be obtainable on acceptable terms or that a claim will not result in litigation or other administrative proceedings.

In the Semiconductor segment, we protect our know-how, trade secrets and other proprietary information through confidentiality agreements with our customers, suppliers, employees and consultants, and through other security measures. We have entered into certain patent cross-license agreements that generally provide for the non-exclusive licensing of rights to design, manufacture and sell products and, in some cases, for cross-licensing of future improvements developed by either party.

In the Storage Systems segment, we own a portfolio of patents and patent applications concerning a variety of storage technologies. We also maintain trademarks for certain of our products and services and claim copyright

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protection for certain proprietary software and documentation. Similar to the Semiconductor segment, we protect our trade secrets and other proprietary information through agreements and other security measures, and have implemented internal procedures to obtain patent protection for inventions and pursue protection in selected jurisdictions.

Please see Item 3, Legal Proceedings, for information regarding pending patent litigation against the Company. Please also refer to the additional risk factors set forth in the Risk Factors section and Note 12 of the Notes to the Consolidated Financial Statements (Notes) for additional information.

Research and Development

Our industry is characterized by rapid changes in intellectual property. We must continue to improve our existing intellectual property and products and to develop new ones in a cost-effective manner to meet changing customer requirements and emerging industry standards. If we are not able to successfully introduce new intellectual property and products, or to achieve volume production of products, there could be a material adverse impact on our operating results and financial condition.

On March 6, 2006, we announced plans to focus our business on growth opportunities in the information storage and consumer markets, increasing associated research and development (R&D) investments, while redirecting R&D from non-core areas. We have ceased further development of our RapidChip product platform.

In the United States, we operate R&D facilities in California, Colorado, Georgia, Kansas, Maryland, Minnesota, Oregon, Texas and selected other states. Internationally, we have facilities in Canada, China, Dubai, Germany, India, Israel, Italy, Russia, Taiwan, and the United Kingdom. During 2005 and 2006, we significantly expanded capabilities in India. The following table shows our expenditures on research and development activities for each of the last three fiscal years (in thousands).

Year	Amount	Percent of Revenue
2006	\$ 413,432	21%
2005	\$ 399,685	21%
2004	\$ 427,805	25%