Ultra Clean Holdings, Inc.
Form 10-Q
November 04, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 25, 2015

or

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

For the transition period from __________ to __________

Commission file number 000-50646

Ultra Clean Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**61-1430858**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
26462 Corporate Avenue, Hayward, California	**94545**
(Address of principal executive offices)	**(Zip Code)**

(510) 576-4400

Registrant s telephone number, including area code

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

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

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

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

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

Number of shares outstanding of the issuer s common stock as of October 23, 2015: 32,254,217

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ULTRA CLEAN HOLDINGS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

ULTRA CLEAN HOLDINGS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited; in thousands, except share and per share amounts)

	September 25, 2015	December 26, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$ 59,783	$ 78,997
Accounts receivable, net of allowance of $132 and $81 in 2015 and 2014, respectively	57,534	61,817
Inventory	75,564	56,850
Deferred tax assets, net of valuation allowance	3,976	3,777
Prepaid expenses and other	8,522	7,006
Total current assets	205,379	208,447
Equipment and leasehold improvements, net	16,968	10,841
Goodwill	84,495	55,918
Purchased intangibles, net	44,952	16,824
Deferred tax assets, net of valuation allowance	3,607	3,445
Other non-current assets	705	667
Total assets	$ 356,106	$ 296,142
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Bank borrowings	$ 11,207	$ 9,541
Accounts payable	47,503	48,944
Accrued compensation and related benefits	5,882	5,308
Deferred rent, current portion	562	245
Other current liabilities	5,371	2,130
Total current liabilities	70,525	66,168
Bank borrowings, net of current portion	65,716	38,614
Deferred tax liability	1,743	105
Deferred rent and other liabilities	3,283	2,703

Total liabilities		141,267		107,590
Commitments and contingencies (See Note 9)				
Stockholders equity:				
Preferred stock $0.001 par value, 10,000,000 authorized; none outstanding				
Common stock $0.001 par value, 90,000,000 authorized; 32,251,550 and 29,562,338 shares issued and outstanding in 2015 and 2014, respectively		32		30
Additional paid-in capital		174,390		153,141
Common shares held in treasury, at cost, 601,944 shares in 2015 and 2014		(3,337)		(3,337)
Retained earnings		43,774		38,718
Accumulated other comprehensive income		(20)		
Total stockholders equity		214,839		188,552
Total liabilities and stockholders equity	$	356,106	$	296,142

(See accompanying notes to condensed consolidated financial statements)

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ULTRA CLEAN HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited; in thousands, except per share data)

	Three months ended		Nine months ended	
	September 25, 2015	September 26, 2014	September 25, 2015	September 26, 2014
Sales	$ 122,816	$ 117,041	$ 365,683	$ 393,942
Cost of goods sold	103,868	106,734	307,994	339,172
Gross profit	18,948	10,307	57,689	54,770
Operating expenses:				
Research and development	2,352	1,806	7,319	5,371
Sales and marketing	2,844	2,493	8,494	7,746
General and administrative	10,673	9,971	32,721	28,395
Total operating expenses	15,869	14,270	48,534	41,512
Income (loss) from operations	3,079	(3,963)	9,155	13,258
Interest and other income (expense), net	(756)	(437)	(2,071)	(1,520)
Income (loss) before provision for income taxes	2,323	(4,400)	7,084	11,738
Income tax provision	647	862	2,028	3,913
Net income (loss)	$ 1,676	$ (5,262)	$ 5,056	$ 7,825
Net income (loss) per share:				
Basic	$ 0.05	$ (0.18)	$ 0.16	$ 0.27
Diluted	$ 0.05	$ (0.18)	$ 0.16	$ 0.26
Shares used in computing net income (loss) per share:				
Basic	31,993	29,477	31,359	29,242
Diluted	32,155	29,477	31,653	29,912

(See accompanying notes to condensed consolidated financial statements)

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ULTRA CLEAN HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited; in thousands)

	Three months ended		Nine months ended	
	September 25, 2015	September 26, 2014	September 25, 2015	September 26, 2014
Net income (loss)	$ 1,676	$ (5,262)	$ 5,056	$ 7,825
Other comprehensive income (loss):				
Change in foreign currency translation	67		67	
Cash flow hedges:				
Change in fair value of derivatives	(91)		(91)	
Adjustment for net (gains) losses realized and included in net income	4		4	
Total change in unrealized (gains) losses on derivative instruments	(87)		(87)	
Total other comprehensive loss	(20)		(20)	
Total comprehensive income (loss)	$ 1,656	$ (5,262)	$ 5,036	$ 7,825

(See accompanying notes to condensed consolidated financial statements)

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ULTRA CLEAN HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited; in thousands)

	Nine months ended	
	September 25, 2015	**September 26, 2014**
Cash flows from operating activities:		
Net income	$ 5,056	$ 7,825
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,447	2,248
Amortization of finite lived intangibles	4,042	3,663
Amortization of debt issuance costs	790	366
Stock-based compensation	2,607	3,169
Excess tax benefit from stock-based compensation	809	
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	7,416	9,991
Inventory	(11,071)	8,589
Prepaid expenses and other	(1,300)	(1,808)
Deferred income taxes	(196)	1,810
Other non-current assets	(12)	209
Accounts payable	(8,180)	(11,375)
Accrued compensation and related benefits	132	(659)
Income taxes payable	(809)	
Other liabilities	1,712	151
Net cash provided by operating activities	4,443	24,179
Cash flows from investing activities:		
Payments made in connection with business acquisitions, net	(44,495)	
Purchases of equipment and leasehold improvements	(5,196)	(2,066)
Disposal of equipment and leasehold improvements		143
Net cash used in investing activities	(49,691)	(1,923)
Cash flows from financing activities:		
Proceeds from bank borrowings	76,981	35,500
Proceeds from issuance of common stock	2,307	1,833
Principal payments on bank borrowings	(51,509)	(43,500)
Payments of debt issuance costs	(611)	
Excess tax benefit from stock-based compensation	(809)	
Employees taxes paid upon vesting of restricted stock units	(331)	(1,357)
Net cash provided (used) in financing activities	26,028	(7,524)

Effect of exchange rate changes on cash and cash equivalents		6		
Net increase (decrease) in cash	$	(19,214)	$	14,732
Cash and cash equivalents at beginning of period		78,997		60,415
Cash and cash equivalents at end of period	$	59,783	$	75,147
Supplemental items:				
Cash paid during the period:				
Income taxes paid	$	2,611	$	2,942
Income tax refunds	$		$	1,356
Interest	$	1,776	$	1,625
Non-cash activities:				
Fair value of common shares issued for acquisition	$	17,661	$	
Fair value of earn-out payments related to Miconex acquisition	$	1,280		
Equipment and leasehold improvements purchased included in accounts payable	$	3,531	$	37

(See accompanying notes to condensed consolidated financial statements)

ULTRA CLEAN HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Organization and Significant Accounting Policies

Organization Ultra Clean Holdings, Inc. (the Company or UCT) was founded in November 2002 for the purpose of acquiring Ultra Clean Technology Systems and Service Inc. Ultra Clean Technology Systems and Service, Inc. was founded in 1991 by Mitsubishi Corporation and was operated as a subsidiary of Mitsubishi until November 2002, when it was acquired by UCT. UCT became a publicly traded company in March 2004. In June 2006, the Company completed the acquisition of Sieger Engineering, Inc. to enhance its position as a subsystem supplier to the semiconductor, research, flat panel, energy and medical equipment industries. Ultra Clean Technology (Shanghai) Co., Ltd and Ultra Clean Micro-Electronics Equipment (Shanghai) Co., Ltd. were established in 2005 and 2007, respectively, to facilitate the Company s operations in China. Ultra Clean Asia Pacific, Pte, Ltd. (Singapore) was established in fiscal year 2008 to facilitate the Company s operations in Singapore. In July 2012, UCT acquired American Integration Technologies LLC (AIT) to add to the Company s existing customer base in the semiconductor and medical spaces and to provide additional manufacturing capabilities. In November 2014, the Company launched Prototype Asia, its 3D printing business in Singapore, to develop additive manufacturing capabilities for the Company s customer base. In February 2015, UCT acquired Marchi Thermal Systems, Inc. (Marchi), a designer and manufacturer of specialty heaters, thermocouples and temperature controllers. Marchi delivers flexible heating elements and thermal solutions to our customers. The Company believes heaters are increasingly critical in equipment design for the most advanced semiconductor nodes. In July 2015, UCT acquired MICONEX s.r.o. (Miconex), a privately-held provider of advanced precision fabrication of plastics, primarily for the semiconductor industry that, initially, is expected to expand the Company s capabilities with existing customers.

The Company is a global leader in the design, engineering, and manufacture of production tools, modules and subsystems for the semiconductor capital equipment industry and industry segments with similar requirements including consumer, medical and flat panel display. The Company focuses on providing specialized engineering and manufacturing solutions for these applications. The Company enables its customers to realize lower manufacturing costs and reduced design-to-delivery cycle times while maintaining high quality standards.

The Company provides its customers with complete solutions that combine its expertise in design, scan, assembly, test and component characterization. The Company s customers value its highly flexible global manufacturing operations, its excellence in quality control and its scale and financial stability. The Company s global footprint enables the Company to reduce manufacturing costs and design-to-delivery cycle times and maintains high quality standards for the Company s customers. The Company believes that these characteristics allow the Company to provide global solutions for its customers growing product demands. The Company ships the majority of its products to U.S. registered customers with locations both in and outside the U.S. In addition to its U.S. manufacturing capabilities, the Company manufactures products in its Asian facilities to support local and U.S. based customers. The Company conducts its operating activities primarily through its wholly owned subsidiaries, Ultra Clean Technology Systems and Service, Inc., AIT LLC, Ultra Clean Technology (Shanghai) Co., Ltd., Ultra Clean Micro-Electronics Equipment (Shanghai) Co., Ltd., Ultra Clean Asia Pacific, Pte Ltd. (Singapore), Marchi and Miconex. The Company s international sales represented 35.6% and 30.7% of total sales for the three months ended September 25, 2015 and September 26, 2014, respectively, and 33.3% and 29.5% of total sales for the nine months ended September 25, 2015 and September 26, 2014, respectively. See Note 10 to the Company s Condensed Consolidated Financial Statements for further information about the Company s geographic areas.

Basis of Presentation The unaudited condensed consolidated financial statements included in this quarterly report on Form 10-Q include the accounts of the Company and its wholly-owned subsidiaries and have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). This financial information reflects all adjustments which are, in the opinion of the Company, normal, recurring and necessary for the fair financial statement presentation for the dates and periods presented. Certain information and footnote disclosures normally included in our annual financial statements, prepared in accordance with GAAP, have been condensed or omitted. The Company s December 26, 2014 balance sheet data were derived from its audited financial statements as of that date.

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Principles of Consolidation The Company s condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and all intercompany accounts and transactions have been eliminated in consolidation. The Company uses a 52-53 week fiscal year ending on the Friday nearest December 31. All references to quarters refer to fiscal quarters and all references to years refer to fiscal years.

Foreign Currency Translation and Remeasurement The Company has one foreign subsidiary whose functional currency is not its local currency or the U.S. dollar. The Company remeasures the monetary assets and liabilities of this subsidiary into its functional currency. Gains and losses from these remeasurements are recorded in interest and other income (expense), net. The Company then translates the assets and liabilities of this subsidiary into the US dollar. Gains and losses from these translations are recognized in foreign currency translation included in the accumulated other comprehensive income (AOCI) in stockholders equity. For the Company s foreign subsidiaries where the U.S. dollar is the functional currency, any gains and losses resulting from the translation of the assets and liabilities of these subsidiaries are recorded in interest and other income (expense), net.

Use of Accounting Estimates The presentation 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 disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates and assumptions include reserves on accounts receivable and inventory, valuation of deferred tax assets and impairment of goodwill and other long-lived assets. The Company bases its estimates and judgments on historical experience and on various other assumptions that it believes are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments may require adjustment. Actual amounts may differ from those estimates.

Certain Significant Risks and Uncertainties The Company operates in a dynamic industry and, accordingly, can be affected by a variety of factors. For example, any of the following areas could have a negative effect on the Company in terms of its future financial position, results of operations or cash flows: the general state of the global economy, the highly cyclical nature of the industries the Company serves; the loss or bankruptcy of any customers within the Company s small customer base; ability to obtain additional financing if needed; inability to meet certain debt covenants; failure to successfully integrate completed acquisitions; ineffectiveness in pursuing acquisition opportunities; regulatory changes; fundamental changes in the technology underlying semiconductor, flat panel, solar and medical device manufacturing processes or manufacturing equipment that the Company fails to be prepared for; the hiring, training and retention of key employees; successful and timely completion of product design efforts; and new product design introductions by competitors.

Concentration of Credit Risk Financial instruments which subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. The Company sells its products primarily to semiconductor capital equipment manufacturers in the United States. The Company performs credit evaluations of its customers financial condition and generally requires no collateral.

Significant sales to customers The Company s most significant customers (having accounted for 10% or more of sales) and their related sales as a percentage of total sales were as follows:

	Three months ended		**Nine months ended**	
	September 25, 2015	**September 26, 2014**	**September 25, 2015**	**September 26, 2014**

Lam Research Corporation	49.4%	39.3%	50.4%	36.0%
Applied Materials, Inc.	26.4	20.9	27.1	22.0
ASM International	*	13.9	*	17.0
Total	75.8%	74.1%	77.5%	75.0%

* Total sales for the period are below 10%.

Three customers accounts receivable balances, Applied Materials, Inc., Lam Research Corporation and ASM International, were individually greater than 10% of accounts receivable as of September 25, 2015 and December 26, 2014 and in the aggregate represented approximately 79.9% and 73.7% of accounts receivable, respectively.

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Fair Value of Measurements The Company measures its cash equivalents, foreign currency and interest rate derivative contracts at fair value on a recurring basis. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or a liability. Assets and liabilities recorded at fair value are measured and classified in accordance with a three-tier fair value hierarchy based on the observability of the inputs available in the market used to measure fair value:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs that are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant inputs are observable in the market or can be derived from observable market data. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and credit ratings.

Level 3 Unobservable inputs that are supported by little or no market activities.

The fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Derivative Financial Instruments The Company recognizes derivative instruments as either assets or liabilities in the accompanying Consolidated Balance Sheets at fair value. The Company records changes in the fair value of the derivatives in the accompanying Condensed Consolidated Statements of Income as interest and other income, net, or as a component of AOCI in the accompanying Condensed Consolidated Balance Sheets.

Inventories Inventories are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market. The Company evaluates the valuation of all inventories, including raw materials, work-in-process, finished goods and spare parts on a periodic basis. Obsolete inventory or inventory in excess of management s estimated usage is written-down to its estimated market value less costs to sell, if less than its cost. Inherent in the estimates of market value are management s estimates related to economic trends, future demand for products, and technological obsolescence of the Company s products.

Inventory write downs inherently involve judgments as to assumptions about expected future demand and the impact of market conditions on those assumptions. Although the Company believes that the assumptions it used in estimating inventory write downs are reasonable, significant changes in any one of the assumptions in the future could produce a significantly different result. There can be no assurances that future events and changing market conditions will not result in significant increases in inventory write downs.

Equipment and Leasehold Improvements Equipment and leasehold improvements are stated at cost, or, in the case of equipment under capital leases, the present value of future minimum lease payments at inception of the related lease. Depreciation and amortization are computed using the straight-line method over the lesser of the estimated useful lives of the assets or the terms of the leases. Useful lives range from three to fifteen years.

Product Warranty The Company provides warranties on its products for a period of up to two years and provides for warranty costs at the time of sale based on historical activity. The determination of such provisions requires the Company to make estimates of product return rates and expected costs to repair or replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from these estimates,

adjustments to cost of sales may be required in future periods. Components of the reserve for warranty costs consisted of the following (in thousands):

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	Nine months ended	
	September 25, 2015	September 26, 2014
Beginning balance	$ 109	$ 101
Change in reserve	300	97
Warranty costs incurred in the current period	(225)	(85)
Ending balance	$ 184	$ 113

Income Taxes The Company utilizes the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. Deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, which will result in taxable or deductible amounts in the future. In evaluating our ability to realize our deferred tax assets within the jurisdiction from which they arise, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax-planning strategies, and results of recent operations. In projecting future taxable income, we begin with historical results and incorporate assumptions about the amount of future state, federal, and foreign pretax operating income adjusted for items that do not have tax consequences. The assumptions about future taxable income require significant judgment and are consistent with the plans and estimates we are using to manage the underlying businesses. In evaluating the objective evidence that historical results provide, we consider recent cumulative income (loss). A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized.

The Company continued to maintain a full valuation allowance on its California, Oregon, and one of its Chinese subsidiaries deferred tax amounts as of September 25, 2015 totaling $3.2 million. Income tax positions must meet a more likely than not recognition threshold to be recognized. Income tax positions that previously failed to meet the more likely than not threshold are recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more likely than not threshold are derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits within the consolidated statements of income as income tax expense. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with the Company s expectations could have a material impact on its results of operations and financial position. Management believes that it has adequately provided for any adjustments that may result from these examinations; however, the outcome of tax audits cannot be predicted with certainty.

The determination of the Company s tax provision is subject to judgments and estimates.

Revenue Recognition Product revenue is generally recorded upon shipment. When arrangements specify title transfer upon delivery, revenue is not recognized until the product is delivered. The Company recognizes revenue when persuasive evidence of an arrangement exists, shipment has occurred, price is fixed or determinable and collectability is reasonably assured. If the Company has not substantially completed a product or fulfilled the terms of a sales agreement at the time of shipment, revenue recognition is deferred until fulfillment. The Company s standard arrangement for its customers includes a signed purchase order or contract, no right of return of delivered products and no customer acceptance provisions. The Company assesses collectability based on the credit worthiness of the customer and past transaction history. The Company continually performs credit evaluations of its customers and, if necessary, may require collateral from its customers.

Research and Development Costs Research and development costs are expensed as incurred.

Net Income per Share Basic net income per share is computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted net income per share is calculated by dividing net income by the weighted average number of common shares outstanding and common equivalent shares from dilutive stock options and restricted stock using the treasury stock method, except when such shares are anti-dilutive. See Note 8 to the Company s Condensed Consolidated Financial Statements).

Segments The Financial Accounting Standards Board s (FASB) guidance regarding disclosure about segments in an enterprise and related information establishes standards for the reporting by public business enterprises of information about reportable segments, products and services, geographic areas, and major customers. The method for determining what information to report is based on the manner in which management organizes the reportable segments within the Company for making operational decisions and assessments of financial performance. The Company s chief operating decision-maker is considered to be the Chief Executive Officer. The Company operates in one reporting segment.

Business Combinations The Company recognizes assets acquired (including goodwill and identifiable intangible assets) and liabilities assumed at fair value on the acquisition date. Subsequent changes to the fair value of such assets acquired and liabilities assumed are recognized in earnings, after the expiration of the measurement period, a period not to exceed 12 months from the acquisition date. Acquisition-related expenses and acquisition-related restructuring costs are recognized in earnings in the period in which they are incurred.

Stock-Based Compensation Expense

The Company maintains stock-based compensation plans which allow for the issuance of equity-based awards to executives, directors and certain employees. These equity-based awards include stock options, restricted stock awards (RSAs) and restricted stock units (RSUs) which can be either time-based or performance-based. The Company also maintains an employee stock purchase plan that provides for the issuance of shares to all eligible employees of the Company at a discounted price.

Stock-based compensation expense includes compensation costs related to estimated fair values of stock options and awards granted. The estimated fair value of the Company s equity-based awards, net of expected forfeitures, is amortized on a straightline basis over the awards vesting period, typically four years for stock options, three years for RSUs and one year for RSAs, and is adjusted for subsequent changes in estimated forfeitures related to all equity-based awards and performance as it relates to performance-based RSUs.

The Company applies the fair value recognition provisions based on the FASB s guidance regarding stock-based compensation. The exercise price of each stock option equals the market price of the Company s stock on the date of grant. Most options are scheduled to vest over four years and expire no later than ten years from the grant date. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding certain variables. These variables include the expected term of the awards; the Company s expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, the risk-free interest rate and expected dividends. The Company estimates the expected term of share-based awards granted based on the Company s historical option term experience. The Company estimates the volatility of its common stock based upon the Company s historical stock price volatility over the length of the expected term of the options. The Company bases the risk-free interest rate that it uses in the option valuation model on U.S. Treasury zero-coupon issues with remaining maturities similar to the expected term of the options. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records share-based compensation expense only for those awards that are expected to vest. The Company also considers, each quarter, whether there have been any significant changes in facts and circumstances that would affect its estimated forfeiture rate.

Stock Options

Stock option activity for the nine months ended September 25, 2015:

	Shares	Weighted Average Exercise Price	Weighted Remaining Contractual	Aggregate Intrinsic Value (in

				Life (years)		thousands)
Outstanding at December 26, 2014	853,551	$	8.87	1.35	$	1,798
Granted						
Exercised	(339,303)	$	6.48			
Canceled	(197,600)	$	11.18			
Outstanding at September 25, 2015	316,648	$	10.01	2.31	$	234,133
Options exercisable at September 25, 2015	316,648	$	10.01	2.31	$	234,133

There were no options granted by the Company during either of the nine month periods ended September 25, 2015 and September 26, 2014. As of September 25, 2015, there was no stock-based compensation expense attributable to stock options as all outstanding options were fully vested.

Employee Stock Purchase Plan

The Company also maintains an employee stock purchase plan (ESPP) that provides for the issuance of shares to all eligible employees of the Company at a discounted price. Under the ESPP, substantially all employees may purchase the Company s common stock through payroll deductions at a price equal to 95 percent of the fair market value of the Company s stock at the end of each applicable purchase period.

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Restricted Stock Units and Restricted Stock Awards

The Company grants RSUs to employees and RSAs to non-employee directors as part of the Company s long term equity compensation plan.

Restricted Stock Units RSUs are granted to employees with a per share or unit purchase price of zero dollars and either have time based or performance based vesting. RSUs typically vest over three years, subject to the employee s continued service with the Company. For purposes of determining compensation expense related to these RSUs, the fair value is determined based on the closing market price of the Company s common stock on the date of award. The expected cost of the grant is reflected over the service period, and is reduced for estimated forfeitures.

During the quarter ended March 27, 2015, the Company granted 456,500 RSU s, with a weighted average fair value of $8.68 per share, and granted 90,500 performance stock units with a weighted average fair value of $8.35 per share. During the quarter ended June 26, 2015, the Company granted 134,000 RSU s, with a weighted average fair value of $6.53 per share. The Company granted 103,500 RSU s with a weighted average fair value of $6.71 per share during the quarter ended September 25, 2015.

During the nine months ended September 25, 2015, 39,938 vested shares were withheld to satisfy withholding tax obligations, resulting in the net issuance of 337,443 shares. As of September 25, 2015, approximately $ 6.8 million of stock-based compensation cost, net of estimated forfeitures, related to RSU s remains to be amortized over a weighted average period of 2.1 years. As of September 25, 2015, a total of 1,277,741 RSU s remain outstanding with an aggregate fair value of $6.8 million and a weighted average remaining contractual term of 1.3 years.

Restricted Stock Awards As of September 25, 2015, a total of 48,000 RSAs were outstanding. The total unamortized expense of the Company s unvested restricted stock awards as of September 25, 2015, was $ 0.2 million.

The following table summarizes the Company s RSU and RSA activity for the nine months September 25, 2015:

	Shares	**Aggregate Fair Value (in thousands)**
Unvested restricted stock units and restricted stock awards at December 26, 2014	1,078,279	$ 9,673
Granted	840,500	
Vested	(424,381)	
Forfeited	(216,657)	
Unvested restricted stock units and restricted stock awards at September 25, 2015	1,277,741	$ 6,800
Vested and expected to vest restricted stock units and restricted stock awards at September 25, 2015	1,076,186	$ 5,686

The following table shows the Company s stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

	Three months ended		Nine months ended	
	September 25, 2015	**September 26, 2014**	**September 25, 2015**	**September 26, 2014**
Cost of sales (1)	$ 304	$ 267	$ 908	$ 862
Research and development	658	100	1,247	245
Sales and marketing	49	119	150	334
General and administrative	103	671	302	1728
	1,114	1,157	2,607	3,169
Income tax benefit	(310)	(226)	(746)	(1,056)
Net stock-based compensation expense	$ 804	$ 931	$ 1,861	$ 2,113

(1) Stock-based compensation expenses capitalized in inventory for the three and nine month periods ended September 25, 2015 and September 26, 2014 were considered immaterial.

Recent Accounting Pronouncements

In September 2015, the Financial Accounting Standards Board (FASB) issued updated guidance on the accounting for purchase accounting adjustments determined during the measurement period (i.e. up to one year after the acquisition). The new guidance requires an acquirer to recognize such adjustments in the reporting period in which the adjustment amounts are determined. Previously, such adjustments were required to be recorded on a retrospective basis. The Company has elected to early adopt this guidance beginning in the third quarter 2015 on a prospective basis. The adoption of this guidance did not have a significant impact on the condensed consolidated financial statements.

In July 2015, the FASB issued authoritative guidance that requires inventory to be measured at the lower of cost and net realizable value instead of at lower of cost or market. This guidance does not apply to inventory that is measured using last-in, first out (LIFO) or the retail inventory method but applies to all other inventory including those measured using first-in, first-out (FIFO) or the average cost method. The authoritative guidance will be effective for the Company in the first quarter of fiscal 2018 and should be applied prospectively. Early adoption is permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the effect of this new guidance on the Company s consolidated financial statements.

In April 2015, the FASB issued authoritative guidance that requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability, consistent with debt discounts. The authoritative guidance is effective for the Company in the first quarter of fiscal 2017 and should be applied retrospectively. Early adoption is permitted. The adoption of this guidance is not expected to have a significant impact on the Company s consolidated financial statements.

2. Financial Instruments

Cash Equivalents

The Company has an overnight sweep account invested in money market funds with maturities of less than 90 days from purchase and is thus classified as cash and cash equivalents on the Company s balance sheet. These money market funds had a carrying value and fair value of $0.3 million at September 25, 2015 based on Level 1 inputs.

Derivative Financial Instruments

A subsidiary of the Company, Miconex, utilizes foreign currency forward contracts with a local financial institution to reduce the risk that its cash flows and earnings will be adversely affected by foreign currency exchange rate fluctuations. The Company also uses certain interest rate derivative contracts to hedge interest rate exposures on existing floating rate debt. The Company classifies its foreign currency and interest rate derivative contracts primarily within Level 2 of the fair-value hierarchy discussed in Note 1of the Company s Condensed Consolidated Financial Statements as the valuation inputs are based on quoted prices and market observable data of similar instruments.

Cash Flow Hedges

In September 2015, the Company entered into an interest rate swap with East West and City National banks with a notional amount of $20.0 million pursuant to which the Company pays the counterparty a fixed rate of 0.99% and receives interest at a variable rate equal to the LIBOR rate the Company is required to pay under its term loan, or 0.2%, as of September 25, 2015. This interest rate swap effectively locks in a fixed interest rate of 3.49% on $20.0 million of the $37.5 million term loan balance outstanding as of September 25, 2015, with a decreasing notional amount based on prorated quarterly principal payments over the remaining period of the term loan. Gains or losses on

the effective portion of a cash flow hedge are reflected as a component of AOCI and subsequently recorded to interest income (expense) when the hedged transactions are realized. If the hedged transactions become probable of not occurring, the corresponding amounts in AOCI would be immediately reclassified to interest and other income, net. As of September 25, 2015, the effective portion of the Company s cash flow hedge before tax effect was $0.1 million, of which $0.1 million is expected to be reclassified from AOCI into earnings within the next 12 months.

Non-Designated Derivatives

Miconex derivatives are not designated as hedging instruments and consist of: a) forward contracts that Miconex uses to hedge forecasted transactions that are denominated in currencies other than the local currency of Miconex, and b) an interest rate swap with a total notional amount of $0.5 million to convert the variable interest rates on Miconex debt to fixed interest rates. The Company recognizes gains and losses on these contracts, as well any related costs in interest and other income, net. The notional principal of foreign exchange contracts outstanding was $1.3 million as of September 25, 2015 and $0 as of December 26, 2014.

The Company records all derivatives in the Condensed Consolidated Balance Sheets at fair value. The Company s accounting treatment for these derivative instruments is based on its hedge designation. The following tables show the Company s derivative instruments at gross fair value (in thousands) as of September 25, 2015. There were no derivative instruments as of December 26, 2014.

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	Balance Sheet Location	September 25, 2015 Fair Value of Derivatives Designated as Hedge Instruments	September 25, 2015 Fair Value of Derivatives Not Designated as Hedge Instruments	Total Fair Value
Derivative liabilities				
Level 2				
Foreign exchange contracts	Deferred rent and other liabilities	$	$ 12	$ 12
Interest rate swap	Deferred rent and other liabilities	$ 91	$ 10	$ 101

The effect of derivative instruments in cash flow hedging relationships on income and other comprehensive income (OCI) is summarized below (in thousands):

	Gains (Losses) Recognized in OCI on Derivatives Before Tax Effect (Effective Portion)			
	Three Months Ended		Nine Months Ended	
	September 25, 2015	September 26, 2014	September 25, 2015	September 26, 2014
Derivatives in Cash Flow Hedging Relationship				
Interest rate swap	$ 87	$	$ 87	$

	Gains Reclassified from AOCI into Income (Effective Portion)				
		Three Months Ended		Nine Months Ended	
	Income Statement Location	September 25, 2015	September 26, 2014	September 25, 2015	September 26, 2014
Derivatives in Cash Flow Hedging Relationship					
Interest rate swap	Interest and other income (expense), net	$ 4	$	$ 4	$

There were no gains (losses) recognized in income on derivatives that are excluded from the effectiveness testing and ineffective portion of the cash flow hedge for the three and nine months ended September 25, 2015 and September 26, 2014.

The effect of derivative instruments not designated as hedging instruments on income for the three and nine months ended September 25, 2015 and September 26, 2014 is immaterial to the financial statements.

3. Balance Sheet Information

Inventory consisted of the following (in thousands):

	September 25, 2015	December 26, 2014
Raw materials	$ 60,484	$ 45,294
Work in process	18,741	14,103
Finished goods	4,111	3,922
	83,336	63,319
Reserve for excess and obsolete	(7,772)	(6,469)
Total	$ 75,564	$ 56,850

Equipment and leasehold improvements, net, consisted of the following (in thousands):

	September 25, 2015	December 26, 2014
Computer equipment and software	$ 10,989	$ 9,299
Furniture and fixtures	6,076	2,582
Machinery and equipment	15,467	10,774
Leasehold improvements	12,853	12,847
	45,385	35,502
Accumulated depreciation	(28,417)	(24,661)
Total	$ 16,968	$ 10,841

4. Acquisitions

Miconex

On July 31, 2015, the Company acquired 100.0% of the shareholding interest of Miconex, a limited liability company incorporated under the laws of the Czech Republic and a provider of advanced precision fabrication of plastics, primarily for the semiconductor industry. This acquisition is expected to expand the Company s capabilities with existing customers. Pursuant to the purchase agreement, the Company paid $15.0 million in cash and issued 500,000 shares of the Company s common stock. In addition, the former owners of Miconex are entitled to up to $4.0 million of potential cash earn-out payments over a two-year period following closing, based on Miconex s achievement of specified performance targets based on EBIT (earnings before interest and taxes) pursuant to the provisions of the purchase agreement. The preliminary estimated acquisition price of Miconex for purposes of the Company s preliminary purchase price allocation was determined to be $20.1 million, which includes the cash payment of $15.0 million, the stock consideration valued at $3.8 million, and the fair value of the potential earn-out payments of approximately $1.3 million.

The fair value of the common stock issued was determined based on the average of the high and low trading prices per share of the Company s common stock on the acquisition date of approximately $7.64 per share. The fair value of the earn-out payments at the acquisition date was determined providing risk adjusted earnings projections using the Monte Carlo Simulation. These inputs are not observable in the market and thus represent a Level 3 measurement as discussed in Note 1 of the Company s Condensed Consolidated Financial Statements. As of September 25, 2015, there were no significant changes in the fair value of the earn-out.

The Company preliminarily allocated the purchase price of Miconex to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. The excess of the purchase price over the aggregate fair value was recorded as goodwill. Goodwill associated with this acquisition is primarily attributable to future technology, market presence and knowledgeable and experienced workforce. The fair value assigned to identifiable intangible assets acquired was determined using the income approach taking into account the Company s consideration of a number of inputs, including an independent third party analysis that was based upon estimates and assumptions provided by the Company. These estimates and assumptions were determined through established and generally accepted valuation techniques.

The primary areas of the preliminary purchase price allocation yet to be finalized relate to the fair value of certain tangible assets and liabilities acquired, income and non-income based taxes and residual goodwill.

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During the measurement period, which can be no more than one year from the date of acquisition, we expect to continue to obtain information to assist us in determining the final fair value of the net assets acquired at the acquisition date. The preliminary purchase price for this acquisition has been allocated as follows:

Fair Market Values (in thousands)	
Cash and cash equivalents	$ 239
Accounts receivable	3,065
Inventories	6,198
Deferred tax assets	196
Prepaid expenses and other	214
Equipment and leasehold improvements	428
Goodwill	10,197
Purchased intangible assets	8,800
Total assets acquired	29,337
Bank borrowings	(3,027)
Accounts payable	(3,509)
Accrued compensation and related benefits	(432)
Other current liabilities	(576)
Deferred tax liability	(1,672)
Other liabilities	(24)
Total liabilities assumed	(9,240)
Purchase price allocated	$ 20,097

	Useful Life (In years)	**Purchased Intangible Assets (In thousands)**
Customer relationships	7.5	$ 8,800

Goodwill is not amortized but is reviewed for impairment at least annually and whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Although goodwill is not amortized for financial accounting purposes, it is amortized in its entirety for tax purposes over fifteen years.

The results of operations for the Company for the three and nine month periods ended September 25, 2015 include two months of operating activity for Miconex. For the three and nine months ended September 25, 2015, net sales of approximately $5.2 million and operating income of approximately $0.4 million attributable to Miconex were included in the consolidated results of operations. For the three and nine months ended September 25, 2015, results of operations included charges of $0.2 million attributable to amortization of purchased intangible assets and $0.4 million of deal costs associated with the acquisition. Deal costs are included in general and administrative expenses in the Company s Condensed Consolidated Statements of Operations.

Marchi

On February 5, 2015, the Company acquired 100.0% of the shareholding interest of Marchi, a designer and manufacturer of specialty thermocouples, heaters and temperature controllers, for approximately $29.9 million in cash and 1,437,500 shares of newly issued common stock for a total purchase price of approximately $43.7 million. In addition, the Company incurred approximately $0.2 million of costs related to the acquisition. The Company completed this acquisition primarily in order to expand its capabilities with existing customers and to bring the Company closer to the customer in the design stage of new products and next generation equipment. The Company financed the cash portion of the acquisition by borrowing a total of $29.7 million under a new Credit Agreement. See further discussion of the borrowing arrangements in Note 6 to the Company s Condensed Consolidated Financial Statements.

The Company allocated the preliminary purchase price of Marchi to the tangible assets, liabilities and identifiable intangible assets acquired, based on their estimated fair values. The excess of purchase price over the aggregate fair value was recorded as goodwill. Goodwill associated with the Marchi acquisition is primarily attributable to the future technology, market presence and knowledgeable and experienced workforce. The fair value assigned to identifiable intangible assets acquired was determined using the income approach taking into account the Company s consideration of a number of inputs, including an independent third party analysis that was based upon estimates and assumptions provided by the Company. These estimates and assumptions were determined

through established and generally accepted valuation techniques. The estimated fair value of the tangible and intangible assets acquired was allocated at Marchi s acquisition date. The primary areas of the preliminary purchase price allocation that are not yet finalized relate to the fair values of inventory, non-income based taxes and residual goodwill.

During the measurement period, which can be no more than one year from the date of acquisition, we expect to continue to obtain information to assist us in determining the final fair value of the net assets acquired at the acquisition. The preliminary purchase price for this acquisition has been allocated as follows:

Fair Market Values (in thousands)	
Inventories	$ 1,297
Equipment and leasehold improvements	767
Goodwill	18,380
Purchased intangible assets	23,370
Other non-current assets	26
Total assets acquired	43,840
Other liabilities	(100)
Total liabilities assumed	(100)
Purchase price allocated	$ 43,740

	Useful Life (In years)	**Purchased Intangible Assets (In thousands)**
Customer relationships	10	$ 9,900
Trade name	6	1,170
Intellectual properties/know-how	8-12	12,300
Total purchased intangible assets		$ 23,370

The results of operations for the Company for the nine month period ended September 25, 2015 include eight full months of operating activity for Marchi. For the three and nine months ended September 25, 2015, net sales of approximately $3.9 million and $10.1 million, respectively and operating income of approximately $1.7 million and $4.4 million, respectively attributable to Marchi were included in the consolidated results of operations. For the three and nine months ended September 25, 2015, results of operations included charges of $0.7 million and $1.7 million, respectively, attributable to amortization of purchased intangible assets and $0.2 million of deal costs associated with the acquisition. Deal costs are included in general and administrative expenses in the Company s consolidated results of operations. The following unaudited pro forma consolidated results of operations assume the Marchi and Miconex acquisitions were completed as of the beginning of the year of the reporting periods presented (in thousands, except per share amounts):

	Three Months Ended		Nine Months Ended	
	September 25, 2015	September 26, 2014	September 25, 2015	September 26, 2014
Net sales	$ 127,348	$ 126,857	$ 386,889	$ 428,703
Net income	$ 1,560	$ (4,301)	$ 6,049	$ 11,414
Basic earnings per share	$ 0.05	$ (0.14)	$ 0.19	$ 0.37
Diluted earnings per share	$ 0.05	$ (0.14)	$ 0.19	$ 0.36

The unaudited pro forma results above include adjustments related to the purchase price allocation and financing of the Marchi and Miconex acquisitions, primarily to increase amortization for the identifiable intangible assets, to increase interest expense for the additional debt incurred to complete the acquisition of Marchi, to reflect the related income tax effect of the pro forma adjustments and to adjust weighted shares issued as part of the acquisitions. The unaudited pro forma results for the three and nine months ended September 25, 2015 include acquisitions related costs of $0.6 million which are not expected to occur in future quarters. The unaudited pro forma condensed combined financial information has been prepared by management for illustrative purposes only and are not necessarily indicative of the condensed consolidated financial position or results of income in future periods or the results that actually would have been realized had UCT, Marchi and Miconex been a combined company during the specified periods. The unaudited pro forma condensed combined financial information does not reflect any operating efficiencies and/or cost savings that we may achieve with respect to the combined companies, or any liabilities that may result from integration activities.

5. Goodwill and Purchased Intangible Assets

The Company s methodology for allocating the purchase price relating to acquisitions is determined through established and generally accepted valuation techniques. Goodwill is measured as the excess of the cost of the acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. The Company assigns assets acquired (including goodwill) and liabilities assumed to one or more reporting units as of the date of acquisition. Typically, acquisitions relate to a single reporting unit and thus do not require the allocation of goodwill to multiple reporting units. If the products obtained in an acquisition are assigned to multiple reporting units, the goodwill is distributed to the respective reporting units as part of the purchase price allocation process. Goodwill and purchased intangible assets with indefinite useful lives are not amortized, but are reviewed for impairment at least annually and whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. The Company regularly monitors current business conditions and other factors including, but not limited to, adverse industry or economic trends and lower projections of profitability that may impact future operating results.

To test goodwill for impairment, the Company first performs a qual