
— PARTICIPANTS

Corporate Participants

Joe Shiffler – Director-Investor Relations & Communications
Balu Balakrishnan – President, Chief Executive Officer & Director
Sandeep Nayyar – Chief Financial Officer & Vice President

Other Participants

Tore Svanberg – Analyst, Stifel, Nicolaus & Co., Inc.
Andrew Huang – Analyst, Sterne, Agee & Leach, Inc.
J. Steven Smigie – Analyst, Raymond James & Associates
Vernon P. Essi – Analyst, Needham & Co. LLC
Sumit Dhanda – Analyst, International Strategy & Investment Group, Inc.
Gus P. Richard – Analyst, Piper Jaffray, Inc.
Chris J. Longiaru – Analyst, Sidoti & Co. LLC

— MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Power Integrations Second Quarter Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Mr. Joe Shiffler. You may begin.

Joe Shiffler, Director-Investor Relations & Communications

Thank you. Good afternoon, and thanks for joining us to discuss Power Integrations' financial results for the second quarter of 2012. With me on the call are Balu Balakrishnan, President and CEO of Power Integrations; and Sandeep Nayyar, our Chief Financial Officer.

During today's call, we will refer to financial measures not calculated according to generally accepted accounting principles. Please refer to today's press release, available on our website at investors.powerint.com, for an explanation of our reasons for using such non-GAAP measures, as well as tables reconciling these measures to our GAAP results.

Also, our discussion today, including the Q&A session, will include forward-looking statements reflecting management's current forecast of certain aspects of the company's future business. Forward-looking statements are denoted by such words as will, would, believe, should, expect, outlook, estimate, plan, goal, anticipate, project, potential, scheduled, forecast, and similar expressions that look toward future events or performance.

Forward-looking statements are based on current information that is, by its nature, dynamic and subject to rapid and even abrupt changes. Our forward-looking statements are subject to risks and uncertainties which may cause actual results to differ materially from those projected or implied in our statements. Such risks and uncertainties are discussed in today's press release and under the caption, Item 1A, Risk Factors, in Part 2 of our most recent Form 10-Q filed with the Securities and Exchange Commission on May 8, 2012.

This conference call is the property of Power Integrations, and any recording or rebroadcast of this conference call is expressly prohibited without the written consent of Power Integrations.

And now I'll turn the call over to Balu.

Balu Balakrishnan, President, Chief Executive Officer & Director

Thanks, Joe, and good afternoon. Like many of our peers, we are experiencing a soft patch in demand driven by global macroeconomic conditions. After relatively healthy orders through the month of May, bookings slowed significantly in June, accompanied by a decrease in distributor sell-through, suggesting that demand had softened or, at the very least, that the end customers had become more cautious about taking on inventory in the face of uncertain demand conditions.

The slowdown was most pronounced in the consumer market, which is our largest end market, at about 40% of sales. Although we saw solid sequential growth in consumer appliances, revenues from consumer electronics applications declined at double-digit rate sequentially, resulting in a mid-single-digit decrease for the overall consumer market. Communications revenues were also down mid-single-digits as a result of weakness at specific end customers in the mobile phone market.

We did see continued strength in the industrial end market, which grew at a double-digit rate sequentially, excluding Concept, driven by LED lighting, metering, and industrial control applications, among others. Including the impact of Concept acquisition, industrial revenues increased nearly 50% sequentially.

Revenues from computer end market grew mid-single-digits sequentially on strength in desktops, including both standby applications and the continuing ramp of high-power products for desktop main power supplies.

All told, second quarter revenues were \$76.4 million, up 6% sequentially and roughly flat excluding the impact of the Concept acquisition, which closed on May 1.

While revenue came in below expectations, non-GAAP gross margin was up more than three percentage points sequentially, thanks to continued execution on our cost reduction efforts plus a more favorable end-market mix reflecting the relative strength of industrial and consumer appliance applications.

Of course, changes in mix can be transitory in the short term, and we do expect a slightly less favorable mix in the second half of this year as we ramp new designs in lower-margin markets like mobile phone chargers.

But it's clear now that our efforts to grow revenues in markets like industrial and consumer appliances have resulted in a sustainable shift in our end-market mix. Whereas a decade ago, roughly two-thirds of our sales came from cell phone chargers and PCs, today nearly two-thirds of our revenues come from industrial and consumer applications where churn is lower, margins are higher, and the customers tend to place a greater value on factors like reliability and efficiency.

Overall, we are ahead of plan with respect to the gross margin trajectory we have discussed on recent conference calls, and we expect our non-GAAP gross margin to remain above the 50% benchmark for the balance of the year. A stronger gross margin combined with our new lower tax rate should enable us to continue delivering healthy earnings and cash flow, even in the event that demand remains muted.

Notwithstanding the near-term macro headwinds, we remain focused on the unique set of growth opportunities we have talked about over the past couple of years, including energy efficiency, LED lighting, and the expansion of our addressable market to include higher power levels.

Regarding energy efficiency, we are seeing increased design activity by customers working towards the new European limitation on standby consumption, which will be reduced from its current level of 1 watt down to 500 milliwatts beginning in 2013.

We are seeing particular interest in our Zero products, which target specific sources of standby consumption in appliances, computers, and a number of other applications, giving designers a convenient, cost-effective way to reduce waste and meet the tighter standards.

Standards development continues in the U.S. as well, including a rule-making process now underway at the California Energy Commission which will result in new standards for end products such as game consoles, displays, set-top boxes, and computers.

New ENERGY STAR specifications for TVs are scheduled to take effect next May, while Department of Energy is well on its way to enacting some of the world's tightest efficiency standards for external adapters and battery chargers.

The push for higher efficiency in chargers and adapters is especially noteworthy in light of rising power requirements for mobile devices. High efficiency and low standby consumption become more difficult to achieve cost-effectively as power levels rise, requiring ever more advanced power conversion products.

Two weeks ago, we launched LinkSwitch-HP, the latest in our LinkSwitch line of primary side control chips, with exactly this need in mind. Power Integrations pioneered primary side regulation with our original LinkSwitch more than a decade ago, and LinkSwitch remains the industry's leading primary side product line.

The key benefit of primary side control is the ability to sense the output of the power supply through the transformer, eliminating the need for unreliable, expensive optical feedback circuitry. Because these feedback components consume a meaningful amount of power, their elimination gives primary side control an inherent advantage when it comes to meeting stringent efficiency specs.

The key limitation of primary side control, until now, has been its lack of suitability above certain power levels where a high degree of accuracy is harder to achieve without feedback circuitry. LinkSwitch-HP breaks through this barrier with an unprecedented level of accuracy, enabling the use of primary side control in applications up to 90 watts of output, including adapters for such products as ultrabooks, tablets, set-top boxes, and LCD monitors, with exceptionally low no-load consumption of less than 30 milliwatts.

LED lighting continues to be another important growth driver for us, with double-digit sequential growth and more than 100 new design wins in the second quarter. We also saw strong growth in revenues from the 50- to 500-watt market, and we remain on track to roughly double sales of these products this year.

On May 1, we completed our acquisition of Concept, the latest step in our efforts to expand the addressable market to include higher power levels. Concept's IGBT drivers address all three phases of the clean power ecosystem: demand-side applications like industrial motor drives and electric vehicles, distribution applications such as high-voltage DC transmission systems, and generation applications such as solar and wind power systems.

Our integration of Concept is progressing well, and while demand for Concept products is not immune to the current macro-economic headwinds, we are encouraged by our interactions with

Concept customers since the acquisition and excited about the pace of design activity. Key design wins for Concept products in Q2 included a high-voltage DC transmission system in the U.K., a solar installation for the India market, and a locomotive application for China, all of which we expect to start production later this year.

With that, I'll turn the call over Sandeep for a review of the financials.

Sandeep Nayar, Chief Financial Officer & Vice President

Thanks, Balu and good afternoon. I will begin with tax, where we've had a significant development with positive implication for our financial model. As outlined in our press release, we have reached an agreement with the IRS that resolves our audit for the years 2003 to 2006, which has been ongoing for the past five years. The settlement validates the tax structure we put in place a decade ago and enables us to realize a substantial reduction in our future effective tax rate.

The key components of the settlement are as follows. First, during the September quarter, Power Integrations will make a one-time cash payment of \$42.6 million in taxes and interest. This amount is partially offset by previously accrued tax liabilities and valuation allowances, resulting in a net one-time charge of \$15.7 million, which we recognized in the June quarter. Approximately \$12.7 million of the charge is for taxes and \$3 million for interest.

Second, we expect our non-GAAP tax rate for 2012 to be approximately 13%, compared to our prior expectation of a rate in the high teens. On a GAAP basis, the full-year tax rate for 2012 will be north of 50% due to the one-time charge in Q2, but should be around 18% for the second half of the year. For 2013, we expect our tax rate to be in the high-single-digits on a GAAP and a non-GAAP basis.

Finally, the agreement will permit us to repatriate approximately \$102 million of earnings from our foreign subsidiary without further federal income tax consequences, which brings us a significant benefit in terms of financial flexibility.

The impact of the tax agreement on our second quarter results is as follows. First, the one-time charge of \$15.7 million resulted in a GAAP tax rate of 175% and a GAAP net loss of \$0.25 per share for the quarter.

Our non-GAAP tax rate, which excludes the charge, was 9% for the quarter, reflecting the benefit of the lower ongoing tax rate, plus an additional benefit to bring the rate for the first six months of the year into line with the 13% rate we now expect for the full year. Compared to our prior expectation of a rate in the high teens, the lower Q2 tax rate contributed approximately \$0.05 to our non-GAAP EPS, which came in at \$0.49 for the quarter.

The other major earnings driver in the quarter was gross margin, which came in at 51.9% on a non-GAAP basis, an increase of 310 basis points from the prior quarter. We have recovered 470 basis points of non-GAAP gross margin over the past three quarters, and we are now back up to the mid-2010 levels despite significant pressure from the stronger yen and higher gold prices over that timeframe.

Continuing on to expenses, non-GAAP operating expenses for the quarter were \$23.8 million, up \$1.2 million sequentially as a result of the Concept acquisition, but slightly below our expected range of \$24 million to \$25 million. Non-GAAP operating margin moved back above the 20% mark, coming in just under 21% for the quarter. GAAP operating expenses were \$28.3 million, up \$2.5 million sequentially, again reflecting the acquisition, including roughly \$700,000 of incremental amortization expenses related to intangible assets.

We had another excellent quarter in terms of cash flow. Cash flow from operations was \$27.7 million, bringing our six-month total to \$49.3 million. Capital expenditures were just \$1.3 million for the quarter, so we clearly had a great quarter in terms of free cash flow. In fact, cash and investments on the balance sheet totaled \$133 million at quarter end, a decrease of only \$81 million during the quarter despite the Concept acquisition.

Inventory remains well within our target range, totaling \$48.6 million at quarter end. The increase of \$5.7 million during the quarter was driven entirely by the acquisition, including roughly \$3 million of inventory write-up that remained to be amortized at quarter end.

Turning to the outlook, we expect revenues to be between \$76 million and \$82 million in the third quarter, and we expect non-GAAP gross margin to be about 51.5%, plus or minus 50 basis points. GAAP gross margin should be in the range of 48% to 49%. We expect non-GAAP operating expenses to be around \$25.2 million, plus or minus \$0.5 million, with the increase driven mainly by the additional month of Concept expenses plus some head count reductions at Concept

GAAP operating expenses should be in the range of \$30 million to \$31 million, including approximately \$4 million of stock-based compensation and \$1 million for amortization of intangibles. Lastly, I expect the non-GAAP effective rate to be around 13%, consistent with our revised expectations for the full year. The GAAP tax rate for the quarter should be around 18%.

With that, I will turn it back over to Joe.

Joe Shiffler, Director-Investor Relations & Communications

Thanks, Sandeep. We'll open it up for Q&A now. In the interest of time, I'd like to ask callers to adhere to a limit of two questions apiece on the first round, and then, time permitting, we'll be happy to come around for another round of questions. Operator, would you please give the instructions?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Tore Svanberg with Stifel, Nicolaus. Your line is open.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Yes, thank you. First question for Balu; Balu; could you talk, maybe more sort of from a linearity perspective, how your sell-through is going? Because obviously you guys recognize them on a sell-through basis through all your distributors, and after that slowdown you saw in June, I'm just wondering what you're seeing in July and so far in August?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Yeah, we don't get complete information on a monthly basis, but at the moment, inventory at our distributors is just about right, so my expectation would be most of what we sell in will go through.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Very good. And my follow-up question is for Sandeep. You mentioned, I believe, 9% tax rate for 2013. I'm just wondering, is this going to be the long-term rate for POWI, or is it going to be a little bit artificially low next year, just given this settlement you're just going through?

<A – Sandeep Nayyar – Power Integrations, Inc.>: Tore, actually, I said 13% for the year. It was 9% only for the quarter because of the catch-up benefit we got of the first quarter, so the non-GAAP tax rate for the year is 13%. For 2013 and going forward, we expect the rate to be in the high – non-GAAP and GAAP to be in the high-single-digits, so the 8%, 9% that you're talking about.

<A – Balu Balakrishnan – Power Integrations, Inc.>: And it is sustainable over the long term.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Great. Thank you very much. I'll go back in queue. Thanks.

Operator: Our next question comes from Andrew Huang of Sterne, Agee. Your line is open.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Thank you very much. I think your June quarter revenue guidance was \$78 million to \$84 million, and of that, you expected CT-Concept to contribute between \$4.3 million and \$5 million. So I'm wondering how much of the shortfall was due to just your organic business, or was CT-Concept a little bit lighter than you had expected?

<A – Sandeep Nayyar – Power Integrations, Inc.>: The CT-Concept revenue came in at about \$4.6 million against the previous year. I think the discussion we had about was \$5 million, so the majority of the shortfall did come in our part of business, but there was slight shortfall on the Concept side of the business too.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Got it. And then within the – if you don't mind me asking – the shortfall within your end markets, can you say which was the weakest relative to your expectations?

<A – Sandeep Nayyar – Power Integrations, Inc.>: Well, I think the major area that, as we had pointed out, is the weakness came in communications and as well as in consumer electronics is where we saw the weakness. And the macroeconomic conditions really attributed to that, though in the cell phone side, you could attribute that there was a little bit of a particular end customer where we had a more significant decline than we had normally expected. And this is one of the larger customers which is having challenges in the market, and if you looked at the last couple of quarters, we thought they had kind of stabilized a bit, but again, we saw a large, significant decline in that one end customer.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Got it. And then – sorry, go ahead.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Andrew, to be specific, this particular customer revenue came down 70% sequentially, and that pretty much accounts for the decline in the cell phone revenue.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Got it. Okay. And then, if you don't mind me asking, in your September quarter guidance, are your expectations for CT – do they remain unchanged? Should we stick with that – should we tweak the \$4.6 million of full quarter by, I guess, dividing by two and multiplying by three?

<A – Sandeep Nayyar – Power Integrations, Inc.>: The way I would look at it, that we expect to be, considering the macroeconomic and if you look in our guidance that we have given, it will be flat to slightly down to your math that you are doing.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Got it. Okay, thanks very much.

<A – Balu Balakrishnan – Power Integrations, Inc.>: You're welcome.

Operator: Our next question comes from Steven Smigie of Raymond James. Your line is open.

<Q – Steve Smigie – Raymond James & Associates>: Great, thank you. I was hoping you could talk a little bit about how we should be thinking about OpEx over the next few quarters. So revenue from the macro's come in a little bit – macro's caused revenue to come in a little bit lighter, and so are you guys seeking any actions to keep OpEx down over the next couple quarters?

<A – Sandeep Nayyar – Power Integrations, Inc.>: Well, as we had indicated one thing is that the real addition to our expenses going up in the next quarter is related to the full month – we only had two months of Concept in Q2; now, we'll have three. Plus, we are making some investments in Concept. The key thing as we bought Concept, we believe – yes, the macro-economic conditions that they have, but we believe for us to realize the true benefits, we have to make a little bit of investments in Concept, and we intend to continue to do that for the long-run benefit in that business. Now, the Q4 operating expenses should be – non-GAAP basis, should be similar to Q3.

<Q – Steve Smigie – Raymond James & Associates>: Okay. And then again on the gross margin front as we look forward, obviously, you already discussed the September, and the puts and takes of mix, but should we see that gross margin as we enter next year also remain above that 50%, and should we be seeing it generally march up over time as you get newer products mixing in? How we should we think about that?

<A – Sandeep Nayyar – Power Integrations, Inc.>: Well, I think as we talked about is that we have got some more design wins coming in on the lower-margin communications business, which should be ramping in Q4, so we talked about that impact happening in Q4. It's a little too early to talk about next year, but we're hopeful that we should be above our 50% mark.

<Q – Steve Smigie – Raymond James & Associates>: Okay, that's helpful.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Unless there is any drastic change in either exchange rate or the pricing and so on, we should stay above the 50% gross margin.

<Q – Steve Smigie – Raymond James & Associates>: Okay, great. I'll get back in the queue. Thank you.

Operator: Thank you. Our next question comes from Vernon Essi of Needham & Company. Your line is open.

<Q – Vernon Essi – Needham & Co. LLC>: Thank you very much. Balu, I was wondering if you could elaborate a little more on the LED market and what you're seeing out there. It sounds like things have picked back up. And I apologize; I don't know if I heard that correctly, but do anticipate your revenue to double again in 2012? Or you made a doubling comment there, and I just wanted to double-check that. Thanks.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Actually, we were projecting earlier in the year potentially a 50% increase in revenue, not 200%, but 50% from where we were last year. But, given the slowdown in the marketplace, I don't believe we're going to make 50%. We'll grow this year, but we don't know exactly how much we'll grow. But I don't believe it's going to be 50% because there is just a significant reduction in demand. However, from a design-in point of view, we are doing really well. As you saw, we said in the script that we added another 100 design wins in Q2.

<Q – Vernon Essi – Needham & Co. LLC>: Is there any reason for the robustness in the design win front, or is it just things keep going on the same trajectory they've been and just sort of the same trend line you've had in the past?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, the design wins are mainly because of the large number of small customers in this business, plus there is a lot of churn in terms of design. They keep coming up with newer products. But of course the macro economy determines the overall demand.

<Q – Vernon Essi – Needham & Co. LLC>: Okay. And then, again – I always ask this question, but is there any customer that's emerging as sort of a larger piece of your revenue or proportion of your revenue, or do you still feel it's fairly well-distributed across smaller customers at this point?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, clearly, we are seeing some of the large guys becoming more significant. And so we have, for example, design wins at Philips, Osram, and General Electric, Samsung, and so on and so forth. So, in the long term, we do expect this market to consolidate, but right now, it's going through a transition.

<Q – Vernon Essi – Needham & Co. LLC>: Okay. And just a quick follow-on, Sandeep, and I apologize if you had mentioned this in your prepared comments, but what was your backlog coverage for the guidance or your turn component for September?

<A – Sandeep Nayar – Power Integrations, Inc.>: It's roughly around 40%, a little over 40%.

<Q – Vernon Essi – Needham & Co. LLC>: Okay. All right, thank you.

<A – Sandeep Nayar – Power Integrations, Inc.>: Yeah, the turns in the quarter.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Yeah, we need in the low 40% turns to meet the midpoint of our guidance.

<Q – Vernon Essi – Needham & Co. LLC>: Okay. Thank you.

<A – Balu Balakrishnan – Power Integrations, Inc.>: You're welcome.

Operator: Thank you. Our next question comes from Sumit Dhanda of ISI. Your line is open.

<Q – Sumit Dhanda – International Strategy & Investment Group, Inc.>: Yes, hi. Balu, I just wanted to first ask you about the LinkSwitch-HP opportunity. And I think I heard you mention

ultrabook, so I just want to clarify that the power ranges you're talking about are in the 10s of watts, and that's sufficient to meet most requirements ultrabook models out there?

<A – Balu Balakrishnan – Power Integrations, Inc.>: That is correct.

<Q – Sumit Dhanda – International Strategy & Investment Group, Inc.>: Okay. And then second, I know you talked about distribution inventory "being in line with demand expectations." Can you give us what it was on a week's basis? And on a deferred income basis, it seems like it was up. Was that partly a function of what happened with the acquisition?

<A – Sandeep Nayyar – Power Integrations, Inc.>: So the weeks is about five-and-a-half weeks, and last quarter, we were at about 4.8 weeks. And half the increase is related to the acquisition; half is because of the older business that we had, and that's just the timing of how the revenue played out. But it's still within our lead times of four to six weeks.

<Q – Sumit Dhanda – International Strategy & Investment Group, Inc.>: Okay, thanks.

Operator: Thank you. Our next question comes from Gus Richard of Piper Jaffray. Your line is open.

<Q – Gus Richard – Piper Jaffray, Inc.>: Yes, a couple of quick ones. First of all, I think you mentioned on the call that you expect your revenue to double in the 50 to 500-watt range. Is that about \$16 million this year? Is that right?

<A – Balu Balakrishnan – Power Integrations, Inc.>: No, it was actually roughly \$5 million last year, and we expect it to double this year and, so far, we are on track to achieve that.

<Q – Gus Richard – Piper Jaffray, Inc.>: Got it. And then I thought I also heard you allude to a new product for the cell phone market, or a sub-5-watt product that you were going to announce or launch in the second half. Could you talk a little bit more about that?

<A – Balu Balakrishnan – Power Integrations, Inc.>: The new product we just talked about is the LinkSwitch-HP, which addresses adapters in the power range of, I would say, 10 watts to 90 watts. Majority of the designs will be in the, I would say, 15 watts to 35 watts, 40 watts is where most of the applications are. And it's a primary side regulator, which means it doesn't require any feedback, and it is able to maintain a very accurate constant voltage and also meet an extremely stringent no-load consumption of 30 milliwatts. And I think this is the first time anybody has been able to do a primary side regulation up to these types of power levels.

<Q – Gus Richard – Piper Jaffray, Inc.>: Got it, got it. I understand. Thanks. I was a little confused.

Operator: Thank you. Our next question comes from Christopher Longiaru of Sidoti & Company. Your line is open.

<Q – Chris Longiaru – Sidoti & Co. LLC>: Hey, guys.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Hi.

<A – Sandeep Nayyar – Power Integrations, Inc.>: Hi.

<Q – Chris Longiaru – Sidoti & Co. LLC>: Can you comment a little bit on where inventories are, where they were at the beginning of the quarter, and what they look like now?

<A – Sandeep Nayyar – Power Integrations, Inc.>: The inventories at the quarter are still within our targeted range, as they were in the last quarter. We are still within the 110 plus-or-minus range, and that's been our model, and we are still pretty comfortable. And part of the reason the levels have gone up this quarter is because of the acquisition, and mainly related to the write-up of inventory that you're required to do as part of an acquisition accounting.

<Q – Chris Longiaru – Sidoti & Co. LLC>: And just as far as your lead times, are they still within the four to six-week range?

<A – Sandeep Nayyar – Power Integrations, Inc.>: That is correct.

<Q – Chris Longiaru – Sidoti & Co. LLC>: Okay, and so towards the lower end or the higher end of that range?

<A – Sandeep Nayyar – Power Integrations, Inc.>: It varies by product, and that's why it's hard, so that's why we give the range.

<Q – Chris Longiaru – Sidoti & Co. LLC>: Okay. And the only other question I have is just, in terms of expenses and the conclusion of this audit, should we see the SG&A expenses kind of move down slightly after the audit, after September?

<A – Sandeep Nayyar – Power Integrations, Inc.>: Well, obviously, in this – after the – you're talking in the fourth quarter, you mean to say?

<Q – Chris Longiaru – Sidoti & Co. LLC>: Yes, in fourth quarter.

<A – Sandeep Nayyar – Power Integrations, Inc.>: Well, so the main reason for the increase – obviously, we did have some expenses related to that, but the primary reason for increase from the second to the third quarter was result of the acquisition, where we have three months versus two months. And added to that, as I had alluded earlier, when we acquired Concept, we knew we had to make investments in this to grow this business in order to realize the full potential. So that's why you see the increase in expenses in the third quarter, but the fourth quarter on a non-GAAP basis should be pretty similar to the third quarter.

<Q – Chris Longiaru – Sidoti & Co. LLC>: Okay, that's all I have for now. Thanks, guys.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Thank you.

Operator: Thank you. We have a follow-up question from Tore Svanberg of Stifel, Nicolaus. Your line is open.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Yes, thank you. The first follow-up is, Balu, you talked about a new European standard for – I think this is probably for next year. I'm just wondering, since this is such a stringent compliance, are you seeing non-European regions starting to move into that same form factor, I guess it's 50 milliwatts?

<A – Balu Balakrishnan – Power Integrations, Inc.>: It's actually 500 milliwatts, but it covers a very broad range of products, including appliances, the large appliances. So, to answer your question, the Zero products that we have introduced are extremely easy to add on to an existing design, so that what they do is they allow for like the CAPZero and SENZero and so on to be used in European models. But when they use the same product for other countries, they just don't populate them. So at least at the moment, this is only for the European market, but it's very possible in the long term, there will be other standards that will come into effect that could broaden this to the rest of the world.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Very good. And the other follow-up was to Sandeep. Sandeep, so just to clarify the cash outflow for the September quarter related to the tax audit is basically going to be none, right, because you already had the liabilities, taken care of that, and then you already took the charge this quarter? Is that how I should look at it?

<A – Sandeep Nayyar – Power Integrations, Inc.>: You should look at it that there will be a cash outflow of about \$43 million. We had accrued for all those taxes in our rate over the years, but the differential is in addition. So there'll be a cash outflow of [\$42.6] million, but the P&L hit was much lower as a result that we had already accrued for the liabilities by our tax rate in the past.

<A – Balu Balakrishnan – Power Integrations, Inc.>: So, Tore, the actual settlement only occurred last week, so the cash outlay will happen in Q3.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Understood.

<A – Sandeep Nayyar – Power Integrations, Inc.>: So we had reached an agreement with the IRS during the quarter, and after you reach an agreement, it takes – so the official signing happened on August 2, but we had reached, in principle, an agreement during the quarter.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Very good, very good. Thank you very much.

<A – Balu Balakrishnan – Power Integrations, Inc.>: You're welcome.

Operator: Thank you. [Operator Instructions] We have a follow up question from Steve Smigie of Raymond James. Your line is open.

<Q – Steve Smigie – Raymond James & Associates>: Great. Thanks for doing the follow-up question. Just with regard to the cash that you're repatriating, is that primarily going to be used for continued dividend payouts, or are you thinking an additional acquisition?

<A – Sandeep Nayyar – Power Integrations, Inc.>: So as we have said, the uses of our cash is obviously – we have always, we look at opportunistically whether we need to make additional internal investments, whether we need to do M&A, dividends, or buyback, and it'll be still a combination of all four. And as you have seen over the past, we have done different things over a different point of time, and depending on the business needs, we will evaluate and opportunistically make those investments.

<Q – Steve Smigie – Raymond James & Associates>: Okay. And, Balu, can you talk a little bit about your strategic perspective? I think, over time, you guys have been trying to move away from the handset charger market. Not that you didn't continue to invest in it, but that's traditionally been a fairly volatile area where you can have low-cost folks come in and disrupt it, either legally or illegally, so I think you guys have been making investments to try to grow around that. Seems like there's been a lot more competition in that space recently, so I'm just curious if you can comment on your commitment to that handset charger space at this point and what you think about the landscape at this point. And if you can include in that a little bit, there's obviously a couple major handset vendors out there, and are those the guys to focus on, or do you view this as sort of cyclical and just try to focus on everybody still?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, we have no intention of just walking away from that market because we think that it's a good market to test how competitive you are. But because it's a smaller portion of our revenue, we are quite picky about what businesses we take. We only take businesses where the customer is willing to provide the value that we offer, which is reliability, efficiency, and so on and so forth. So what I would say is that our share of that market will fluctuate, but my expectation is that we will grow our share over the next year or so –

not necessarily in Q3. Q3 will most likely be flat, maybe even slightly down. But Q4 onwards, we have a number of designs coming into production, so we expect that to grow.

<Q – Steve Smigie – Raymond James & Associates>: Okay. And then with regard to your focus on the ultrabooks, in the past, you've come out with some fairly good products for notebook adaptors, and I think at the time, ran into issues where there were only a few suppliers of the notebook adaptors, and they wanted to use either the cheapest solution or just wanted to make sure their engineering teams remained employed. So is there something that's new about the Ultrabook market that you think will now allow you guys to penetrate there, where a value-added solution will be adopted rather than just going for the cheapest device?

<A – Balu Balakrishnan – Power Integrations, Inc.>: I think the difference is that there are a lot broader set of vendors who provide adaptors for the ultrabook and the LCD monitors and tablets and also modems and routers, I would say. So we address all adapters in the power range we just discussed. And the hard challenge we have had on the notebook is that there are very few – there are only literally three companies that provide most of the notebook adaptors, and they already have proven a design, and they were unwilling to change that design because of the costs involved in changing the design. And I don't believe that restriction is there in the markets I just mentioned for LinkSwitch-HP.

<Q – Steve Smigie – Raymond James & Associates>: Great. Thank you.

<A – Balu Balakrishnan – Power Integrations, Inc.>: You're welcome.

Operator: Thank you. We have a follow-up question from Andrew Huang of Sterne, Agee. Your line is open.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Hi. Thank you very much. Just two clarifications; first, on LED lighting, do you have an opinion on why the business slowed this year – because I think you referred to some kind of a transition, so I was wondering if you could clarify?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, I think the biggest one is the overall economy, macro-economic situation. But also there is lot more competitors, so it's a little bit harder to grow share when you have so many new competitors. Having said that, I think the LED market will continue to grow, and even with the added competitors, our revenue should continue to grow. The question is how much will it grow each year, and that remains to be seen.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Should I take that to mean that there's more ASP pressure for your LED lighting chips?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Not necessarily because of competition as much as that there is more consolidation, so as the market consolidates around the larger lighting companies, then there will be more pressure on margins. Right now, the margins are still pretty healthy in the LED market because it is still dominated by hundreds of smaller customers, but we are definitely seeing signs of consolidation at this point.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Okay, got it. Oh, actually, when you say signs of consolidation, can you give me an example of what you're seeing?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, all of the big guys, the ones you would think of, like Phillips, GE, Toshiba, Osram; we see them taking a much more aggressive role in offering LED products. Initially, the market was really dominated by very, very small – hundreds of small customers, but now we are seeing that the big guys are gaining momentum in the LED market.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Got it. Okay. And just a follow-on question, now that you have the CT acquisition, is average ASP no longer meaningful?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Yeah, I would say so. For example, in Q2, our average ASP was \$0.31 versus \$0.28 in Q1, and if not for CT-Concept, it would have been \$0.29. It would have still gone up a little bit, but CT-Concept took us to \$0.31 because, even though they're 10% of revenue, their ASP is two orders of magnitude higher.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Right, right. So that's basically no longer a meaningful metric, I think?

<A – Balu Balakrishnan – Power Integrations, Inc.>: I think so, yeah.

<Q – Andrew Huang – Sterne, Agee & Leach, Inc.>: Okay. Okay, thank you very much.

<A – Balu Balakrishnan – Power Integrations, Inc.>: You're welcome.

Operator: Thank you. Our next question comes from Gus Richard of Piper Jaffray. Your line is open.

<Q – Gus Richard – Piper Jaffray, Inc.>: Yes, thanks for taking the follow-up. I noticed that the R&D is kind of creeping up from where it has been over the last five years or so, and I was wondering if the new operating model is going to be a little bit higher in terms of a percentage going forward.

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, we are certainly investing in a number of R&D initiatives for the future, so it is very deliberate. As you might remember, we bought an R&D outfit in the East Coast that is working on some important technologies for us. Plus, even internally, we have grown our R&D to address some new areas that we want to be in. So, yes, that is very deliberate, and that's the investment we are making for the future.

<Q – Gus Richard – Piper Jaffray, Inc.>: Okay, so should we think going forward about R&D being between 14% and 15% as we think about our models over the next couple years?

<A – Sandeep Nayyar – Power Integrations, Inc.>: Well, on a non-GAAP basis, it's hovering around 13%, give and take. This quarter, because of revenue, it has gone up to 13.7%, but it's somewhere in the 13% on a non-GAAP basis.

<Q – Gus Richard – Piper Jaffray, Inc.>: Okay. So not all the way up into the 14%?

<A – Sandeep Nayyar – Power Integrations, Inc.>: No, and the revenue growth obviously, even if the R&D grows somewhat, it will be at a percentage. I don't think it will change that much.

<Q – Gus Richard – Piper Jaffray, Inc.>: Okay. And then just in the press release, there wasn't a split between tiny, Link, and Top. Could you give us that, please?

<A – Balu Balakrishnan – Power Integrations, Inc.>: Well, in the past, it's been easier because we had very simple product lines, and now with high-power having a lot of product, Qspeeds having a lot of product, and CT having, it's kind of going to get – it's very impractical. And that was done historically, so I don't think we are going to break that out going forward.

<Q – Gus Richard – Piper Jaffray, Inc.>: Got it. Okay. All right, that's it for me. Thank you.

Operator: Thank you. I'm showing no further questions in the queue at this time. I'll hand the call back to Joe Shiffler for closing remarks.

Joe Shiffler, Director-Investor Relations & Communications

Okay. That'll conclude the call for today. Thanks, everyone, for listening. There will be a replay of the webcast available on our website, which is investors.powerint.com, and thanks for listening and good afternoon.

Operator: Thank you. Ladies and gentlemen, this concludes the conference for today. You may all disconnect, and have a wonderful day.

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