

TEEKAY SHIPPING CORP

Form 424B2

February 13, 2003

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The information in this preliminary prospectus supplement is not complete and may be changed. We may not deliver these securities until the registration statement filed with the Securities and Exchange Commission is effective and a final prospectus supplement is delivered. This preliminary prospectus supplement and the accompanying prospectus are not offers to sell these securities and we are not soliciting offers to buy these securities in any state where the offer or sale is not permitted.

PROSPECTUS SUPPLEMENT *Issued February 10, 2003*  
(To Prospectus Dated January 17, 2003)

*(Subject to Completion)*

**5,000,000 PEPS Units**  
*(Initially Consisting of 5,000,000 Corporate Units)*  
**TEEKAY SHIPPING CORPORATION**

**% PEPS<sup>SM</sup> Units**

*(Premium Equity Participating Security Units PEPS<sup>SM</sup> Units)*

Each PEPS Unit will have a stated amount of \$25 and will consist of (a) a purchase contract issued by us and (b) initially, \$25 principal amount of our subordinated notes due May 18, 2006, which we refer to collectively as a Corporate Unit.

The purchase contract will obligate you to purchase from us, no later than February 16, 2006, for a price of \$25 in cash, the following number of shares of our common stock, subject to anti-dilution adjustments:

if the average closing price of our common stock over the 20-trading day period ending on the third trading day prior to February 16, 2006 equals or exceeds \$ \_\_\_\_\_, \_\_\_\_\_ shares of our common stock;

if the average closing price of our common stock over the same period is less than \$ \_\_\_\_\_ but greater than \$ \_\_\_\_\_, a number of shares of our common stock having a value, based on the 20-trading day average closing price, equal to \$25; and

if the average closing price of our common stock over the same period is less than or equal to \$ \_\_\_\_\_, \_\_\_\_\_ shares of our common stock.

We will also pay you quarterly contract adjustment payments at a rate of \_\_\_\_\_ % per year of the stated amount of \$25 per PEPS Unit, or \$ \_\_\_\_\_ per year, subject to our right to defer contract adjustment payments, as described in this prospectus supplement.

The notes will initially be our unsecured, subordinated obligations and bear interest at a rate of \_\_\_\_\_ % per year, payable quarterly, subject to our right to defer interest payments, as described in this prospectus supplement. On and after February 16, 2006, except in the event of our earlier bankruptcy, insolvency or reorganization, the notes will be our senior, unsecured obligations. The notes will be remarketed as described in this prospectus supplement. Following a successful remarketing, the interest rate on the notes will be reset.

You can create Treasury Units from Corporate Units by substituting Treasury securities for the notes comprising a part of the Corporate Units, and you can recreate Corporate Units by substituting notes for the Treasury securities comprising a part of the Treasury Units.

The notes or, if substituted for the notes, the Treasury securities, will be pledged to us to secure your obligation under the related purchase contract.

The PEPS Units have been approved for listing on the New York Stock Exchange under the symbol TK-PA. Our common stock is traded on the New York Stock exchange under the symbol TK. On February 10, 2003, the reported last sale price of our common stock on the New York Stock Exchange was \$38.52 per share.

***Investing in the PEPS Units involves risks. You should carefully consider the Risk Factors beginning on page S-18 of this prospectus supplement.***

	<i>Price to Public</i>	<b>Underwriting Discounts And Commissions</b>	<b>Proceeds to Company</b>
Per Corporate PEPS Unit	\$25.00	\$	\$
Total	\$125,000,000	\$	\$

We have granted the underwriters a 30-day option to purchase up to 750,000 additional PEPS Units on the same terms and conditions as set forth above solely to cover over-allotments, if any.

The Securities and Exchange Commission and state and other regulators have not approved or disapproved these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Morgan Stanley & Co. Incorporated and Salomon Smith Barney Inc. expect to deliver the PEPS Units to purchasers on or about February , 2003.

*Joint Book-running Managers*

***MORGAN STANLEY***  
February , 2003

***SALOMON SMITH BARNEY***

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*This document is in two parts. The first part is this prospectus supplement, which describes the terms of the offering of PEPS Units and also adds to and updates information contained in the accompanying prospectus and the documents incorporated by reference into the prospectus. The second part is the accompanying prospectus, which gives more general information, some of which may not apply to the PEPS Units.*

*You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with information other than that contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. The information in this prospectus supplement and the accompanying prospectus may be accurate only as of their respective dates.*

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*We are offering to sell the PEPS Units, and are seeking offers to buy the PEPS Units, only in jurisdictions where offers and sales are permitted. The distribution of this prospectus supplement and the accompanying prospectus and the offering of the PEPS Units in certain jurisdictions may be restricted by law. Persons outside the United States who come into possession of this prospectus supplement and the accompanying prospectus must inform themselves about and observe any restrictions relating to the offering of the PEPS Units and the distribution of this prospectus supplement and the accompanying prospectus outside the United States. This prospectus supplement and the accompanying prospectus do not constitute, and may not be used in connection with, an offer or solicitation by anyone in any jurisdiction in which such offer or solicitation is not authorized or in which the person making such offer or solicitation is not qualified to do so or to any person to whom it is unlawful to make such offer or solicitation.*

*PEPS<sup>SM</sup> Units is a service mark of Morgan Stanley & Co. Incorporated.*

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**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Our disclosure and analysis in this prospectus supplement, in the accompanying prospectus and in the documents incorporated by reference contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include statements regarding, among other items:

our estimated results of operations for fiscal 2002, and other future earnings and operating results;

prospects and trends of the tanker industry;

tanker supply and demand;

our market share in the Aframax tanker market and in the world shuttle tanker market;

expectations as to funding our future capital requirements;

future capital expenditures;

our growth strategy and measures to implement our growth strategy;

the expected financing, benefits and results of our pending acquisition of Navion ASA;

competition;

regulatory matters; and

other discussions of future plans and strategies, anticipated developments and other matters that involve predictions of future events.

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Other statements contained in this prospectus supplement, in the accompanying prospectus and in the documents incorporated by reference are forward-looking statements and are not based on historical fact, such as statements containing the words believes, may, will, estimates, continue, anticipates, intends, expects and words of similar import.

These forward-looking statements are subject to risks, uncertainties and assumptions, including those risks discussed in Risk Factors and those risks discussed in documents incorporated by reference and in other reports we file with the SEC. The risks, uncertainties and assumptions involve known and unknown risks and are inherently subject to significant uncertainties and contingencies, many of which are beyond our control.

Actual results may differ materially from those projected in forward-looking statements. Although we believe that our estimates are reasonable, you should not unduly rely on these estimates, which are based on our current expectations. Factors that could cause actual results to differ materially include:

the cyclical nature of the tanker industry and its dependence on oil markets;

the supply of tankers available to meet the demand for transportation of petroleum products;

our potential inability to close our pending acquisition of Navion ASA and our potential inability to integrate effectively the operations of Navion or any other future acquisition with our own;

our substantial dependence on spot oil voyages;

unforeseen information relating to our results for fiscal 2002 or accounting adjustments made during the 2002 year-end financial statement close process;

environmental and other regulations;

the impact on the tanker industry of significant oil spills or similar events;

possible disruption in commercial activities due to threatened or actual terrorist activity and armed conflict;

our potential inability to achieve and manage growth; and

the risks discussed in Risk Factors and those risks discussed in documents incorporated by reference and in other reports we file with the SEC, including the factors described in Factors That May Affect Future Results in our annual report on Form 20-F for the year ended December 31, 2001 filed with the SEC on March 29, 2002.

We undertake no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict all of these factors. Further, we cannot assess the impact of each such factor on our business or the extent to which any factor, or combination of factors, may cause actual results to be materially different from those contained in any forward-looking statement. Neither we, nor any underwriters, make any representation, warranty or assurance as to the completeness or accuracy of these projections, and neither express an opinion or any other form of assurance regarding them.

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**PROSPECTUS SUPPLEMENT SUMMARY**

The following summary contains basic information about us and our PEPS Units. It does not contain all the information that is important to you. You should read the summary together with the more detailed information and financial statements and notes to the financial statements contained elsewhere or incorporated by reference into this prospectus supplement or the accompanying prospectus. To fully understand this offering, you should read all of these documents. To the extent there is a conflict between the information contained in this prospectus supplement, on the one hand, and the information contained in the accompanying prospectus or any document incorporated by reference, on the other hand, the information in this prospectus supplement shall control.

*In this prospectus supplement we use the terms Teekay, we, us and our to refer, depending on the context, to Teekay Shipping Corporation, a Marshall Islands corporation, or to Teekay Shipping Corporation and its consolidated subsidiaries. Unless otherwise indicated, all dollar references in this prospectus supplement are to U.S. dollars and financial information presented in this prospectus supplement is prepared in accordance with accounting principles generally accepted in the United States.*

**TEEKAY SHIPPING CORPORATION**

Teekay is a leading provider of international crude oil and petroleum product transportation services through the world's largest fleet of medium-size oil tankers. We provide transportation services to major oil companies, major oil traders and government agencies worldwide. As of December 31, 2002, our fleet consisted of 102 tankers (including 12 newbuildings, five vessels time-chartered-in and four vessels owned by joint ventures). We believe our Aframax fleet as of such date was approximately three times larger than that of our nearest direct Aframax competitor. Through our acquisition of Ugland Nordic Shipping AS, or UNS, in 2001, we are also the largest owner of shuttle tankers, which engage in the transportation of oil from offshore production platforms to onshore storage and refinery facilities.

As of December 31, 2002, our fleet (excluding newbuildings) had a total cargo capacity of approximately 9.0 million deadweight tons. As of such date our Aframax tankers represented approximately 12% of the total tonnage of the world Aframax fleet, and our shuttle tankers represented approximately 26% of the total tonnage of the world shuttle tanker fleet.

The Teekay organization was founded in 1973. Teekay is incorporated under the laws of the Republic of The Marshall Islands.

**RECENT DEVELOPMENTS**

**Recent Results**

Based on our preliminary review of unaudited operating results for our quarter and fiscal year ended December 31, 2002, we expect to report net income of approximately \$33.1 million, or \$0.82 per share, for the quarter ended December 31, 2002, compared to net income of \$31.2 million, or \$0.78 per share, for the quarter ended December 31, 2001. We expect to report net voyage revenues of approximately \$155.1 million for the quarter ended December 31, 2002, compared to \$152.2 million recorded for the quarter ended December 31, 2001, while income from vessel operations is expected to increase to approximately \$48.6 million for the quarter ended December 31, 2002, from \$46.1 million for the quarter ended December 31, 2001.

We expect to report net income of approximately \$53.4 million, or \$1.33 per share, for the fiscal year ended December 31, 2002, compared to net income of \$336.5 million, or \$8.31 per share, for the fiscal year ended December 31, 2001. Net voyage revenues are expected to be approximately \$543.9 million for the fiscal year ended December 31, 2002, compared to net voyage revenues of \$789.5 million for our fiscal year ended December 31, 2001, while income from vessel operations is expected to decrease to approximately \$119.3 million for the fiscal year ended December 31, 2002, from \$383.5 million for the fiscal year ended December 31, 2001.

Since our financial statements for the year ended December 31, 2002 have not been finalized, information regarding our results for the quarter and the fiscal year ended December 31, 2002 are subject to change and, with

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respect to the fiscal 2002 year-end results, remain subject to a final audit by our outside independent chartered accountants.

The decreases in our net voyage revenues and net income for fiscal 2002 compared to fiscal 2001 primarily relate to a decrease in our average time charter equivalent, or TCE, rates during fiscal 2002. The decline in net voyage revenues was partially offset by the increase in our fleet size as a result of our acquisition of UNS, which was completed in the first half of fiscal 2001. TCE rates recently have increased substantially. Worldwide industry average Aframax spot TCE rates rose from \$14,822 per day in the third quarter of 2002 to \$27,923 per day in the fourth quarter. Increased tanker demand combined with relatively tight tanker supply caused the recent increase in TCE rates.

Tanker demand increased as:

global oil demand rose in the fourth quarter of 2002, compared to third quarter levels, primarily due to seasonal factors and the shutdown of nuclear power plants in Japan;

global oil production increased in the fourth quarter of 2002, compared to third quarter levels, with Iraq being the country most responsible for such increased production;

the general strike in Venezuela disrupted oil exports and reduced that country's production, which resulted in a partial replacement of short-haul crude supplies with long-haul supplies to meet the production shortfall; and

war fears in the Middle East also influenced the market as charterers transported increased amounts of oil due to fears of potential supply disruptions.

Tanker supply remained tight in the fourth quarter of 2002, primarily as a consequence of the sinking in November 2002 of the tanker *Prestige*, a 26-year-old single-hull vessel, which spilled approximately 27,000 metric tonnes of heavy fuel oil off the Spanish coast. This incident contributed to increased discrimination by charterers against older single-hull tonnage, resulting in increased demand for suitable tonnage.

### **Regulatory Action Following *Prestige* Sinking**

In response to the environmental contamination caused by the sinking of the tanker *Prestige*, the European Transport Commission issued a proposal on December 20, 2002, that would, among other things, accelerate the phasing out of single-hull oil tankers and prohibit the transport to or from European Union ports of heavy grades of oil on single-hull tankers. Member countries are currently examining the proposal and consulting with affected parties. The European Transport Council is scheduled to meet on March 27, 2003, to vote on the proposal. Although individual European Union members are not currently required to implement such proposal, Spain has issued a Royal decree banning the transport of heavy oils on single-hull tankers, and there are indications that Portugal and Italy may unilaterally implement similar measures. Some other countries, including the United States, Japan and Australia, are also considering revisions to their existing pollution regulations applicable to tankers. See Regulation.

The proposed regulations may be amended before they are adopted, if at all. If the proposals are adopted in their current form, there could be a tightening in the world tanker supply and a reallocation of affected tonnage. This could result in firm tanker market conditions and increased TCE rates for modern vessels. The proposals could, however, also result in higher depreciation expenses related to a reduction of the estimated useful life of single-hull vessels for accounting purposes.

### **Navion ASA**

We announced on December 16, 2002, that we and Statoil ASA have entered into a definitive agreement under which we will acquire Statoil's wholly-owned subsidiary, Navion ASA (excluding its oil drilling ship and related operations and one floating production, storage and offload vessel), on a debt-free basis, for approximately \$800 million in cash. We anticipate funding our acquisition of Navion by borrowing under a new credit facility, together with available cash or cash generated from operations and borrowings under other existing credit facilities. The closing of the transaction is expected to take place in the second quarter of 2003.

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Navion, based in Norway, operates primarily in the shuttle tanker and the conventional crude oil and product tanker markets. Its modern shuttle tanker fleet, which as of December 31, 2002 consisted of nine owned and 17 chartered-in vessels (including four vessels chartered-in from our subsidiary Uglund Nordic Shipping), provides logistical services to Statoil and other oil companies in the North Sea under fixed-rate, long-term contracts of affreightment. Navion's modern, chartered-in, conventional tanker fleet, which as of December 31, 2002 consisted of 12 crude oil tankers and nine product tankers, operates primarily in the Atlantic region, providing services to Statoil and other oil companies. In addition, Navion owns two floating storage and off-take vessels currently trading as conventional crude tankers in the Atlantic region, and one gas carrier on long-term charter to Statoil.

Through a joint venture with Statoil, Navion is responsible for meeting Statoil's transportation needs for crude oil, condensate and refined petroleum products. As part of this arrangement, Navion has a right of first refusal on Statoil's oil transportation requirements at the prevailing market rate until December 31, 2007. After the acquisition, we believe this arrangement may increase the utilization of our conventional fleet. We also believe that the acquisition of Navion will provide added stability to our cash flow and earnings throughout the tanker market cycle, due to the fixed-rate, long-term nature of Navion's shuttle tanker contracts.

***Alliance Spirit***

On February 1, 2003, one of our vessels, the *Alliance Spirit*, was empty of cargo and waiting off Skikda, Algeria to load crude oil when a severe storm arose and pushed the vessel aground. Three other vessels, not in our fleet, were also pushed aground by the storm. We contracted with SMIT, an internationally recognized emergency response organization, to assist us in refloating the vessel. However, weather conditions remained severe, hampering recovery efforts and inflicting further significant damage to the vessel. On February 6, 2003, the crew members of the vessel were safely evacuated without injury.

The vessel is insured for its full value. We have advised our hull and machinery insurer that the vessel is now a constructive total loss and have requested payment to us of the insurance proceeds. Efforts to salvage the vessel continue. Approximately 1300 metric tonnes of bunker fuel, as well as small quantities of diesel fuel and lube oils, remain on board the vessel. In addition, between 40 to 80 metric tonnes of residual crude oil cargo remain in the cargo tanks. The bunker fuel and lube tanks remain intact, and efforts to remove their contents continue. The vessel could roll over or break apart, resulting in a spillage or leakage of fuel and oil. We maintain insurance coverage on the vessel for environmental damage or pollution liability in an amount of \$1 billion. We believe any liability resulting from the escape of any fuel or oil into the environment would be substantially below this amount, and that, under the applicable global convention, our liabilities for any oil spill in this region relating to this incident would be limited to approximately \$32 million.

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Your investment in the PEPS Units will involve risks. For a discussion of some of these risks, please see "Risk Factors," beginning on page S-18 and the other information included in or incorporated by reference into this prospectus supplement and the accompanying prospectus, before deciding whether an investment in the PEPS Units is suitable for you.

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**THE OFFERING**

**What are PEPS Units?**

PEPS Units may be either Corporate Units or Treasury Units as described below. The PEPS Units offered will initially consist of 5,000,000 Corporate Units (or 5,750,000 Corporate Units if the underwriters exercise their over-allotment option in full), each with a stated amount of \$25. You can create Treasury Units from the Corporate Units in the manner described below under **How can I create Treasury Units from Corporate Units?** All references in this prospectus supplement to our common stock include, among others, the rights evidenced by such common stock to the extent provided in the Rights Agreement dated as of September 8, 2000, between us and The Bank of New York, as rights agent.

**What are the components of a Corporate Unit?**

Each Corporate Unit consists of a purchase contract and, initially, \$25 principal amount of our notes due May 18, 2006. The notes will be our unsecured obligations and will initially be subordinated to all our senior debt. However, on and after February 16, 2006, except in the event of our earlier bankruptcy, insolvency or reorganization, the notes will be our senior, unsecured obligations. The note that is a component of a Corporate Unit is owned by you, but it will be pledged to us to secure your obligation under the related purchase contract.

**What is a purchase contract?**

Each purchase contract underlying a PEPS Unit obligates the holder of the purchase contract to purchase, and obligates us to sell, on February 16, 2006 (which we refer to as the purchase contract settlement date), for \$25 in cash (which we refer to as the settlement price), a number of newly issued shares of our common stock equal to the settlement rate. The settlement rate will be calculated, subject to adjustment under the circumstances set forth in **Description of the Purchase Contracts** **Anti-Dilution Adjustments**, as follows:

if the applicable market value (as defined below) of our common stock is equal to or greater than \$ (which we refer to as the threshold appreciation price), the settlement rate will be shares of our common stock;

if the applicable market value of our common stock is less than the threshold appreciation price but greater than \$ (which we refer to as the reference price), the settlement rate will be a number of shares of our common stock equal to \$25 divided by the applicable market value; and

if the applicable market value of our common stock is less than or equal to the reference price, the settlement rate will be shares of our common stock.

Applicable market value means the average of the closing price per share of our common stock on each of the 20 consecutive trading days ending on the third trading day immediately preceding the purchase contract settlement date. The reference price is the reported last sale price of our common stock on the New York Stock Exchange on the date of this prospectus supplement. The threshold appreciation price represents a % appreciation over the reference price.

**Can I settle purchase contracts early?**

You can settle purchase contracts at any time on or prior to the fifth business day immediately preceding the purchase contract settlement date by paying \$25 cash per purchase contract, in which case shares of our common stock will be issued to you pursuant to each purchase contract. In addition, if we are involved in a merger in which at least 30% of the consideration for our common stock consists of cash or cash equivalents, you will have the right to accelerate and settle purchase contracts early at the settlement rate in effect immediately prior to the closing of that merger. Your early settlement right is subject to the condition that, if required under the U.S. federal securities laws, we have a registration statement under the U.S. Securities Act of 1933 in effect covering the shares of common stock and other securities, if any, deliverable upon settlement of the purchase contracts. We have agreed that, if required by U.S. federal securities laws, we will use our best efforts to have a

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registration statement in effect covering those shares of common stock and other securities to be delivered in respect of the purchase contracts being settled.

### **What are Treasury Units?**

Treasury Units are units created from Corporate Units and consist of a purchase contract and a 1/40th, or 2.5%, undivided beneficial ownership interest in a zero-coupon U.S. Treasury security with a principal amount of \$1,000 that matures on February 15, 2006 (CUSIP No. 912803AJ2), which we refer to as a Treasury security. The ownership interest in the Treasury security that is a component of a Treasury Unit will be owned by you, but will be pledged to us through the collateral agent to secure your obligation under the related purchase contract.

### **How can I create Treasury Units from Corporate Units?**

Each holder of Corporate Units will have the right, at any time on or prior to the fifth business day immediately preceding the purchase contract settlement date, to substitute for the related notes held by the collateral agent, Treasury securities in a total principal amount at maturity equal to the aggregate principal amount of the notes for which substitution is being made. Because Treasury securities are issued in integral multiples of \$1,000, holders of Corporate Units may make this substitution only in integral multiples of 40 Corporate Units. This substitution will create Treasury Units, and the applicable notes will be released to the holder and be separately tradable from the Treasury Units.

### **How can I recreate Corporate Units from Treasury Units?**

Each holder of Treasury Units will have the right, at any time on or prior to the fifth business day immediately preceding the purchase contract settlement date, to substitute for the related Treasury securities held by the collateral agent, notes having a principal amount equal to the aggregate principal amount at stated maturity of the Treasury securities for which substitution is being made. Because Treasury securities are issued in integral multiples of \$1,000, holders of Treasury Units may make these substitutions only in integral multiples of 40 Treasury Units. This substitution will recreate Corporate Units and the applicable Treasury securities will be released to the holder and be separately tradable from the Corporate Units.

### **What payments am I entitled to as a holder of Corporate Units?**

Subject to our right to defer payments as described below, holders of Corporate Units will be entitled to receive in respect of each Corporate Unit quarterly cash distributions consisting of interest payments calculated at the rate of % per year on the notes, and contract adjustment payments payable by us at the rate of % per year on the stated amount of \$25 per Corporate Unit until the earliest of the purchase contract settlement date, the early settlement date (in the case of a cash merger early settlement) and the most recent quarterly payment date on or before any other early settlement of the related purchase contracts (in the case of early settlement other than upon a cash merger).

### **What payments will I be entitled to if I convert my Corporate Units to Treasury Units?**

Subject to our right to defer contract adjustment payments as described below, holders of Treasury Units will be entitled to receive quarterly contract adjustment payments payable by us at the rate of % per year on the stated amount of \$25 per Treasury Unit. There will be no distributions in respect of the Treasury securities that are a component of the Treasury Units but, subject to our right to defer interest payments on the notes as described below, holders of the Treasury Units will continue to receive the scheduled quarterly interest payments on the notes that were released to them when they created the Treasury Units as long as they continue to hold the notes.

### **Do we have the option to defer current payments?**

We have the right to defer interest payments on our notes until no later than February 16, 2006. Any deferred interest will accrue additional interest at a rate of % per year, compounded quarterly, until paid. We also have the right to defer contract adjustment payments until no later than the date on which your purchase contract

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is settled. Any deferred contract adjustment payments will accrue additional contract adjustment payments at a rate of % per year, compounded quarterly, until paid.

### **What are the payment dates for the PEPS Units?**

The payments described above in respect of the PEPS Units will be payable quarterly in arrears on February 16, May 16, August 16 and November 16 of each year, commencing May 16, 2003.

### **What is remarketing?**

The notes that comprise part of the Corporate Units will be remarketed on the third business day immediately preceding the purchase contract settlement date, which we refer to as the remarketing date, at a price of approximately 100.25% of the principal amount of the notes remarketed. To obtain that price, the remarketing agent may increase or decrease the interest rate on the notes. If the remarketing is successful, any increase or decrease in the interest rate on the notes will take effect on the third business day following the remarketing date.

If the remarketing is successful, a portion of the proceeds from the remarketing equal to the aggregate principal amount of the notes sold in the remarketing that comprised part of the Corporate Units will automatically be applied to satisfy in full each Corporate Unit holder's obligations to purchase common stock under the related purchase contracts on the purchase contract settlement date. The remarketing agent will deduct, as a remarketing fee, an amount not exceeding 25 basis points (0.25%) of the aggregate principal amount of the remarketed notes from proceeds from the remarketing in excess of the aggregate principal amount of the notes remarketed. Any remaining portion of the proceeds will be for the benefit of the holders. Remarketing will be considered successful if the resulting proceeds (net of any fees and commissions, if any) are at least 100% of the aggregate principal amount of the notes.

### **What happens if the notes are not successfully remarketed?**

If the notes have not been successfully remarketed on the remarketing date, the interest rate on the notes will not be reset and all holders of notes will have the right to put the notes to us on the purchase contract settlement date at a put price equal to \$25 per note plus accrued and unpaid interest.

A holder of a note that is part of a Corporate Unit will be deemed to have automatically exercised this put right unless, prior to 11:00 a.m., New York City time, on the second business day immediately preceding the purchase contract settlement date such holder provides a written notice of an intention to settle the related purchase contract with separate cash and, on or prior to the business day immediately preceding the purchase contract settlement date, delivers to the collateral agent such separate cash. Unless a Corporate Unit holder has settled the related purchase contracts with separate cash on or prior to the purchase contract settlement date, the put price will be delivered to the collateral agent, who will apply such amount in satisfaction of such Corporate Unit holder's obligations under the related purchase contract on the purchase contract settlement date. Any remaining amount of the put price following satisfaction of the purchase contract will be paid to such Corporate Unit holder.

### **Do I have to participate in the remarketing?**

You may elect not to participate in the remarketing and to retain the notes underlying your Corporate Units by (1) creating Treasury Units at any time on or prior to the second business day prior to the remarketing date or (2) notifying the purchase contract agent of your intention to pay cash to satisfy your obligation under the related purchase contracts on or prior to the fifth business day before the purchase contract settlement date and delivering the cash payment required under the purchase contracts to the collateral agent on or prior to the fourth business day before the purchase contract settlement date.

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**If I am holding a note as a separate security from the Corporate Units, can I still participate in the remarketing of the notes?**

Holders of notes that are not part of the Corporate Units may elect, in the manner described in this prospectus supplement, to have their notes remarketed by the remarketing agent along with the notes included in the Corporate Units. See Description of the Notes Optional Remarketing. Such holders may also participate in the remarketing by recreating Corporate Units from their Treasury Units at any time on or prior to the second business day immediately prior to the remarketing date.

**Besides participating in a remarketing, how else can I satisfy my obligation under the purchase contracts?**

Holders of Corporate Units or Treasury Units may also satisfy their obligations, or their obligations will be terminated, under the purchase contracts as follows:

through early settlement as described under Can I settle purchase contracts early? above;

through cash settlement prior to the remarketing date in the case of holders of Corporate Units as described under Do I have to participate in the remarketing? above;

through the automatic application of the proceeds of the Treasury securities in the case of the Treasury Units;

through exercise of the put right, if the remarketing is unsuccessful and none of the above events has taken place, as described under What happens if the notes are not successfully remarketed? above; or

without any further action, upon the termination of the purchase contracts as a result of our bankruptcy, insolvency or reorganization.

**What interest payments will I receive on the notes?**

Subject to our right to defer interest payments on the notes as described above, interest on the notes will be payable quarterly in arrears initially at the annual rate of % per annum to, but excluding, the reset effective date, which will be the third business day following the date of a successful remarketing of the notes. Following a reset of the interest rate, interest will be payable on the notes at the reset rate from and including the reset effective date to, but excluding, May 18, 2006. If the notes are not successfully remarketed, the interest rate will not be reset and the notes will continue to bear interest at the initial interest rate.

**What are the interest payment dates on the notes?**

The interest payment dates on the notes are February 16, May 16, August 16 and November 16 of each year, commencing May 16, 2003 and ending on the maturity date of the notes, provided that May 16, 2006 will not be an interest payment date and the interest payment date next following February 16, 2006 will be the maturity date of the notes.

**When will the interest rate on the notes be reset and what is the reset rate?**

The interest rate on the notes will be reset on the date, if any, the notes are successfully remarketed and the reset rate will become effective three business days thereafter. The reset rate will be the interest rate determined by the remarketing agent as the rate (subject to the last sentence of this paragraph) the notes should bear in order for the notes included in the Corporate Units to have an approximate aggregate market value on the remarketing date of 100.25% of their aggregate principal amount. The interest rate on the notes will not be reset if the remarketing is unsuccessful. The reset rate may not exceed the maximum rate, if any, permitted by applicable law.



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### **Are the notes redeemable?**

The notes are not redeemable.

### **What is the ranking of the notes?**

The notes will be our general, unsecured obligations and initially will be subordinate in right of payment to all of our existing and future senior debt. However, on and after February 16, 2006, except in the event of our earlier bankruptcy, insolvency or reorganization, the subordination provisions of the notes and the related indenture will no longer be applicable and the notes will be our senior, unsecured obligations ranking equally in right of payment with all our existing and future unsubordinated debt. The indenture under which the notes will be issued will not limit our ability to issue or incur other debt or issue preferred stock.

### **What are the United States federal income tax consequences for United States holders?**

A PEPS Unit will initially consist of two components, a purchase contract and a note. The purchase price of each PEPS Unit will be allocated between the purchase contract and the note in proportion to their respective fair market values at the time of purchase. We expect that, as of the date of issuance of the PEPS Units, the fair market value of each purchase contract will be \$0.00 and the fair market value of each note will be \$25.

We intend to treat the notes as reset bonds under Treasury regulations relating to variable rate debt instruments and to take the position that a United States holder will be required to include stated interest on the notes as ordinary interest income in such holder's gross income at the time the interest is paid or accrued in accordance with such holder's regular method of accounting. However, if we exercise our right to defer payments of stated interest on the notes, the stated interest on the notes will become original issue discount. In such case, a United States holder generally will recognize interest income prior to the actual receipt of the interest payments.

If a United States holder owns Treasury Units, such holder will continue to take into account items of income or deduction otherwise includible or deductible, respectively, by such holder with respect to the Treasury securities and the notes.

We intend to report the purchase contract adjustment payments as ordinary income to holders. However, prospective investors are urged to consult their own tax advisors concerning alternative characterizations of such payments.

Because there is no statutory, judicial or administrative authority directly addressing the tax treatment of PEPS Units or instruments similar to PEPS Units, United States holders are urged to consult their own tax advisors concerning the United States federal income tax consequences of an investment in PEPS Units in light of their own particular circumstances, as well as the effect of any state, local, or foreign tax laws.

**FOR ADDITIONAL INFORMATION, SEE TAX CONSEQUENCES MATERIAL UNITED STATES FEDERAL INCOME TAX CONSEQUENCES IN THIS PROSPECTUS SUPPLEMENT, STARTING ON PAGE S-66.**

### **What are the material United States federal income tax consequences for Non-United States holders?**

Subject to certain exceptions, payments to Non-United States holders of principal and interest (including original issue discount, if any, and acquisition discount) on the notes or the Treasury securities, contract adjustment payments, and dividends, if any, paid on the shares of our common stock acquired under the purchase contracts, and any gain realized upon the sale, exchange or other disposition of the purchase contracts, notes or Treasury securities, or shares of our common stock acquired under the purchase contracts, generally should not be subject to United States federal income tax, including United States federal withholding tax.

Non-United States holders are urged to consult their own tax advisors with respect to the United States federal, state, local and foreign tax consequences of an investment in PEPS Units in light of their own particular circumstances.

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**FOR ADDITIONAL INFORMATION, SEE TAX CONSEQUENCES MATERIAL UNITED STATES FEDERAL INCOME TAX CONSEQUENCES IN THIS PROSPECTUS SUPPLEMENT, STARTING ON PAGE S-66**

**What are the rights and privileges of the common stock?**

The shares of our common stock that you will be obligated to purchase under the purchase contracts have one vote per share. For more information, please see the discussion of our common stock in this prospectus supplement under the heading Risk Factors, and in the accompanying prospectus under the heading Description of Capital Stock.

**What are the uses of proceeds from the offering?**

We estimate that the net proceeds from the offering will be approximately \$ million (approximately \$ million if the underwriters exercise their over-allotment option in full), after deducting the underwriters estimated discounts and commissions and our estimated fees and expenses for the offering.

We expect to use the net proceeds from the sale of PEPS Units offered hereby to finance acquisitions and for general corporate purposes. General corporate purposes may include capital expenditures, working capital and the repayment of debt. See Use of Proceeds in this prospectus supplement.

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**THE OFFERING EXPLANATORY DIAGRAMS**

The following diagrams demonstrate some of the key features of the purchase contracts, notes, Corporate Units and Treasury Units, and the transformation of Corporate Units into Treasury Units and notes.

The following diagrams assume that the notes are successfully remarketed and the interest rate on the notes is reset on the third business day immediately preceding the purchase contract settlement date, the settlement rate is not adjusted, early settlement does not apply and payments are not deferred.

**Purchase Contract**

Corporate Units and Treasury Units both include a purchase contract under which the holder agrees to purchase shares of our common stock on the purchase contract settlement date. In addition, these purchase contracts include unsecured contract adjustment payments as shown in the diagrams on the following pages.

**Value of Shares Delivered Upon  
Settlement of a Purchase Contract**

**Number of Shares Delivered Upon  
Settlement of a Purchase Contract**

**Applicable Market Value<sup>(6)</sup>**

**Applicable Market Value<sup>(6)</sup>**

Notes:

- (1) If the applicable market value of our common stock is less than or equal to the reference price of \$ \_\_\_\_\_, the number of shares of our common stock to be delivered to a holder of a PEPS Unit will be calculated by dividing the stated amount of \$25 by the reference price.
- (2) If the applicable market value of our common stock is between the reference price and the threshold appreciation price of \$ \_\_\_\_\_, the number of shares of our common stock to be delivered to a holder of a PEPS Unit will be calculated by dividing the stated amount of \$25 by the applicable market value.
- (3) If the applicable market value of our common stock is greater than or equal to the threshold appreciation price, the number of shares of our common stock to be delivered to a holder of a PEPS Unit will be calculated by dividing the stated amount by the threshold appreciation price.
- (4) The reference price is the reported last sale price of our common stock on the New York Stock Exchange on the date of this prospectus supplement.
- (5) The threshold appreciation price represents a \_\_\_\_\_ % appreciation over the reference price.
- (6) The applicable market value means the average of the closing price per share of our common stock on each of the 20 consecutive trading days ending on the third trading day immediately preceding the purchase contract settlement date.

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**Corporate Units**

A Corporate Unit consists of two components as described below:

<b>Purchase Contract</b>	<b>Note</b>
(Owed to Holder)	(Owed to Holder)
Common Stock + Contract Adjustment Payments % per annum paid quarterly	Interest % per annum paid quarterly  (at reset rate from February 16, 2006)
(Owed to Teekay)	(Owed to Holder)
\$25 at Settlement (February 16, 2006)	\$25 at Maturity (May 18, 2006)

The holder of a Corporate Unit owns the note that forms a part of the Corporate Unit, but will pledge it to us to secure its obligation under the related purchase contract.

The foregoing analysis assumes the notes are successfully remarketed on the third business day immediately preceding February 16, 2006.

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**Treasury Units**

A Treasury Unit consists of two components as described below:

<b>Purchase Contract</b>	<b>Treasury Security</b>
(Owed to Holder)	
Common Stock + Contract Adjustment Payments % per annum paid quarterly	
(Owed to Teekay)	(Owed to Holder)
\$25 at Settlement (February 16, 2006)	\$25 at Maturity (as a 1/40th, or 2.5%, ownership interest in \$1,000 principal amount) (February 15, 2006)

The holder owns the 1/40th, or 2.5%, ownership interest in the Treasury security that forms a part of the Treasury Unit, but will pledge it to us through the collateral agent to secure its obligations under the related purchase contract. Unless the purchase contract is terminated as a result of our bankruptcy, insolvency or reorganization or the holder recreates a Corporate Unit, the 1/40th, or 2.5%, ownership interest in the Treasury security will be used to satisfy the holder's obligation under the related purchase contract.

Treasury Units can only be created with integral multiples of 40 Corporate Units.

**The Notes**

The notes have the terms described below:

<b>Note</b>
(Owed to Holder)
Interest % per annum paid quarterly (at reset rate from February 16, 2006)
(Owed to Holder)
\$25 at Maturity (May 18, 2006)

**Table of Contents****Transforming Corporate Units into Treasury Units and Notes**

Because Treasury Securities are issued in integral multiples of \$1,000, the transformation of Corporate Units into Treasury Units requires integral multiples of 40 Corporate Units, and the transformation of Treasury Units into Corporate Units also requires multiples of 40 Treasury Units.

To create a Treasury Unit, a holder separates a Corporate Unit into its components—the purchase contract and the note—and then combines each purchase contract with a 1/40th, or 2.5%, ownership interest in a Treasury security that matures on the day immediately preceding the purchase contract settlement date.

Each 1/40th, or 2.5%, ownership interest in the Treasury security together with a purchase contract constitutes a Treasury Unit. The note, which is no longer a component of the related Corporate Unit, is released to the holder and is tradable as a separate security.

A holder owns the applicable ownership interest in the Treasury security that forms a part of the Treasury Unit, but will pledge it to us through the collateral agent to secure its obligation under the related purchase contract.

<b>Purchase Contract</b>	<b>Note</b>	<b>Purchase Contract</b>	<b>Treasury Security</b>	<b>Note</b>
(Owed to Holder)	(Owed to Holder)	(Owed to Holder)		(Owed to Holder)
Common Stock + Contract Adjustment Payments % per annum paid quarterly	Interest % per annum paid quarterly  (at reset rate from February 16, 2006)	Common Stock + Contract Adjustment Payments % per annum paid quarterly		Interest % per annum paid quarterly  (at reset rate from February 16, 2006)
(Owed to Teekay)	(Owed to Holder)	(Owed to Teekay)	(Owed to Holder)	(Owed to Holder)
\$25 at Settlement (February 16, 2006)	\$25 at Maturity (May 18, 2006)	\$25 at Settlement (February 16, 2006)	(as a 1/40th, or 2.5%, ownership interest in \$1,000 principal amount) \$25 at Maturity (February 15, 2006)	\$25 at Maturity (May 18, 2006)
	<b>Corporate Unit</b>		<b>Treasury Unit</b>	

The holder can also transform Treasury Units and notes into Corporate Units. Following that transformation, the Treasury security, which will no longer be a component of the related Treasury Units, will be released to the holder and will be tradable as a separate security.

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**RISK FACTORS**

Before investing in our PEPS Units, you should consider carefully the following factors, as well as the information contained in the rest of this prospectus supplement, the accompanying prospectus and in the documents that are incorporated by reference into the accompanying prospectus.

**Risks Relating to Our PEPS Units**

**You Will Bear the Entire Risk of a Decline in the Price of Our Common Stock**

Although as a holder of Corporate Units or Treasury Units you will be the owner of the related notes or applicable ownership interest in the Treasury securities, as the case may be, you do have an obligation to buy shares of our common stock pursuant to the purchase contract that is a part of the Corporate Units and Treasury Units. On February 16, 2006, unless you pay cash to satisfy your obligation under the related purchase contracts or the purchase contracts are terminated due to our bankruptcy, insolvency or reorganization, (a) in the case of Corporate Units, either (1) the proceeds derived from the successful remarketing of the notes or (2) the put price paid upon the automatic put of the notes if the remarketing is unsuccessful, or (b) in the case of Treasury Units, the principal of the related Treasury securities when paid at maturity, will automatically be used to purchase a specified number of shares of our common stock on your behalf.

The number of shares of our common stock that you will receive upon the settlement of a purchase contract is not fixed but instead will depend on the average of the closing price per share of our common stock on the 20 consecutive trading days ending on the third trading day immediately preceding February 16, 2006. We refer to this average closing price as the applicable market value. There can be no assurance that the applicable market value of common stock received by you on the purchase contract settlement date will be equal to or greater than the price per share paid by you for our common stock. If the applicable market value of our common stock is less than \$ \_\_\_\_\_, the market value of our common stock issued to you pursuant to each purchase contract on February 16, 2006 (assuming that the market value on such date is the same as the applicable market value of our common stock) will be less than the effective price per share paid by you for our common stock on the date of issuance of the PEPS Units. Accordingly, you will bear the full risk that the market value of our common stock may decline. Any such decline could be substantial.

**The Opportunity for Equity Appreciation Provided by an Investment in the PEPS Units Is Less Than That Provided by a Direct Investment in Our Common Stock**

Your opportunity for equity appreciation afforded by investing in the PEPS Units is less than your opportunity for equity appreciation if you directly invested in our common stock. This opportunity is less because the market value of our common stock to be received by you pursuant to the purchase contract on February 16, 2006 (assuming that the market value on such date is the same as the applicable market value of our common stock), will only exceed the price per share paid by you for our common stock on the purchase contract settlement date if the applicable market value of our common stock exceeds the threshold appreciation price (which represents an appreciation of \_\_\_\_\_% over the reference price of \$ \_\_\_\_\_). If the applicable market value of our common stock exceeds the reference price but falls below the threshold appreciation price, you realize no equity appreciation of our common stock for the period during which you own the purchase contract. Furthermore, if the applicable market value of our common stock equals or exceeds the threshold appreciation price, you would receive on February 16, 2006, only approximately \_\_\_\_\_% of the value of the shares of common stock you could have purchased with \$25 at the reported last sale price of our common stock on the date we price this offering of PEPS Units.

**The Trading Prices for the Corporate Units and Treasury Units Will Be Directly Affected by the Trading Prices of Our Common Stock**

The trading prices of Corporate Units and Treasury Units in the secondary market will be directly affected by the trading prices of our common stock, the general level of interest rates and our credit quality. It is impossible to predict whether the price of our common stock or interest rates will rise or fall. Trading prices of

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our common stock will be influenced by our operating results and prospects and by economic, political, financial and other factors. In addition, general market conditions, including the level of, and fluctuations in the trading prices of stocks generally, and sales of substantial amounts of common stock by us in the market after the offering of the PEPS Units, or the perception that such sales could occur, could affect the price of our common stock. Fluctuations in interest rates may give rise to arbitrage opportunities based upon changes in the relative value of our common stock underlying the purchase contracts and of the other components of the PEPS Units. Any such arbitrage could, in turn, affect the trading prices of the Corporate Units, Treasury Units, the notes and our common stock.

### **If You Hold Corporate Units or Treasury Units, You Will Not Be Entitled to Any Rights With Respect to Our Common Stock, But You Will Be Subject to All Changes Made With Respect to Our Common Stock**

If you hold Corporate Units or Treasury Units, you will not be entitled to any rights with respect to our common stock (including, without limitation, voting rights and rights to receive any dividends or other distributions on our common stock), but you will be subject to all changes affecting our common stock. You will only be entitled to rights on our common stock if and when we deliver shares of common stock in exchange for Corporate Units or Treasury Units on February 16, 2006, or as a result of early settlement, as the case may be, and the applicable record date, if any, for the exercise of rights occurs after that date. For example, in the event that an amendment is proposed to our charter documents requiring shareholder approval and the record date for determining the shareholders of record entitled to vote on the amendment occurs prior to delivery of our common stock, you will not be entitled to vote on the amendment, although you will nevertheless be subject to any changes in the powers, preferences or special rights of our common stock.

### **We May Issue Additional Shares of Common Stock and Thereby Materially and Adversely Affect the Price of Our Common Stock**

The number of shares of common stock that you are entitled to receive on February 16, 2006, or as a result of early settlement of a purchase contract, is subject to adjustment for certain events arising from stock splits and combinations, stock dividends and certain other actions by us that modify our capital structure. We will not adjust the number of shares of common stock that you are to receive on February 16, 2006, or as a result of early settlement of a purchase contract for other events, including offerings of common stock for cash by us or in connection with acquisitions. We are not restricted from issuing additional common stock during the term of the purchase contracts and have no obligation to consider your interests for any reason. If we issue additional shares of common stock, it may materially and adversely affect the price of our common stock and, because of the relationship of the number of shares to be received on February 16, 2006, to the price of our common stock, such other events may adversely affect the trading price of the Corporate Units or Treasury Units.

### **The Secondary Market for the Corporate Units, Treasury Units or the Notes May Be Illiquid**

It is not possible to predict how Corporate Units, Treasury Units or the notes will trade in the secondary market or whether any market will be liquid or illiquid. There is currently no secondary market for either our Corporate Units, Treasury Units or the notes. The Corporate Units have been approved for listing on the New York Stock Exchange, subject to official notice of issuance. If the Treasury Units or the notes are separately traded to a sufficient extent that applicable exchange listing requirements are met, we will try to list the Treasury Units or the notes on the same exchange as the Corporate Units. There can be no assurance as to the liquidity of any market that may develop for the Corporate Units, the Treasury Units or the notes, your ability to sell these securities or whether a trading market, if it develops, will continue. In addition, in the event you were to substitute Treasury securities for the notes or the notes for Treasury securities, thereby converting your Corporate Units to Treasury Units or your Treasury Units to Corporate Units, as the case may be, the liquidity of Corporate Units or Treasury Units could be adversely affected. If the Corporate Units are listed, there can be no assurance that the Corporate Units will not be delisted from the New York Stock Exchange or that trading in the Corporate Units will not be suspended as a result of your election to create Treasury Units by substituting collateral, which could



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cause the number of Corporate Units to fall below the requirement for listing securities on the New York Stock Exchange.

### **Your Rights to the Pledged Securities Will Be Subject to Our Security Interest**

Although you will be the beneficial owner of the notes or Treasury securities, as applicable, those securities will be pledged to us through the collateral agent to secure your obligations under the related purchase contracts. Thus, your rights to the pledged securities will be subject to our security interest. Additionally, notwithstanding the automatic termination of the purchase contracts, in the event that we become the subject of a case under applicable bankruptcy laws, the delivery of the pledged securities to you may be delayed by the imposition of any automatic stay under Section 362 of the U.S. Bankruptcy Code or such bankruptcy laws and claims arising out of the notes, like all other claims in bankruptcy proceedings, will be subject to the equitable jurisdiction and powers of the bankruptcy court.

### **We May Defer Current Payments**

We have the option to defer the payment of contract adjustment payments on the purchase contracts until the earlier of February 16, 2006, or the date on which the purchase contracts are settled. However, any deferred contract adjustment payments will accrue additional contract adjustment payments at the rate of \_\_\_\_\_ % per year, compounded quarterly, until paid. If the purchase contracts are settled early, other than pursuant to a cash merger, or if the purchase contracts are terminated due to our bankruptcy, insolvency or reorganization, the right to receive accrued and unpaid contract adjustment payments will terminate. If the purchase contracts are terminated due to our bankruptcy, insolvency or reorganization, the right to receive deferred contract adjustment payments, if any, will also terminate.

We also have the right to defer interest payments on the notes until no later than February 16, 2006. However, any deferred interest will accrue additional interest at a rate of \_\_\_\_\_ % per year, compounded quarterly, until paid. If we defer interest payments on the notes, a United States holder will generally recognize interest income on the notes prior to the actual receipt of the interest payments for United States federal income tax purposes, because the stated interest on the notes will become original issue discount. See Tax Consequences United States Federal Income Tax Consequences Notes. If we exercise our right to defer payments of interest on the notes, the market price of the Corporate Units is likely to decrease. In addition, the mere existence of the right to defer interest payments may cause the market price of the Corporate Units to be more volatile than the market price of other securities that are not subject to such deferrals.

### **The United States Federal Income Tax Consequences of the Purchase, Ownership and Disposition of the PEPS Units Are Unclear**

No statutory, judicial or administrative authority directly addresses the treatment of the PEPS Units or instruments similar to the PEPS Units for United States federal income tax purposes. As a result, the United States federal income tax consequences of the purchase, ownership and disposition of PEPS Units are not entirely clear. We intend to treat the notes as reset bonds under Treasury regulations relating to variable rate debt instruments and to take the position that a United States holder will be required to include stated interest on the notes as ordinary interest income in such holder's gross income at the time the interest is paid or accrued in accordance with such holder's regular method of accounting. If we exercise our right to defer payments of the stated interest on the notes, the stated interest on the notes will become original issue discount. In such case, a United States holder generally will recognize interest income prior to the actual receipt of the interest payments. For a discussion of tax related risks, see Tax Consequences Material United States Federal Income Tax Consequences.

### **The Purchase Contract Agreement Will Not Be Qualified Under the U.S. Trust Indenture Act and the Obligations of the Purchase Contract Agent Are Limited**

The purchase contract agreement between us and the purchase contract agent will not be qualified as an indenture under the U.S. Trust Indenture Act of 1939, and the purchase contract agent will not be required to qualify as a trustee under the Trust Indenture Act. Thus, you will not have the benefit of the protection of the Trust Indenture Act with respect to the purchase contract agreement or the purchase contract agent. The notes

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constituting a part of the Corporate Units will be issued pursuant to an indenture, which will be qualified under the Trust Indenture Act. If you hold Corporate Units, or Treasury Units and notes, you will have the benefit of the protections of the Trust Indenture Act only to the extent applicable to the notes. Some of the protections generally afforded the holder of a security issued under an indenture that has been qualified under the Trust Indenture Act include:

disqualification of the indenture trustee for conflicting interests, as defined under the Trust Indenture Act;

provisions preventing a trustee that is also a creditor of the issuer from improving its own credit position at the expense of the security holders immediately prior to or after a default under the indenture; and

the requirement that the indenture trustee deliver reports at least annually with respect to certain matters concerning the indenture trustee and the securities.

### **Our Substantial Debt Could Adversely Affect Our Financial Condition and Prevent Us From Fulfilling Our Obligations Under the Notes**

We have substantial debt and debt service requirements. As of September 30, 2002, we and our subsidiaries had outstanding debt in an aggregate principal amount of approximately \$1.1 billion, including \$84.4 million of joint venture debt guaranteed by us or certain of our subsidiaries. As of such date, we would have been able to borrow an additional \$419.4 million under our credit facilities. In addition, as of December 31, 2002, we and our subsidiaries had commitments from lenders for additional credit facilities related to our proposed acquisition of Navion ASA (\$500 million), vessel purchases (\$77 million) and newbuildings (\$232 million).

The amount of our debt could have important consequences to you. For example, it could:

make it more difficult for us to satisfy our obligations under the PEPS Units;

increase our vulnerability to general adverse economic and industry conditions;

limit our ability to fund future capital expenditures, working capital and other general corporate requirements;

require us to dedicate a substantial portion of our cash flow from operations to make interest and principal payments on our debt;

limit our flexibility in planning for, or reacting to, changes in our business and the shipping industry;

place us at a competitive disadvantage compared to competitors that have less debt; and

limit our ability to borrow additional funds, even when necessary to maintain adequate liquidity.

### **To Pay Amounts Due Under the PEPS Units and Service Our Other Debt Will Require a Significant Amount of Cash, Which May Not Be Available to Us**

The PEPS Units will be the sole obligations of Teekay. Our ability to pay amounts due under the PEPS Units and on our other debt will depend upon our future operating performance and a number of other factors, many of which are beyond our control. Such factors include the effect of the general economy on the demand for oil and thus the oil shipping market. In addition, we will rely on dividends and other intercompany cash flows from our subsidiaries to repay our obligations. Financing arrangements between some of our subsidiaries and their respective lenders contain restrictions on dividends by and distribution from such subsidiaries to us.

If we are unable to generate sufficient cash flow to meet our debt service requirements, we may have to renegotiate the terms of our debt. We may be unable to renegotiate successfully those terms or refinance our debt when required, in which event we would have to consider options such as:

sales of certain assets to meet our debt service obligations;

sales of equity; and

negotiations with our lenders to restructure applicable debt.

Our credit agreements, existing debt indentures and the indenture governing the notes may restrict our ability to do some of these things.

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**The Notes Will Initially Be Our Unsecured, Subordinated Obligations, Will Rank Below Our Existing and Future Senior Debt and Will Be Effectively Subordinated to the Debt And Liabilities of Our Subsidiaries. On and After February 16, 2006, Except in the Event of Our Earlier Bankruptcy, Insolvency or Reorganization, the Notes Will Be Our Senior, Unsecured Obligations, But Will Be Effectively Subordinated to Our Existing and Future Senior Secured Debt, to the Extent of Assets Securing Such Debt, and Will Be Effectively Subordinated to the Debt and Liabilities of Our Subsidiaries**

The notes will be unsecured and will initially rank subordinate in right of payment to all of our existing and future senior debt, and in the event of a bankruptcy, liquidation, dissolution, reorganization or similar proceeding of our company, our assets will be available to satisfy obligations on our senior debt before any payment may be made on the notes. In such an event, we may not have sufficient assets remaining to pay outstanding amounts on the notes.

On and after February 16, 2006, except in the event of our earlier bankruptcy, insolvency or reorganization, the notes will cease to be subordinated debt, and will rank equally in right of payment with all of our then existing and future senior, unsubordinated debt. In the event of a bankruptcy, liquidation, dissolution, reorganization or similar proceeding of our company, assets we have pledged to satisfy our obligations on our senior, secured debt will be used to satisfy such secured obligations before such assets would be available to make any payment on the notes and our other senior, unsecured debt. In addition, to the extent that such assets cannot satisfy in full our senior, secured debt, the holders of such debt would have a claim for any shortfall that would rank equally in right of payment (or effectively senior if the debt were issued by a subsidiary) with the notes and our other senior, unsecured debt. In such an event, we may not have sufficient assets remaining to pay outstanding amounts on the notes.

In addition, the notes, whether subordinated or senior, will be effectively subordinated to existing and future liabilities of our subsidiaries. Our right to receive assets of any subsidiaries upon their liquidation or reorganization, and the rights of the holders of the notes to share in those assets, would be subject to the prior satisfaction of claims of the subsidiaries' creditors. Consequently, the notes will be effectively subordinate to all liabilities of any of our subsidiaries. Substantially all of our business is currently conducted through our subsidiaries, and we expect this to continue.

The notes will be our obligations exclusively. The indenture and the purchase contracts do not limit our ability to incur senior or secured debt, or our ability or that of any of our subsidiaries to incur other indebtedness and other liabilities. Our ability to pay our obligations under the notes may decrease if we, or any of our subsidiaries, incur additional indebtedness or liabilities.

As of September 30, 2002, we and our subsidiaries had outstanding debt in an aggregate principal amount of approximately \$1.1 billion, including \$84.4 million of joint venture debt guaranteed by us or certain of our subsidiaries. Of this \$1.1 billion, as of such date we were directly obligated for or guaranteed \$686.1 million, \$704.1 million was secured by our assets or the assets of certain of our subsidiaries, and \$704.1 million was directly obligated for or guaranteed by our subsidiaries.

### **Failure to Comply With Covenants Could Lead to Acceleration of Debt**

Our existing financing agreements and those of our subsidiaries impose operating and financial restrictions that restrict our actions. These restrictions limit or prohibit our ability to, among other things:

- incur additional debt;
- create liens;
- sell capital stock of subsidiaries or other assets;
- make certain investments;
- engage in mergers and acquisitions;
- make certain capital expenditures; or
- pay dividends.



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Failure to comply with any of the covenants in our existing or future financing agreements could result in a default under those agreements or under other agreements containing cross-default provisions. A default would permit lenders to accelerate the maturity of the debt under these agreements and to foreclose upon any collateral securing that debt. Under these circumstances, we might not have sufficient funds or other resources to satisfy all of our obligations, including our obligations under the notes. In addition, the secured nature of a portion of our other debt, together with the limitations imposed by financing agreements on our ability to incur additional debt and to take other actions, might significantly impair our ability to obtain other financing.

Some of our existing financing agreements also impose restrictions on changes of control of us or our ship-owning subsidiaries, including requirements for prior consent and that we make an offer to redeem certain debt. See Description of Our Other Indebtedness.

### **Declining Market Values of Our Vessels Could Adversely Affect Our Liquidity and Result in Breaches of Our Financing Agreements**

Market values of tankers fluctuate depending upon general economic and market conditions affecting the tanker industry and competition from other shipping companies, other types and sizes of vessels, and other modes of transportation. In addition, as vessels become older, they generally decline significantly in value. Declining vessel values of our tankers could adversely affect our liquidity by limiting our ability to raise cash by refinancing vessels. Declining vessel values could also result in a breach of loan covenants and events of default under relevant financing agreements that require us to maintain certain loan-to-value ratios. If vessel values decline and we are unable to decrease our debt or pledge additional collateral, the lenders could accelerate our debt and foreclose on our vessels pledged as collateral for the loans.

### **We May Not Be Able to Pay Cash Dividends**

In each quarter since the initial public offering of our common stock in 1995, we have paid a cash dividend of \$0.215 per share. Any future cash dividends will depend upon our results of operations, financial condition, cash requirements, the availability of surplus and other factors, including the ability of our subsidiaries to make distributions to us, which, as described above, is restricted by financing arrangements. Any failure to pay cash dividends could adversely affect the value of our common stock and of the PEPS Units.

## **Risks Relating to Our Business**

### **The Cyclical Nature of the Tanker Industry Causes Volatility in Our Profitability**

Historically, the tanker industry has been cyclical, experiencing volatility in profitability due to changes in the supply of, and demand for, tanker capacity. Increases in tanker capacity supply or decreases in tanker capacity demand could harm our business, financial condition and results of operations. The supply of tanker capacity is a function of the number of new vessels built, older vessels scrapped, converted and lost and the number of vessels that are out of service. The demand for tanker capacity is influenced by, among other factors:

global and regional economic conditions;

increases and decreases in industrial production and demand for crude oil and petroleum products;

increases and decreases in OPEC production quotas;

the distance crude oil and petroleum products need to be transported by sea; and

developments in international trade and changes in seaborne and other transportation patterns.

Because many of the factors influencing the supply of and demand for tanker capacity are unpredictable, the nature, timing and degree of changes in tanker industry conditions are also unpredictable.

### **We Depend Upon Oil Markets, Changes in Which Could Result in Decreased Demand for Our Vessels and Services**

Demand for our vessels and services in transporting crude oil and petroleum products depends upon world and regional oil markets. Any decrease in shipments of crude oil in those markets could harm our business and results of operations. Historically, those markets have been volatile as a result of the many conditions and events that affect the price, production and transport of oil, as well as competition from alternative energy sources. A



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slowdown of the economic recovery in the United States and world economies may result in reduced consumption of oil and a decreased demand for our vessels and services. In addition, Venezuela is experiencing political unrest, which has led to a shutdown of much of the country's economy, including a significant decrease in its production of crude oil and petroleum products. Continued political unrest in Venezuela or similar unrest in other major oil-producing countries could disrupt the export of petroleum from these or nearby countries and adversely affect the demand for our vessels.

**Continued Terrorist Attacks or War Could Lead to Further Economic Instability and Decrease Demand for Oil, Which Could Harm Our Business**

Terrorist attacks, such as the attacks that occurred in New York, Pennsylvania and Washington, D.C., on September 11, 2001, and current and future war risks may adversely affect our business, results of operation, financial condition, ability to raise capital or future growth. The United States has made strong overtures of going to war with Iraq. Terrorist attacks and potential war in the Middle East may lead to additional armed hostilities or to further acts of terrorism and civil disturbance in the United States or elsewhere, which may further contribute to economic instability and could adversely affect oil markets. In addition, oil tankers, oil pipelines and offshore oil fields could be targets of future terrorist attacks. Any such attacks could lead to, among other things, increased insurance costs for oil tanker operations, increased tanker operational costs and inability to transport oil from or to certain locations.

**Our Dependence on Spot Voyages May Result in Significant Fluctuations in the Utilization of Our Vessels and in Our Profitability**

During the nine months ended September 30, 2002 and the year ended December 31, 2001, we derived approximately 64% and 78%, respectively, of our net voyage revenues from spot voyages or time charters and contracts of affreightment priced on a spot market basis. Because we depend on the spot charter market, declining charter rates in a given period generally will result in corresponding declines in our operating results for that period. The spot charter market is highly competitive and spot charter rates are subject to significant fluctuations based on tanker and oil supply and demand. Charter rates have varied significantly in the last few years. Future spot charters may not be available at rates that will be sufficient to enable our vessels to be operated profitably or provide sufficient cash flow to service the notes or our other obligations. Although Navion's shuttle tanker fleet operates on long-term fixed-rate contracts of affreightment, its conventional tanker fleet generates revenues from spot voyages and contracts of affreightment priced on a spot market basis. Accordingly, these revenues historically have been, and after our acquisition of Navion will continue to be, subject to spot market price fluctuations.

**Reduction in Oil Produced From Offshore Oil Fields Could Harm Our Shuttle Tanker Business**

Demand for our shuttle tankers in transporting crude oil and petroleum products depends upon the amount of oil produced from offshore oil fields, especially in the North Sea, where our shuttle tankers primarily operate. As oil prices increase, the prospect of exploration and development of offshore oil fields, which cost more to develop than land oil fields, becomes more attractive to oil companies. However, if oil prices decline, it becomes less attractive for oil companies to explore for oil offshore and develop offshore oil fields. If the amount of oil produced from offshore oil fields declines, especially in the North Sea, our shuttle tanker business could be harmed. In addition, if for environmental or other reasons, there is a change in policy towards using pipelines rather than oceangoing vessels in transporting crude oil and petroleum products from offshore oil fields, our shuttle tanker business could be harmed. As of December 31, 2002, we had 20 vessels (including two new buildings) in our shuttle tanker fleet. If we close our pending acquisition of Navion ASA, we will acquire an additional nine owned and 13 chartered-in shuttle tankers, which would increase our exposure to the foregoing shuttle-tanker-related risks. Most of Navion's shuttle tanker revenues are derived from long-term contracts of affreightment. Revenue under most of these contracts depends upon the amount of oil we transport, the production of which is beyond our control and which can vary depending upon the nature of a given oil field and the field operator's production decisions.



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### **Our Substantial Operations Outside the United States Expose Us to Political, Governmental and Economic Instability, Which Could Harm Our Operations**

Because our operations are primarily conducted outside of the United States, they may be affected by changing economic, political and governmental conditions in the countries where we are engaged in business or where our vessels are registered. Any disruption caused by these factors could harm our business.

We derive a substantial portion of our total revenues from our operations in the Indo-Pacific Basin. Past political conflicts in this region, particularly in the Arabian Gulf, have included attacks on tankers, mining of waterways and other efforts to disrupt shipping in the area. Vessels trading in this region have also been subject to, in limited instances, acts of terrorism and piracy. Future hostilities or other political instability in this region or other regions where we operate could affect our trade patterns and harm our business. For example, any war resulting from the recent disputes between the United States and Iraq could significantly alter the supply and transportation of oil in the Indo-Pacific Basin, which could harm our business. In addition, tariffs, trade embargoes, and other economic sanctions by the United States or other countries against countries in the Indo-Pacific Basin or elsewhere as a result of terrorist attacks or other hostilities may limit trading activities with those countries, which could also harm our business.

### **Our Inability to Renew or Replace Long-Term Charter Contracts Could Adversely Affect Our Operating Results and Make Them More Volatile**

Thirty-four of our tankers, including all 20 of our shuttle tankers, currently are subject to long-term charter contracts. Sixteen of these contracts terminate by their terms between March 2003 and August 2004. The 18 remaining contracts terminate by their terms between October 2005 and April 2018. If we complete our pending acquisition of Navion ASA, we will have an additional nine owned and 13 chartered-in shuttle tankers subject to fixed-rate contracts of affreightment with terms from six months to the life of the oil field being served, and one owned gas carrier subject to a 13 year time charter. Our inability to renew or replace long-term contracts on favorable terms, if at all, or the early termination of a significant number of these contracts, could harm our results of operations and make them more volatile.

### **The Intense Competition in Our Markets May Lead to Reduced Profitability**

Our vessels operate in highly competitive markets. Competition arises primarily from other Aframax and shuttle tanker owners, including major oil companies and independent companies. We also compete with owners of other size tankers. Our market share is insufficient to enforce any degree of pricing discipline in the markets in which we operate and our competitive position may erode in the future. Any new markets we enter could include participants that have greater financial strength and capital resources than us and we may not be successful in entering into new markets.

### **The Tanker Industry Is Subject to Substantial Environmental and Other Regulations, Which May Significantly Increase Our Expenses**

Our operations are affected by extensive and changing environmental protection laws and other regulations. We have incurred, and expect to continue to incur, substantial expenses in complying with these laws and regulations, including expenses for ship modifications and changes in operating procedures. Additional laws and regulations may be adopted that could limit our ability to do business or further increase the cost of our doing business. This could harm our business.

The United States Oil Pollution Act of 1990 ( OPA 90 ) in particular has increased our expenses. OPA 90 provides for the phase-in of the exclusive use of double-hull tankers at United States ports, as well as potentially unlimited liability for owners, operators and demise or bareboat charterers for oil pollution in U.S. waters. To comply with OPA 90, tanker owners generally incur increased costs in meeting additional maintenance and inspection requirements, in developing contingency arrangements for potential spills and in obtaining required insurance coverage. OPA 90 contains financial responsibility requirements for vessels operating in U.S. waters and requires owners and operators of vessels to establish and maintain with the United States Coast Guard evidence of insurance or of qualification as a self-insurer or other evidence of financial responsibility sufficient to meet their potential liabilities under OPA 90.

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Following the example of OPA 90, the International Maritime Organization, the United Nations agency for maritime safety, adopted regulations for tanker design and inspection that are designed to reduce oil pollution in international waters and that will be phased in on a schedule depending upon vessel age. In addition, as a result of the November 2002 sinking of the tanker *Prestige* and related oil spill, the European Union, the United States and certain other countries are considering or have adopted stricter technical and operational requirements for tankers, including the accelerated phase-out of single-hull vessels, and legislation that may affect the liability of tanker owners and operators for oil pollution.

Our shuttle tankers primarily operate in the North Sea. In addition to the regulations imposed by the International Maritime Organization, countries having jurisdiction over North Sea areas impose regulatory requirements in connection with operations in those areas. These regulatory requirements, together with additional requirements imposed by operators in North Sea oil fields, require us to make further expenditures for sophisticated equipment, reporting and redundancy systems on our shuttle tankers and for the training of seagoing staff. Additional regulations and requirements may be adopted or imposed that could limit our ability to do business or further increase the cost of doing business in the North Sea.

### **We May Not Be Able to Successfully Integrate Any Future Acquisitions**

A principal component of our strategy is to continue to grow by expanding our business both in the geographic areas and markets where we have historically focused as well as into new geographic areas, market segments and services. We may not be successful in expanding our operations and any expansion may not be profitable. Our strategy of growth through acquisitions, including our pending acquisition of Navion ASA, involves business risks commonly encountered in acquisitions of companies, including:

- disruption of our ongoing business;
- difficulties in integrating the operations, personnel and business cultures of acquired companies;
- difficulties of coordinating and managing geographically separate organizations;
- adverse effects on relationships with our existing suppliers and customers, and those of the companies we acquire;
- difficulties entering geographic markets or new market segments in which we have no or limited experience; and
- loss of key officers and employees of acquired companies.

Our failure to successfully and cost-effectively integrate Navion or any other businesses we may acquire in the future will harm our business and results of operations.

The process of integrating operations could also cause an interruption of, or loss of momentum in, the activities of one or more of an acquired company's businesses and our businesses. Members of our senior management may be required to devote considerable amounts of time to this integration process, which will decrease the time they will have to manage our business, service existing customers and attract new customers. If our senior management is not able to effectively manage the integration process, or if any significant business activities are interrupted as a result of the integration process, our business could suffer.

### **We May Not Realize Expected Benefits from Acquisitions, and Implementing Our Strategy of Growth Through Acquisitions May Harm Our Financial Condition and Performance**

Present and future acquisitions, including our pending acquisition of Navion ASA, may not be profitable to us at the time of their completion and may not generate revenues sufficient to justify our investment. In addition, our acquisition growth strategy exposes us to risks that may harm our results of operations and financial condition, including risks that we may:

- fail to realize anticipated benefits, such as cost-savings and revenue enhancements;
- decrease our liquidity by using a significant portion of our available cash or borrowing capacity to finance acquisitions;

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incur additional indebtedness, which may result in significantly increased interest expense or financial leverage, or issue additional equity securities to finance acquisitions, which may result in significant shareholder dilution;

incur or assume unanticipated liabilities, losses or costs associated with the business acquired; or

incur other significant charges, such as impairment of goodwill or other intangible assets, asset devaluation or restructuring charges.

We expect to realize financial and operating benefits as a result of the pending Navion ASA acquisition, including added stability to our cash flow and earnings throughout the tanker market cycle as a result of the fixed-rate, long-term nature of Navion's contracts of affreightment related to its shuttle tanker business. However, revenue under most of these contracts depends upon the amount of oil we transport, the production of which is beyond our control and which can vary depending upon the nature of a given oil field and the field operator's production decisions. In addition, Navion has a right of first refusal on Statoil's oil transportation requirements at the prevailing market rate until December 31, 2007. Although we believe this arrangement may increase the utilization of our conventional fleet after the acquisition, we may be unable to achieve such increased fleet utilization.

### **The Strain That Growth Places Upon Our Systems and Management Resources May Harm Our Business**

Our growth has placed and will continue to place significant demands on our management, operational and financial resources. If we close our pending acquisition of Navion ASA, we will have an additional 46 tankers, including 34 vessels time-chartered in, worldwide to deploy, control and monitor. These would represent an increase of 45% over our current fleet of tankers. As we expand our operations, we must effectively manage and monitor operations, control costs and maintain effective quality and control in geographically dispersed markets, which will increase our operating complexity. Our future growth and financial performance will also depend on our ability to:

recruit, train, manage and motivate our employees to support our expanded operations; and

continue to improve our customer support, financial controls and information systems.

These efforts may not be successful and may not occur in a timely or cost-effective manner. Failure to effectively manage our growth and the system and procedural transitions required by expansion in a cost-effective manner or at all could harm our business.

### **Our Insurance May Not Be Sufficient to Cover the Losses That May Occur to Our Property or as a Result of Our Operations**

The operation of oil tankers carries the risk of environmental damage from an oil spill as well as the risk of catastrophic marine disasters and property losses inherent to any ocean-going vessel. We carry protection and indemnity coverage to protect against most of the accident-related risks involved in the conduct of our business and maintain environmental damage and pollution coverage. We do not carry insurance covering the loss of revenue resulting from vessel off-hire time. All risks may not be adequately insured against, and any particular claim may not be paid. In addition, we may not be able to procure adequate coverage at commercially reasonable rates in the future. Any uninsured loss could harm our business and financial condition.

More stringent environmental regulations at times in the past have resulted in increased costs for, and in the future may result in the lack of availability of, insurance against the risks of environmental damage or pollution. We currently maintain \$1 billion in coverage for liability for pollution, spillage or leakage of oil for each of our vessels. A catastrophic spill could exceed the coverage available, which could harm our business, financial condition and results of operations.

On February 1, 2003, one of our vessels, the *Alliance Spirit*, was empty of cargo and waiting off Skikda, Algeria to load crude oil when a severe storm arose and pushed aground the vessel and three other vessels, not in our fleet. The vessel is listing heavily and could roll over or break apart, resulting in a spillage or leakage of bunker fuel or lube oils on board or residual crude oil cargo remaining in the cargo tanks. Any damages resulting from this incident could harm our financial condition to the extent not covered by insurance.

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**An Incident Involving Environmental Damage or Pollution and Any of Our Vessels Could Harm Our Reputation and Business**

Oil spills related to the sinkings of the tanker *Erika* off the coast of France in 1999 and the tanker *Prestige* off the coast of Spain in 2002, and other tanker-related environmental incidents have created increased demand for modern vessels operated by ship management companies with a reputation for safety and environmental compliance. Any event involving our tankers that results in material environmental damage or pollution could harm our reputation for safety and environmental compliance and decrease demand for our services, which could harm our business. While we believe that the grounding of the *Alliance Spirit* was weather related and not caused by any deficiency in our operations, adverse publicity or perceptions on the part of our customers could harm our reputation and business.

**Our Operating Results Are Subject to Seasonal Fluctuations**

Our tankers operate in markets that have historically exhibited seasonal variations in demand and, therefore, in charter rates. This seasonality may result in quarter-to-quarter volatility in our results of operations. Tanker markets are typically stronger in the winter months as a result of increased oil consumption in the northern hemisphere. In addition, unpredictable weather patterns in these months tend to disrupt vessel scheduling. The oil price volatility resulting from these factors has historically led to increased oil trading activities in the winter months. As a result, our revenues have historically been weaker during our fiscal quarters ended June 30 and September 30, and, conversely, revenues have been stronger in our fiscal quarters ended March 31 and December 31.

**We Expend Substantial Sums During Construction of Newbuildings Without Earning Revenue and Without Assurance That They Will Be Completed**

We are typically required to expend substantial sums as progress payments during the construction of a newbuilding, but we do not derive any revenue from the vessel until after its delivery. If we were unable to obtain financing required to complete payments on any of our newbuilding orders, we could effectively forfeit all or a portion of the progress payments previously made. We currently have 12 newbuildings on order, with deliveries scheduled between March 2003 and October 2004. We may order additional newbuildings in the future.

**The Loss of Any Key Customer Could Result in a Significant Loss of Revenue in a Given Period**

We have derived, and believe that we will continue to derive, a significant portion of our voyage revenues from a limited number of customers. A single customer, an international oil company, accounted for approximately \$131 million, or 13%, of our consolidated voyage revenues during the year ended December 31, 2001. No other customer accounted for more than 10% of our consolidated voyage revenues in fiscal 2001 and no customer accounted for more than 10% of our consolidated voyage revenues during the nine months ended September 30, 2002. Giving effect to our pending acquisition of Navion ASA as if it had occurred on January 1, 2001, one customer would have accounted for approximately \$491 million, or 26%, and \$236 million, or 22%, respectively, of our consolidated voyage revenues during the year ended December 31, 2001 and the nine months ended September 30, 2002. No other customer would have accounted for more than 10% of such consolidated voyage revenues during either of such periods. The loss of any significant customer, or a substantial decline in the amount of services requested by a significant customer, could harm our results of operations.

**Exposure to Currency Exchange Rate and Interest Rate Fluctuations Could Result in Fluctuations in Our Net Income.**

While virtually all of our revenues are earned in U.S. Dollars, a portion of our operating costs is incurred in currencies other than U.S. Dollars. This partial mismatch in operating revenues and expenses could lead to fluctuations in net income due to changes in the value of the U.S. Dollar relative to other currencies, in particular the Japanese Yen, the Singapore Dollar, the Canadian Dollar, the Norwegian Kroner, the British Pound and the Australian Dollar.

As of September 30, 2002, approximately \$452.5 million, or 46.6%, of our debt, bore interest at floating interest rates. Increases in interest rates would increase interest payments on this and any other floating-rate debt, and could harm our results of operations. To partially mitigate our floating interest rate exposure, as of

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September 30, 2002, we had entered into three interest rate swaps, totaling \$70 million in notional principal amount with maturities between December 2002 and May 2004. The average interest rate of the swaps is 6.48%. As of September 30, 2002, the fair value of these interest rate swaps was negative \$2.1 million.

**We May Not Be Exempt From United States Tax on Our United States Source Income, Which Would Reduce Our Net Income and Cash Flow by the Amount of the Applicable Tax.**

If we are not exempt from tax under Section 883 of the United States Internal Revenue Code, the shipping income we derive from U.S. sources attributable to our transportation of cargoes to or from the United States will be subject to U.S. federal income tax. If we are subject to such tax, our net income and cash flow would be reduced by the amount of such tax. We currently claim an exemption under Section 883. Proposed regulations, if they become final as proposed, may not permit us to continue to claim this exemption. We can give no assurance that future changes and shifts in ownership of our stock will not preclude us from being able to satisfy the existing exemption requirements or, if we were to initially qualify for an exception thereunder, the proposed regulations as adopted and finalized.

In the nine months ended September 30, 2002 and the year ended December 31, 2001, approximately 18.1% and 18.0%, respectively, of our voyage revenues was derived from U.S. sources attributable to the transportation of cargoes to or from the United States. The average U.S. federal income tax on such U.S. source income, in the absence of exemption under Section 883, would have been 4% thereof, or approximately \$4.1 million for such nine-month period and \$7.5 million for our fiscal year 2001.

**The International Nature of Our Operations May Make the Outcome of Any Bankruptcy Proceedings Difficult to Predict.**

We are incorporated under the laws of the Republic of the Marshall Islands and our subsidiaries are incorporated under the laws of various countries other than the United States of America, and we conduct operations in countries around the world. Consequently, in the event of any bankruptcy, insolvency or similar proceeding involving us or one of our subsidiaries, any bankruptcy laws of the Republic of the Marshall Islands or other countries in which our subsidiaries are organized or operate could apply. Under bankruptcy laws in the United States, courts typically have jurisdiction over a debtor's property, wherever located, including property situated in other countries. There can be no assurance, however, that courts in other countries that have jurisdiction over us and our operations would recognize a United States bankruptcy court's jurisdiction. Accordingly, difficulties may arise in administering a United States bankruptcy case involving a debtor with its principal operating assets outside the United States, and any orders or judgments of a bankruptcy court in the United States may not be enforceable.

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**USE OF PROCEEDS**

We estimate that the net proceeds from the offering, after deducting the underwriters' discounts and commissions and fees and expenses payable by us, will be approximately \$ \_\_\_\_\_ million (approximately \$ \_\_\_\_\_ million if the underwriters exercise their over-allotment option in full).

We expect to use the net proceeds from the sale of PEPS Units offered hereby to finance acquisitions and for general corporate purposes. General corporate purposes may include capital expenditures, working capital and the repayment of debt.

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**SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA**

The following tables present our selected financial and other data as at and for the nine-month periods ended September 30, 2002 and 2001 and the fiscal years ended December 31, 2001 and 2000, the nine-month period ended December 31, 1999 and the fiscal years ended March 31, 1999 and 1998. We derived the selected financial data set forth below with respect to our statements of income for the fiscal years ended December 31, 2001 and 2000 and the nine-month period ended December 31, 1999 and our balance sheets as at December 31, 2001 and 2000, from our audited consolidated financial statements that are included in our Form 20-F for the year ended December 31, 2001. We derived the income statement data for each of the fiscal years ended March 31, 1999 and 1998 and the balance sheet data as at December 31, 1999 and March 31, 1999 and 1998, from our audited consolidated financial statements not included in our Form 20-F. We derived the selected financial and other data set forth below with respect to our statements of income for each of the nine-month periods ended September 30, 2002 and 2001 and our balance sheets as at September 30, 2002 and 2001 from our unaudited consolidated financial statements included in our Form 6-K filed on November 14, 2002 with respect to the our fiscal quarter ended September 30, 2002. In management's opinion, the unaudited consolidated financial statements reflect all adjustments necessary (consisting only of normal recurring adjustments) for a fair presentation of such financial data. Our results for the nine-month period ended September 30, 2002 are not necessarily indicative of the eventual results for the year.

You should read the data below in conjunction with our consolidated financial statements and the related notes, the financial information and Management's Discussion and Analysis of Results of Operations and Financial Condition included in our Report on Form 20-F for our fiscal year ended December 31, 2001 and our Report on Form 6-K for the quarter ended September 30, 2002, each of which is incorporated by reference into this prospectus supplement.

We changed our fiscal year end from March 31 to December 31, commencing December 31, 1999, in order to facilitate comparison of our operating results to those of other companies in the transportation industry. Our financial statements are prepared in accordance with accounting principals generally accepted in the United States.

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	Fiscal Years Ended					Nine Months Ended September 30,	
	Mar. 31, 1998	Mar. 31, 1999	Dec. 31, 1999	Dec. 31, 2000	Dec. 31, 2001	2001	2002
						(unaudited)	(unaudited)
	(nine months)						
	(in thousands, except share data, ratios, fleet and ship data and per day data)						
<b>Income Statement Data:</b>							
Voyage revenues	\$ 406,036	\$ 411,922	\$ 377,882	\$ 893,226	\$ 1,039,056	\$ 825,910	\$ 560,492
Voyage expenses	100,776	93,511	129,532	248,957	249,562	188,637	171,764
Net voyage revenues	305,260	318,411	248,350	644,269	789,494	637,273	388,728
Operating expenses:							
Vessel operating expenses <sup>(1)</sup>	70,510	84,397	98,780	125,415	154,831	113,404	127,415
Time charter hire expense	10,627	29,666	30,681	53,547	66,019	51,477	37,640
Depreciation and amortization expense	94,941	93,712	68,299	100,153	136,283	99,473	110,136
General and administrative expense	21,542	25,002	27,018	37,479	48,898	35,572	42,824
Total operating expenses	197,620	232,777	224,778	316,594	406,031	299,926	318,015
Income from vessel operations	107,640	85,634	23,572	327,675	383,463	337,347	70,713
Interest expense	(56,269)	(44,797)	(44,996)	(74,540)	(66,249)	(50,944)	(43,854)
Interest income	7,897	6,369	5,842	13,021	9,196	7,867	2,691
Other income (loss)	11,236	(1,800)	(4,013)	3,864	10,108	11,051	(9,265)
Net income (loss) <sup>(2)</sup>	\$ 70,504	\$ 45,406	\$ (19,595)	\$ 270,020	\$ 336,518	\$ 305,321	\$ 20,285
<b>Per Share Data:</b>							
Net income (loss) basic	2.46	1.46	(0.54)	7.02	8.48	7.69	0.51
Net income (loss) diluted	2.44	1.46	(0.54)	6.86	8.31	7.53	0.50
Cash earnings basic <sup>(3)</sup>	5.78	4.72	1.19	9.67	11.91	10.18	3.22
Cash dividends declared	0.86	0.86	0.65	0.86	0.86	0.65	0.65
<b>Balance Sheet Data (at end of period):</b>							
Cash and marketable securities	\$ 115,254	\$ 132,256	\$ 226,381	\$ 223,123	\$ 196,004	\$ 171,095	\$ 172,234
Capital stock	261,353	330,493	427,937	452,808	467,341	472,241	470,299
Total assets	1,460,183	1,452,220	1,982,684	1,974,099	2,467,781	2,463,805	2,517,833
Total debt	725,369	641,719	1,085,167	797,484	935,702	947,333	971,740
Total stockholders' equity	689,455	777,390	832,067	1,098,512	1,398,200	1,386,277	1,394,249
Number of outstanding shares of common stock	28,832,765	31,648,318	38,064,264	39,145,219	39,550,326	39,966,948	39,659,460
<b>Other Financial Data:</b>							
EBITDA <sup>(4)</sup>	\$ 209,582	\$ 186,069	\$ 95,875	\$ 451,066	\$ 539,324	\$ 462,892	\$ 187,752
EBITDA to interest expense <sup>(4)(5)</sup>	3.8x	4.0x	2.1x	6.1x	8.0x	8.9x	4.0x
Total debt to LTM EBITDA <sup>(4)(6)</sup>	3.5x	3.5x	8.3x	1.8x	1.7x	1.5x	3.6x
Total debt to total capitalization <sup>(7)</sup>	51.3%	45.2%	56.6%	42.1%	39.8%	40.3%	40.7%
Net debt to total capitalization <sup>(8)</sup>	46.9%	39.6%	50.7%	34.2%	34.3%	35.6%	35.9%
Ratio of earnings to fixed charges <sup>(2)(9)</sup>	2.3x	2.0x	0.6x	4.6x	5.8x	6.8x	1.5x
Cash earnings <sup>(3)</sup>	\$ 165,575	\$ 146,489	\$ 43,343	\$ 372,168	\$ 472,749	\$ 403,954	\$ 127,595
Capital expenditures:							



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Vessel and equipment purchases, gross <sup>(10)</sup>	197,199	85,445	23,313	43,512	184,983	167,071	93,115
Drydocking	18,376	11,749	6,598	11,941	20,064	14,450	23,027
<b>Total Fleet Data(11):</b>							
Average number of ships	43	47	65	72	82	81	84
Average age of our fleet (in years at end of period)	7.8	8.7	8.4	9.0	10.2	9.9	10.7
Operating cash flow per ship per day <sup>(12)</sup>	\$ 12,682	\$ 11,171	\$ 5,177	\$ 16,687	\$ 17,682	\$ 20,116	\$ 7,378
<b>Spot Aframax Fleet Data(13):</b>							
Average number of ships	42	43	55	59	60	60	59
Average age of our fleet (in years at end of period)	7.6	8.0	7.4	8.3	9.4	9.1	10.3
TCE per ship per day <sup>(14)</sup>	\$ 21,373	\$ 19,576	\$ 13,462	\$ 27,138	\$ 30,542	\$ 33,701	\$ 17,363
Vessel operating expenses per ship per day <sup>(1)</sup>	4,554	4,969	5,621	4,980	5,374	5,321	5,592
Operating cash flow per ship per day <sup>(12)</sup>	12,664	10,903	4,731	18,145	19,747	22,714	6,795

(Footnotes on following page)

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- (1) Vessel operating expenses consist of all expenses relating to the operation of vessels (other than voyage expenses), including crewing, repairs and maintenance, insurance, stores and lubes, and communications expenses. Ship days are calculated on the basis of a 365-day year multiplied by the average number of owned vessels in our fleet for the respective year. Vessel operating expenses exclude vessels time-chartered-in.
- (2) Net income (loss) and the ratio of earnings to fixed charges for our fiscal year ended March 31, 1999 have been restated to reflect early adoption of Statement of Financial Accounting Standards No. 145, Extinguishment of Debt and Capital Lease Modification, which requires any gain or loss on debt extinguishments to be classified as income or loss from continuing operations, rather than as an extraordinary item as previously required under Statement of Financial Accounting Standards No. 4.
- (3) Cash earnings represents net income (loss) before foreign exchange gains (losses) and depreciation and amortization expense. Cash earnings is included because it is used by certain investors to measure a company's financial performance as compared to other companies in the shipping industry. Cash earnings is not required by accounting principles generally accepted in the United States and should not be considered as an alternative to net income or any other indicator of our performance required by accounting principles generally accepted in the United States.
- (4) EBITDA represents net income (loss) before interest expense, income tax expense, depreciation and amortization expense, minority interest, and gains or losses arising from foreign exchange translation and disposal of assets. EBITDA is included because such data is used by certain investors to measure a company's financial performance. EBITDA is not required by accounting principles generally accepted in the United States and should not be considered as an alternative to net income or any other indicator of our performance required by accounting principles generally accepted in the United States.
- (5) For purposes of computing EBITDA to interest expense, interest expense includes capitalized interest but excludes amortization of loan costs.
- (6) Total debt to LTM EBITDA represents total debt as of the end of the period compared to EBITDA for the 12-month period then ended.
- (7) Total capitalization represents total debt, minority interest and total stockholders' equity.
- (8) Net debt represents total debt less cash, cash equivalents and marketable securities. Total capitalization represents net debt, minority interest and total stockholders' equity.
- (9) For purposes of computing the consolidated ratio of earnings to fixed charges, earnings consist of net income (loss) before income taxes, minority interest expense, equity income, interest expense and amortization of capitalized interest, deferred costs and bond premium. Fixed charges consist of interest expense, capitalized interest and amortization of deferred financing costs and bond premium.
- (10) Excludes vessels purchased in connection with our corporate acquisitions of Bona Shipbuilding Ltd. in 1999 and Ugland Nordic Shipping ASA in 2001.
- (11) Excludes vessels of our joint ventures, newbuildings and one Aframax tanker that has been subject to a bareboat charter.
- (12) Operating cash flow represents income from vessel operations plus depreciation and amortization expense (other than drydock amortization expense). Ship days are calculated on the basis of a 365-day fiscal year multiplied by the average number of vessels in our fleet for the respective year (excluding vessels of our joint ventures). Operating cash flow is not required by accounting principles generally accepted in the United States and should not be considered as an alternative to net income or any other indicator of our performance required by accounting principles generally accepted in the United States.
- (13) Includes our core Aframax fleet that operates primarily in the spot charter market and excludes vessels that operate primarily under long-term fixed-rate contracts, including our ten Aframax-size shuttle tankers and our Aframax-size Australian-crewed vessels. Time charter equivalent and vessel operating expense data is separately presented only for this portion of our fleet because the remainder of our fleet generally has varying revenues and expense characteristics that make period-to-period comparisons not meaningful. Also excludes one Aframax tanker that has been subject to a bareboat charter and Aframax tankers of our joint ventures.
- (14) TCE, or time charter equivalent, is a measure of the revenue performance of a vessel, which, on a per voyage basis, is generally determined by Clarkson Research Studies Inc. ( Clarkson ) and other industry data sources by subtracting voyage expenses (except commissions) which are incurred in transporting cargo from gross revenue per voyage and dividing the remaining revenue by the total number of days required

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for the round-trip voyage. For purposes of calculating our average TCE for the year, TCE has been calculated consistent with Clarkson's method, by deducting total voyage expenses (except commissions) from total voyage revenues and dividing the remaining sum by our total voyage days in the year.

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**Table of Contents****CAPITALIZATION**

The following table presents our consolidated capitalization at September 30, 2002 to reflect:

- (1) our actual capitalization; and
- (2) our capitalization as adjusted to give effect to this offering of PEPS Units as if it had occurred on September 30, 2002, and the payment of estimated underwriting discount and commissions and estimated expenses with respect to this offering from cash then on hand.

You should read the following table in conjunction with our historical and pro forma consolidated condensed financial statements and related notes included in our Report on Form 20-F for our fiscal year ended December 31, 2001 and our Report on Form 6-K for the quarter ended September 30, 2002, each of which is incorporated by reference into the accompanying prospectus. See Use of Proceeds and Description of Our Other Indebtedness.

	September 30, 2002	
	Actual	Pro Forma
	(unaudited) (dollars in thousands)	(unaudited)
Cash and marketable securities	\$ 175,234	\$
Current portion of long-term debt <sup>(1)</sup>	\$ 55,165	\$
Long-term debt: <sup>(1)</sup>		
Long-term debt	916,575	
% notes due May 18, 2006 <sup>(2)</sup>		
Total long-term debt	916,575	
Minority interest	20,042	
Stockholders' equity:		
Capital stock (\$470,988 as of December 31, 2002) <sup>(3)(4)</sup>	470,299	
Retained earnings	929,426	
Accumulated other comprehensive loss	(5,476)	
Total stockholders' equity	1,394,249	
Total capitalization	\$2,386,031	\$

(1) For information concerning our borrowing arrangements, see Note 7 to our consolidated financial statements included in our Report on Form 20-F for our 2001 fiscal year, filed with the SEC on March 29, 2002, and Note 5 to our consolidated financial statements included in our Report on Form 6-K for the quarter ended September 30, 2002, filed with the SEC on November 14, 2002, which reports are incorporated herein by reference.

(2) Issued in connection with the sale of the PEPS Units. Assumes no exercise of the underwriters' over-allotment option.

(3) Reflects an adjustment of approximately \$5.0 million, representing the present value of the contract adjustment payments payable in connection with the PEPS Units.

(4) Excludes the effects of issuance costs allocated to the purchase contracts issued in connection with this offering.

As of September 30, 2002, we and our subsidiaries had outstanding indebtedness in an aggregate principal amount of approximately \$1.1 billion, including \$84.4 million of joint venture debt guaranteed by us or certain of our subsidiaries. Of this \$1.1 billion, we were directly obligated for or guaranteed \$686.1 million as of September 30, 2002, and \$704.1 million was secured by our assets or the assets of certain of our subsidiaries.

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In addition, as of December 31, 2002, we and our subsidiaries had commitments from lenders for additional credit facilities related to our proposed acquisition of Navion ASA (\$500 million), vessel purchases (\$77 million) and newbuildings (\$232 million).

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**Table of Contents****COMMON STOCK PRICE RANGE AND DIVIDENDS**

Our common shares are listed for trading on the New York Stock Exchange under the symbol TK.

The following table sets forth on a per share basis the high and low sales prices for consolidated trading in our common shares on the New York Stock Exchange for the periods indicated.

	Common Share Price		Cash Dividends Declared Per Share
	High	Low	
Year ended March 31, 1998	\$37.88	\$27.88	\$0.860
Year ended March 31, 1999	30.75	14.25	0.860
Nine months ended December 31, 1999	18.94	13.75	0.645
Year ended December 31, 2000	50.88	15.31	0.860
Year ended December 31, 2001			
First Quarter	45.60	33.25	0.215
Second Quarter	52.61	38.62	0.215
Third Quarter	41.00	29.16	0.215
Fourth Quarter	35.01	25.49	0.215
Year ended December 31, 2002			
First Quarter	39.12	32.05	0.215
Second Quarter	40.58	35.05	0.215
Third Quarter, 2002			
July 2002	36.50	31.09	0.215
August 2002	36.18	31.50	
September 2002	31.94	27.90	
Fourth Quarter, 2002			
October 2002	32.78	26.35	0.215
November 2002	38.71	32.80	
December 2002	44.70	36.70	
Year ended December 31, 2003			
First Quarter, 2003			
January 2003	43.16	38.98	0.215
February (through February 10, 2003)	40.50	38.35	

Commencing with the fiscal quarter ended September 30, 1995, we have declared and paid quarterly cash dividends in the amount of \$0.215 per share on our common stock. Subject to financial results and declaration by our board of directors, we currently intend to continue to declare and pay a regular quarterly dividend in such amount per share on our common stock. Pursuant to our dividend reinvestment program, holders of common stock are permitted to choose, in lieu of receiving cash dividends, to reinvest any dividends in additional shares of common stock at then prevailing market prices, but without brokerage commissions or services charges.

The timing and amount of dividends, if any, will depend, among other things, on our results of operations, financial condition, cash requirements, restrictions in financing agreements and other factors deemed relevant by our board of directors. Because we are a holding company with no material assets other than the stock of our subsidiaries, our ability to pay dividends on our common stock is dependent on the earnings and cash flow of our subsidiaries. Financing agreements to which certain of our subsidiaries are party restrict these subsidiaries from paying dividends to us. The indentures relating to our 8.32% First Preferred Ship Mortgage Notes due 2008 and our 8.875% Senior Notes due 2011 and agreements governing our credit facilities place limitations on our ability to pay dividends based on our cumulative net income plus certain additional amounts, including the proceeds received by us from any issuance of our capital stock. After giving effect to the anticipated net proceeds to us of this offering, we do not believe that these restrictions will restrict payment of cash dividends on our common stock for the foreseeable future.

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**ACCOUNTING TREATMENT**

The net proceeds of the offering of the Corporate Units will be allocated between the notes and the purchase contracts in proportion to their respective fair market values at the time of the issuance. The present value of the Corporate Units contract adjustment payments will be initially charged to stockholders' equity, with an offsetting credit to liabilities. This liability is accreted over three years by interest charges to the income statement based on a constant rate calculation. Subsequent contract adjustment payments reduce this liability.

The purchase contracts are forward transactions in our common stock. Upon settlement of each purchase contract, we will receive \$25 on the purchase contract and will issue the requisite number of shares of our common stock. The \$25 that we receive will be credited to stockholders' equity.

Before the issuance of our common stock upon settlement of the purchase contracts, the purchase contracts will be reflected in our diluted earnings per share calculations using the treasury stock method. Under this method, the number of shares of our common stock used in calculating diluted earnings per share is deemed to be increased by the excess, if any, of the number of shares that would be issued upon settlement of the purchase contracts (based on the settlement formula applied at the end of the reporting period) over the number of shares that could be purchased by us in the market (at the average market price during the period) using the proceeds receivable upon settlement. Consequently, we anticipate there will be no dilutive effect on our earnings per share except during periods when the average market price of our common stock is above the threshold appreciation price of \$ .

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**Table of Contents****DESCRIPTION OF THE PEPS UNITS**

*The following is a summary of the terms of the PEPS Units. This summary, together with the summary of some of the provisions of the related documents described below, contains a description of all of the material terms of the PEPS Units but is not necessarily complete. We refer you to the copies of those documents which have been or will be filed and incorporated by reference in the registration statement of which this prospectus supplement and accompanying prospectus form a part. This summary supplements the description of the stock purchase units in the accompanying prospectus, and, to the extent it is inconsistent, replaces the description in the accompanying prospectus. All references in this prospectus supplement to our common stock include, among others, the rights evidenced by such common stock to the extent provided in the Rights Agreement dated as of September 8, 2000, between us and The Bank of New York, as rights agent.*

We will issue the PEPS Units under a purchase contract agreement to be entered into between us and The Bank of New York, which we refer to as the purchase contract agent. PEPS Units may be either Corporate Units or Treasury Units. The PEPS Units will initially consist of 5,000,000 Corporate Units (or 5,750,000 Corporate Units if the underwriters exercise their over-allotment option in full), each with a stated amount of \$25.

**Corporate Units**

Each Corporate Unit will consist of a unit comprising:

- (a) a purchase contract under which
  - (1) the holder will agree to purchase from us, and we will agree to sell to the holder, not later than February 16, 2006 (which we refer to as the purchase contract settlement date), for \$25 in cash (which we refer to as the settlement price), a number of newly issued shares of our common stock equal to the settlement rate described below under Description of the Purchase Contracts Purchase of Common Stock, subject to anti-dilution adjustments, and
  - (2) subject to our right to defer these payments, we will pay the holder quarterly contract adjustment payments at the rate of \_\_\_\_\_ % per year on the stated amount of \$25, or \$ \_\_\_\_\_ per year, and
- (b) a note issued by us having a \$25 principal amount.

The purchase price of each PEPS Unit will be allocated between the related purchase contract and the note in proportion to their respective fair market values at the time of issuance. We expect that, at the time of issuance, the fair market value of each note will be \$25 and the fair market value of each purchase contract will be \$0.00. This position generally will be binding on each beneficial owner of each PEPS Unit but not on the United States Internal Revenue Service.

As long as a unit is in the form of a Corporate Unit, your note forming a part of the Corporate Unit will be pledged to us through the collateral agent to secure your obligation to purchase common stock under the related purchase contract.

**Creating Treasury Units**

Each holder of Corporate Units will have the right, at any time on or prior to the fifth business day immediately preceding the purchase contract settlement date, to substitute for the related notes held by the collateral agent, zero-coupon Treasury securities that mature on February 15, 2006 (CUSIP No. 912803AJ2), which we refer to as Treasury securities, in a total principal amount at maturity equal to the aggregate principal amount of the notes for which substitution is being made.

Because Treasury securities are issued in integral multiples of \$1,000, holders of Corporate Units may make this substitution only in integral multiples of 40 Corporate Units.

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Each Treasury Unit will consist of a unit with a stated amount of \$25 comprising:

- (a) a purchase contract under which
  - (1) the holder will agree to purchase from us, and we will agree to sell to the holder, not later than the purchase contract settlement date, for \$25 in cash, a number of newly issued shares of our common stock equal to the settlement rate, subject to anti-dilution adjustments, and
  - (2) subject to our right to defer these payments, we will pay the holder quarterly contract adjustment payments at the rate of \_\_\_\_\_ % per year on the stated amount of \$25, or \$ \_\_\_\_\_ per year and
- (b) a 1/40th, or 2.5%, undivided beneficial interest in a Treasury security with a principal amount of \$1,000.

To create 40 Treasury Units, the Corporate Unit holder will:

deposit with the collateral agent a Treasury security that has a principal amount at maturity of \$1,000, which must be purchased in the open market at the Corporate Unit holder's expense unless otherwise owned by the holder, and

transfer 40 Corporate Units to the purchase contract agent accompanied by a notice stating that the holder has deposited a Treasury security with the collateral agent and requesting the release to the holder of the 40 notes relating to the 40 Corporate Units.

Upon the deposit and receipt of an instruction from the purchase contract agent, the collateral agent will release the related notes from the pledge under the pledge agreement, free and clear of our security interest, to the purchase contract agent. The purchase contract agent then will:

cancel the 40 Corporate Units,

transfer the related 40 notes to the holder, and

deliver 40 Treasury Units to the holder.

The Treasury security will be substituted for the notes and will be pledged to us through the collateral agent to secure the holder's obligation to purchase common stock under the related 40 purchase contracts. The related notes released to the holder thereafter will trade separately from the resulting Treasury Units.

**Recreating Corporate Units**

Each holder of Treasury Units will have the right at any time on or prior to the fifth business day immediately preceding the purchase contract settlement date, to substitute for the related Treasury securities held by the collateral agent, notes having a principal amount equal to the aggregate principal amount at stated maturity of the Treasury securities for which substitution is being made.

Because Treasury securities are issued in integral multiples of \$1,000, holders of Treasury Units may make these substitutions only in integral multiples of 40 Treasury Units.

This substitution will recreate Corporate Units, and the applicable Treasury securities will be released to the holder and be separately tradable from the Corporate Units.

To recreate 40 Corporate Units from 40 Treasury Units, the Treasury Unit holder will:

deposit with the collateral agent 40 of our notes, which must be purchased in the open market at the holder's expense unless otherwise owned by the holder, and

transfer 40 Treasury Units to the purchase contract agent accompanied by a notice stating that the Treasury Unit holder has deposited 40 notes with the collateral agent and requesting the release to the holder of the Treasury security relating to the Treasury Units.

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Upon the deposit and receipt of an instruction from the purchase contract agent, the collateral agent will release the related Treasury security from the pledge under the pledge agreement, free and clear of our security interest, to the purchase contract agent. The purchase contract agent will then

cancel the 40 Treasury Units,

transfer the related Treasury security to the holder, and

deliver 40 Corporate Units to the holder.

The substituted notes will be pledged to us through the collateral agent to secure the Corporate Unit holder's obligation to purchase common stock under the related purchase contracts.

Holders that elect to substitute pledged securities, thereby creating Treasury Units or recreating Corporate Units, will be responsible for any fees or expenses payable in connection with the substitution.

## **Current Payments**

Subject to our right to defer interest payments on the notes until February 16, 2006, holders of Corporate Units will be entitled to receive quarterly cash distributions consisting of interest payments calculated at the rate of % per year on the note. Subject to our right to defer contract adjustment payments until the purchase contract settlement date, holders of the Corporate Units will also be entitled to receive quarterly cash distributions consisting of contract adjustment payments payable by us at the rate of % per year on the stated amount of \$25 per Corporate Unit until the earliest of the purchase contract settlement date, the early settlement date (in the case of a cash merger early settlement, as described under Description of the Purchase Contracts Early Settlement Upon Cash Merger ) and the most recent quarterly payment date on or before any other early settlement of the related purchase contracts (in the case of an early settlement other than upon a cash merger, as described in Description of the Purchase Contracts Early Settlement ).

Subject to our right to defer contract adjustment payments until the date on which the purchase contracts are settled, holders of Treasury Units will be entitled to receive quarterly contract adjustment payments payable by us at the rate of % per year on the stated amount of \$25 per Treasury Unit until the earliest of the purchase contract settlement date, the early settlement date (in the case of a cash merger early settlement) and the most recent quarterly payment date on or before any other early settlement of the related purchase contracts (in the case of an early settlement other than upon a cash merger). There will be no distributions in respect of the Treasury securities that are a component of the Treasury Units but, subject to our right to defer interest payments on the notes until February 16, 2006, holders of the Treasury Units will continue to receive the scheduled quarterly interest payments on the notes that were released to them when the Treasury Units were created for as long as they hold the notes.

## **Ranking**

The notes will be our general, unsecured obligations and initially will be subordinate in right of payment to all of our existing and future senior debt. However, on and after February 16, 2006, except in the event of our earlier bankruptcy, insolvency or reorganization, the subordination provisions of the notes and the related indenture will no longer be applicable and the notes will be our senior, unsecured obligations ranking equally in right of payment with all our existing and future unsubordinated debt. Our obligations with respect to the contract adjustment payments will also be subordinate in right of payment to our senior debt. Senior debt with respect to payments on the notes (so long as the notes remain subordinated obligations) and with respect to the contract adjustment payments means the principal of, premium, if any, and interest on debt, whether incurred on, prior to, or after the date of the indenture relating to the notes or of the purchase contract agreement, as the case may be, unless the instrument creating or evidencing that debt or pursuant to which that debt is outstanding states that those obligations are not superior in right of payment to the notes, while they are subordinated, or the purchase contracts or to other debt which ranks equally with, or junior to, the notes, while they are subordinated, or the purchase contracts. However, senior debt shall not include any debt of Teekay that is expressly subordinated in right of payment to any senior debt, any debt that by operation of law is subordinate to Teekay's general unsecured obligations, any debt which when incurred and without regard to any election under Section 1111(b) of

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the U.S. Bankruptcy Code was without recourse to Teekay, any debt of Teekay to any of its subsidiaries or affiliates (or their subsidiaries), any debt of Teekay to any employee of Teekay, amounts owed by Teekay for compensation to employees or for services rendered to Teekay, any redeemable capital stock of Teekay, amounts owing under leases, any liability for taxes, or any debt for goods, materials or services purchased in the ordinary course of business or debt consisting of trade account payables or other current liabilities (other than the current portion of long-term debt which would otherwise constitute senior debt). The indenture under which the notes will be issued will not limit our ability to issue or incur other debt or issue preferred stock. See Description of Debt Securities in the accompanying prospectus.

**Voting and Certain Other Rights**

Holders of purchase contracts forming part of the Corporate Units or Treasury Units, in their capacities as such holders, will have no voting or other rights in respect of the common stock.

**Listing of the Securities**

The Corporate Units have been approved for listing on the New York Stock Exchange, subject to official notice of issuance. Unless and until substitution has been made as described in Creating Treasury Units or Recreating Corporate Units, the notes will trade as a unit with the purchase contract components of the Corporate Units. If the Treasury Units or the notes are separately traded to a sufficient extent that applicable exchange listing requirements are met, we will try to list the Treasury Units or the notes on the same exchange as the Corporate Units are then listed, if any, including, if applicable, the New York Stock Exchange.

**Miscellaneous**

We or our affiliates may from time to time purchase any of the securities offered by this prospectus supplement which are then outstanding by tender, in the open market or by private agreement.

**Table of Contents****DESCRIPTION OF THE PURCHASE CONTRACTS**

*This section summarizes some of the terms of the purchase contract agreement, purchase contracts, pledge agreement, remarketing agreement and indenture for the notes. The summary should be read together with the purchase contract agreement, pledge agreement, remarketing agreement and indenture for the notes, forms of which have been or will be filed and incorporated by reference as exhibits to the registration statement of which this prospectus supplement and the accompanying prospectus form a part.*

**Purchase of Common Stock**

Each purchase contract underlying a Corporate Unit or Treasury Unit will obligate the holder of the purchase contract to purchase, and us to sell, on the purchase contract settlement date, for an amount in cash equal to the stated amount of the Corporate Unit or Treasury Unit, a number of newly issued shares of our common stock equal to the settlement rate. The settlement rate will be calculated, subject to adjustment under the circumstances described in Anti-Dilution Adjustments, as follows:

If the applicable market value of our common stock is equal to or greater than the threshold appreciation price of \$ \_\_\_\_\_, the settlement rate will be \_\_\_\_\_ shares of our common stock, which is equal to the stated amount of \$25 divided by the threshold appreciation price.

Accordingly, if the market value for the common stock increases between the date of this prospectus supplement and the period during which the applicable market value is measured and the applicable market value is greater than the threshold appreciation price, the aggregate market value of the shares of common stock issued upon settlement of each purchase contract will be higher than the stated amount, assuming that the market price of the common stock on the purchase contract settlement date is the same as the applicable market value of the common stock. If the applicable market value is the same as the threshold appreciation price, the aggregate market value of the shares issued upon settlement will be equal to the stated amount, assuming that the market price of the common stock on the purchase contract settlement date is the same as the applicable market value of the common stock.

If the applicable market value of our common stock is less than the threshold appreciation price but greater than the reference price of \$ \_\_\_\_\_, the settlement rate will be a number of shares of our common stock equal to the stated amount of \$25 divided by the applicable market value.

Accordingly, if the market value for the common stock increases between the date of this prospectus supplement and the period during which the applicable market value is measured, but the applicable market value is less than the threshold appreciation price, the aggregate market value of the shares of common stock issued upon settlement of each purchase contract will be equal to the stated amount, assuming that the market price of the common stock on the purchase contract settlement date is the same as the applicable market value of the common stock.

If the applicable market value of our common stock is less than or equal to the reference price, the settlement rate will be \_\_\_\_\_ shares of our common stock, which is equal to the stated amount of \$25 divided by the reference price.

Accordingly, if the market value for the common stock decreases between the date of this prospectus supplement and the period during which the applicable market value is measured and the applicable market value is less than the reference price, the aggregate market value of the shares of common stock issued upon settlement of each purchase contract will be less than the stated amount, assuming that the market price on the purchase contract settlement date is the same as the applicable market value of the common stock. If the applicable market value is the same as the reference price, the aggregate market value of the shares will be equal to the stated amount, assuming that the market price of the common stock on the purchase contract settlement date is the same as the applicable market value of the common stock.

Applicable market value means the average of the closing price per share of our common stock on each of the 20 consecutive trading days ending on the third trading day immediately preceding the purchase contract

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settlement date. The reference price is the reported last sale price of our common stock on the New York Stock Exchange on the date of this prospectus supplement. The threshold appreciation price represents a % appreciation over the reference price.

Closing price of the common stock on any date of determination means the closing sale price (or, if no closing price is reported, the last reported sale price) of the common stock on the New York Stock Exchange on that date or, if the common stock is not listed for trading on the New York Stock Exchange on any such date, as reported in the composite transactions for the principal United States securities exchange on which the common stock is so listed. If the common stock is not so listed on a United States national or regional securities exchange, the closing price means the last closing sale price of the common stock as reported by the Nasdaq National Market, or, if the common stock is not so reported, the last quoted bid price for the common stock in the over-the-counter market as reported by the National Quotation Bureau or similar organization. If the bid price is not available, the closing price means the market value of the common stock on the date of determination as determined by a nationally recognized independent investment banking firm retained by us for this purpose.

A trading day means a day on which the common stock

is not suspended from trading on any national or regional securities exchange or association or over-the-counter market at the close of business, and

has traded at least once on the national or regional securities exchange or association or over-the-counter market that is the primary market for the trading of the common stock.

We will not issue any fractional shares of common stock pursuant to the purchase contracts. In lieu of fractional shares otherwise issuable (calculated on an aggregate basis) in respect of purchase contracts being settled by a holder of Corporate Units or Treasury Units, the holder will be entitled to receive an amount of cash equal to the fraction of a share times the applicable market value.

On the business day immediately preceding February 16, 2006, unless:

a holder of Corporate Units or Treasury Units has settled the related purchase contracts prior to February 16, 2006 through the early delivery of cash to the purchase contract agent in the manner described under Early Settlement, or Early Settlement Upon Cash Merger,

a holder of Corporate Units has settled the related purchase contracts with separate cash on the fourth business day immediately preceding February 16, 2006 pursuant to prior notice given in the manner described under Notice to Settle with Cash, or

an event described under Termination has occurred,  
then,

in the case of Corporate Units where the remarketing of the notes has been successful, the portion of the proceeds from the remarketing equal to the principal amount of the notes remarketed will automatically be applied to satisfy in full the holders obligations to purchase shares of our common stock under the related purchase contracts,

in the case of Corporate Units where the remarketing of the notes has not been successful, (1) if holders of Corporate Units exercise their put right with respect to the related notes, \$25 of the put price per Corporate Unit received by the collateral agent or (2) if such holders elect not to exercise their put right, the cash delivered by such holders in settlement of the related purchase contracts, in each case will automatically be applied to satisfy in full the holders obligation to purchase common stock under the related purchase contracts, and

in the case of Treasury Units, the principal amount of the related Treasury securities, when paid at maturity, will automatically be applied to satisfy in full the holders obligations to purchase common stock under the related purchase contracts.

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In connection with settlement of any purchase contract included in a Corporate Unit following a successful remarketing or included in a Treasury Unit,

the amount of any unpaid deferred contract adjustment payments shall be deducted from the proceeds to be applied to payment of the purchase price under such purchase contract, and shall be paid to the holder of such Corporate or Treasury Unit, and

such holder's obligation under the purchase contract to pay the purchase price for the shares of common stock shall be deemed satisfied in full.

The common stock will then be issued and delivered to the holder or the holder's designee, upon presentation and surrender of the certificate evidencing the Corporate Units or Treasury Units and payment by the holder of any transfer or similar taxes payable in connection with the issuance of the common stock to any person other than the holder.

Each holder of Corporate Units or Treasury Units, by acceptance of these securities, will be deemed to have:

irrevocably agreed to be bound by the terms and provisions of the related purchase contracts and the pledge agreement and to have agreed to perform its obligations thereunder for so long as the holder remains a holder of the Corporate Units or Treasury Units, and

duly appointed the purchase contract agent as the holder's attorney-in-fact to enter into and perform the related purchase contracts and pledge agreement on behalf of and in the name of the holder.

In addition, each beneficial owner of Corporate Units or Treasury Units, by acceptance of the beneficial interest therein, will be deemed to have agreed to treat:

itself as the owner of the notes or the Treasury securities, as the case may be, and

the notes as indebtedness for all United States federal income tax purposes.

## **Remarketing**

### ***General***

Pursuant to the remarketing agreement that we will enter into with the purchase contract agent and the remarketing agent, and subject to the terms of the remarketing agreement among the remarketing agent, the purchase contract agent and us, the remarketing agent will use its reasonable efforts to remarket the notes held by Corporate Unit holders as a part of Corporate Units on the third business day immediately preceding the purchase contract settlement date, which we refer to as the remarketing date, at a price of approximately 100.25% of the principal amount of the notes remarketed. To obtain that price, the remarketing agent may increase or decrease the interest rate on the notes, provided that the reset rate will not exceed the maximum rate permitted by applicable law. We currently expect the remarketing agent to be Morgan Stanley & Co. Incorporated.

If the remarketing of the notes is successful, a portion of the proceeds from this remarketing equal to the aggregate principal amount of the notes included in the Corporate Units at the time of remarketing will automatically be applied to satisfy in full the Corporate Unit holders obligations to purchase common stock under the related purchase contracts on the purchase contract settlement date. The remarketing agent will deduct, as a remarketing fee, an amount not exceeding 25 basis points (0.25%) of the aggregate principal amount of the remarketed notes from any proceeds from the remarketing in excess of the aggregate principal amount of the notes remarketed. Any remaining portion of the proceeds will be for the benefit of the holders of the notes included in the remarketing. Remarketing will be considered successful if the resulting proceeds (net of any fees and commissions, if any) are at least 100% of the aggregate principal amount of the notes.

We will cause a notice of failed remarketing to be published on the business day immediately following the remarketing date in a daily newspaper in the English language of general circulation in The City of New York, which is expected to be *The Wall Street Journal*, and on Bloomberg news. In addition, we will request, not later than seven nor more than 15 calendar days prior to the remarketing date, that the depositary notify its participants holding notes, Corporate Units and Treasury Units of the remarketing, including, in the case of a failed

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remarketing, the procedures that must be followed if a noteholder wishes to exercise its right to put its note to us as described in this prospectus supplement. If required, we will use our best efforts to ensure that a registration statement with regard to the full amount of the notes to be remarketed will be effective in a form that will enable the remarketing agent to rely on it in connection with the remarketing process.

### ***Put Right***

If the notes underlying the Corporate Units have not been successfully remarketed prior to the purchase contract settlement date, the holders of notes will have the right to put such notes to us on the purchase contract settlement date, at a price equal to \$25 for each note, plus accrued and unpaid interest. The put right of holders of notes that are part of Corporate Units will be automatically exercised unless such holders (1) prior to 11:00 a.m., New York City time, on the second business day immediately preceding the purchase contract settlement date, provide written notice of their intention to settle the related purchase contract with separate cash, and (2) on or prior to the business day immediately preceding the purchase contract settlement date, deliver to the collateral agent \$25 in cash per purchase contract. Unless a Corporate Unit holder has settled the related purchase contract with separate cash on or prior to the purchase contract settlement date, \$25 of the put price will be delivered to the collateral agent who will apply such amount in satisfaction of such holder's obligations under the related purchase contract on the purchase contract settlement date. Any remaining amount of the put price following satisfaction of the purchase contract will be paid to such Corporate Unit holder. If we fail to deliver the put price to the collateral agent, we will be deemed to have netted our obligation to pay the put price against the holder's obligation to pay the purchase price under the related purchase contract on the purchase contract settlement date.

You may elect not to participate in the remarketing and to retain the notes underlying your Corporate Units by (1) creating Treasury Units at any time on or prior to the second business day prior to the remarketing date or (2) notifying the purchase contract agent of your intention to pay cash to satisfy your obligation under the related purchase contracts on or prior to the fifth business day before the purchase contract settlement date and delivering the cash payment required under the purchase contracts to the collateral agent on or prior to the fourth business day before the purchase contract settlement date.

### **Early Settlement**

Subject to the conditions described below, a holder of Corporate Units or Treasury Units may settle the related purchase contracts in cash at any time on or prior to 5:00 p.m., New York City time, on the fifth business day immediately preceding the purchase contract settlement date by presenting and surrendering the related Corporate Unit or Treasury Unit certificates, if they are in certificated form, at the offices of the purchase contract agent with the form of Election to Settle Early on the reverse side of such certificate completed and executed as indicated, accompanied by payment to us in immediately available funds of an amount equal to

the stated amount of \$25 times the number of purchase contracts being settled, plus

if the delivery is made with respect to any purchase contract during the period from the close of business on any record date next preceding any payment date to the opening of business on such payment date, an amount equal to the contract adjustment payments payable on the payment date with respect to the purchase contract.

So long as the PEPS Units are evidenced by one or more global security certificates deposited with the depository, procedures for early settlement will also be governed by standing arrangements between the depository and the purchase contract agent. The early settlement right is also subject to the condition that, if required under the U.S. federal securities laws, we have a registration statement under the U.S. Securities Act of 1933 in effect covering the shares of common stock and other securities, if any, deliverable upon settlement of a purchase contract. We have agreed that, if required under the U.S. federal securities laws, we will use our best efforts to (1) have a registration statement in effect covering those shares of common stock and other securities to be delivered in respect of the purchase contracts being settled and (2) provide a prospectus in connection therewith, in each case in a form that may be used in connection with the early settlement right.



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Upon early settlement of the purchase contracts related to any Corporate Units or Treasury Units:

except as described below in **Early Settlement Upon Cash Merger** the holder will receive newly issued shares of common stock per Corporate Unit or Treasury Unit, subject to adjustment under the circumstances described under **Anti-Dilution Adjustments**, accompanied by an appropriate prospectus if required by law,

the note or the Treasury security, as the case may be, related to the Corporate Units or Treasury Units will be transferred to the holder free and clear of our security interest,

the holder will receive any unpaid deferred contract adjustment payments,

the holder's right to receive future contract adjustment payments will terminate, and

no adjustment will be made to or for the holder on account of any contract adjustment payments referred to in the preceding bullet.

If the purchase contract agent receives Corporate Unit certificates or Treasury Unit certificates (if they are in certificated form) accompanied by the completed **Election to Settle Early** and required immediately available funds, from a holder of Corporate Units or Treasury Units by 5:00 p.m., New York City time, on a business day and all conditions to early settlement have been satisfied, that day will be considered the settlement date. If the purchase contract agent receives the above after 5:00 p.m., New York City time, on a business day or at any time on a day that is not a business day, the next business day will be considered the settlement date.

Upon early settlement of purchase contracts in the manner described above, presentation and surrender of the certificate evidencing the related Corporate Units or Treasury Units (if they are in certificated form) and payment of any transfer or similar taxes payable by the holder in connection with the issuance of the related common stock to any person other than the holder of the Corporate Units or Treasury Units, we will cause the shares of common stock being purchased to be issued, and the related notes or the Treasury securities, as the case may be, securing the purchase contracts to be released from the pledge under the pledge agreement described in **Pledged Securities and Pledge Agreement** and transferred, within three business days following the settlement date, to the purchasing holder or the holder's designee.

### **Notice to Settle with Cash**

A holder of Corporate Units may settle the related purchase contracts with separate cash. A holder of Corporate Units wishing to settle the related purchase contracts with separate cash must notify the purchase contract agent by presenting and surrendering the Corporate Unit certificates evidencing the Corporate Units at the offices of the purchase contract agent with the form of **Notice to Settle by Cash** on the reverse side of the certificates completed and executed as indicated on or prior to 5:00 p.m., New York City time, on the fifth business day immediately preceding the purchase contract settlement date and delivering the required cash payment to the collateral agent on or prior to 5:00 p.m., New York City time, on the fourth business day immediately preceding the purchase contract settlement date.

If a holder that has given notice of its intention to settle the related purchase contracts with separate cash fails to deliver the cash to the collateral agent on the fourth business day immediately preceding the purchase contract settlement date, such holder's notes will be included in the remarketing of notes occurring on the third business day immediately preceding the purchase contract settlement date.

### **Early Settlement Upon Cash Merger**

Prior to the purchase contract settlement date, if we are involved in a merger in which at least 30% of the consideration for our common stock consists of cash or cash equivalents, which we refer to as a cash merger, then following the cash merger, each holder of a purchase contract will have the right to accelerate and settle such contract early at the settlement rate in effect immediately prior to the closing of the cash merger, provided that at such time, if so required under the U.S. federal securities laws, there is in effect a registration statement covering the common stock and other securities, if any, to be delivered in respect of the purchase contracts being settled. We refer to this right as the **merger early settlement right**.

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We will provide each of the holders with a notice of the completion of a cash merger within five business days thereof. The notice will specify a date, which shall be at least five days after the date of the notice, but no later than the earlier of 20 days after the date of such notice and five business days prior to the purchase contract settlement date by which each holder's merger early settlement right must be exercised. The notice will set forth, among other things, the applicable settlement rate and the amount of the cash, securities and other consideration receivable by the holder upon settlement. To exercise the merger early settlement right, you must deliver to the purchase contract agent, three business days before the early settlement date, the certificate evidencing your Corporate Units or Treasury Units if they are held in certificated form, and payment of the applicable purchase price in immediately available funds.

If you exercise the merger early settlement right, we will deliver to you on the early settlement date the kind and amount of securities, cash or other property that you would have been entitled to receive if you had settled the purchase contract immediately before the cash merger at the settlement rate in effect at such time plus accrued and unpaid contract adjustment payments, including any unpaid deferred contract adjustment payments, with respect to such purchase contract. You will also receive the notes or Treasury securities underlying the Corporate Units or Treasury Units, as the case may be. If you do not elect to exercise your merger early settlement right, your Corporate Units or Treasury Units will remain outstanding and subject to normal settlement on the purchase contract settlement date, subject to adjustment as provided under

Anti-Dilution Adjustments. We have agreed that, if required under the U.S. federal securities laws, we will use our best efforts to (1) have in effect a registration statement covering the common stock and other securities, if any, to be delivered in respect of the purchase contracts being settled and (2) provide a prospectus in connection therewith, in each case in a form that may be used in connection with the early settlement upon a cash merger.

**Contract Adjustment Payments**

Contract adjustment payments in respect of Corporate Unitoman, Times, serif; WIDTH: 1%; VERTICAL-ALIGN: bottom; MARGIN-LEFT: 0pt; BACKGROUND-COLOR: #cceeef" noWrap>

**Options exercisable at September 30, 2015**

149 \$16.19 1.2 \$5,213

Total intrinsic value of options exercised was \$0.4 million and \$2.3 million for the three months ended September 30, 2015 and 2014, respectively. Total intrinsic value of options exercised was \$15.8 million and \$14.1 million for the nine months ended September 30, 2015 and 2014, respectively. The net cash proceeds from the exercise of stock options were \$6.9 million and \$10.4 million for the nine months ended September 30, 2015 and 2014, respectively. As of September 30, 2015, unamortized compensation expense related to unvested options was not material.

***Employee Stock Purchase Plan ("ESPP")***

For the three months ended September 30, 2015 and 2014, 26,000 and 34,000 shares, respectively, were issued under the ESPP. For the nine months ended September 30, 2015 and 2014, 56,000 and 78,000 shares, respectively, were issued under the ESPP. As of September 30, 2015, 4.7 million shares were available for future issuance.

The intrinsic value of shares issued was \$0.2 million and \$0.5 million for the three months ended September 30, 2015 and 2014, respectively. The intrinsic value of shares issued was \$0.6 million and \$0.9 million for the nine months ended September 30, 2015 and 2014, respectively. As of September 30, 2015, the unamortized expense was \$0.2 million, which will be recognized through the first quarter of 2016. The Black-Scholes model was used to value the

employee stock purchase rights with the following weighted-average assumptions:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Expected term (years)	0.5	0.5	0.5	0.5
Expected volatility	24.8 %	25.1 %	30.3 %	29.5 %
Risk-free interest rate	0.2 %	0.1 %	0.2 %	0.1 %
Dividend yield	1.6 %	1.4 %	1.4 %	0.7 %

Cash proceeds from the shares issued under the ESPP were \$2.2 million and \$2.1 million for the nine months ended September 30, 2015 and 2014, respectively.

### 3. ACQUISITION

On July 22, 2014 (the “Acquisition Date”), the Company acquired 100% of the outstanding capital stock of Sensima Technology SA (“Sensima”), a company based in Switzerland that develops magnetic sensor technologies for angle measurements as well as three-dimensional magnetic field sensing. The acquisition creates new opportunities with customers by offering enhanced solutions in power management for key industries such as automotive, industrial and cloud computing. As a result of the acquisition, Sensima became a subsidiary of the Company and changed its name to MPS Tech Switzerland Sarl. Its results of operations have been included in the Company’s consolidated financial statements subsequent to the acquisition.

***Purchase Consideration***

The fair value of the purchase consideration consists of the following (in thousands):

Cash paid at the Acquisition Date	\$ 11,735
Contingent consideration	2,507
Total	\$ 14,242

Cash paid at the Acquisition Date included \$1.2 million that was held in an escrow account for a one-year period, which was subject to Sensima's satisfaction of certain representations and warranties. The full amount was released from the escrow account on July 22, 2015.

The contingent consideration arrangement requires the Company to pay up to an additional \$8.9 million to former Sensima shareholders if Sensima achieves a new product introduction as well as certain product revenue and direct margin targets in 2016. The fair value of the contingent consideration at the Acquisition Date was \$2.5 million, which was estimated based on a probability-weighted analysis of possible future cash flow outcomes. The fair value of the contingent consideration is recorded in other long-term liabilities in the Condensed Consolidated Balance Sheets and is remeasured at the end of each reporting period, with any changes in fair value recorded in operating expense in the Condensed Consolidated Statements of Operations. Actual amounts that will ultimately be paid may differ from the obligations recorded.

The Company incurred \$0.6 million of transaction costs that were expensed as incurred to selling, general and administrative expenses.

***Purchase Consideration Allocation***

The fair value of assets acquired and liabilities assumed is as follows (in thousands):

Cash	\$ 145
Other tangible assets acquired, net of liabilities assumed	42
Intangible assets:	
Know-how	1,018
Developed technologies	4,421

IPR&D	2,045
Total identifiable net assets acquired	7,671
Goodwill	6,571
Total net assets acquired	\$ 14,242

Intangible assets with finite lives included know-how and developed technologies with estimated useful lives of three to five years. The fair value of know-how was determined using the relief from royalty method, and the fair value of the developed technologies was determined using the income approach. Intangible assets with indefinite lives included in-process research and development (“IPR&D”), which consisted of incomplete R&D projects that had not reached technological feasibility as of the Acquisition Date. The fair value of the IPR&D assets was determined using the income approach. During the third quarter of 2015, management determined that the acquired IPR&D was completed and reclassified it as a finite-lived intangible asset with an estimated useful life of four years.

The goodwill arising from the acquisition was primarily attributed to synergies which will enable the Company to develop advanced solutions in power management by integrating Sensima’s magnetic sensor technologies. The goodwill is not expected to be deductible for tax purposes.

### *Equity Awards*

On the Acquisition Date, the Board of Directors granted \$1.7 million of time-based RSUs (or 40,000 shares) to key Sensima employees who became employees of the Company. These awards vest over four years. In addition, the Board of Directors granted \$2.0 million of PSUs (or 47,000 shares) to these employees, with the right to earn up to a maximum of \$8.0 million based on the achievement of certain cumulative Sensima product revenue targets during the performance period from the Acquisition Date to July 22, 2019. 50% of the awards subject to each revenue goal will vest immediately when the pre-determined revenue goal is met and approved by the Compensation Committee, and the remaining shares will vest over the following two years. The vesting is subject to the employees’ continued employment with the Company. These equity awards are considered arrangements for post-acquisition services and the related compensation expense is being recognized over the requisite service period.

***Pro Forma Information (Unaudited)***

Supplemental information of the Company's results of operations on a pro forma basis, as if the Sensima acquisition had been consummated on January 1, 2014, is presented as follows (in thousands, except per-share amounts):

	<b>Three Months Ended September 30, 2014</b>	<b>Nine Months Ended September 30, 2014</b>
Revenue	\$ 78,336	\$ 206,882
Net income	\$ 11,025	\$ 24,886
Diluted net income per share	\$ 0.28	\$ 0.63

These pro forma results are not necessarily indicative of the Company's consolidated results of operations in future periods or the results that would have been realized had the Company acquired Sensima during the periods presented. The pro forma results include adjustments primarily related to Sensima's results of operations, amortization of intangible assets, stock-based compensation expense and the related tax effects.

**4. BALANCE SHEET COMPONENTS*****Inventories***

Inventories consist of the following (in thousands):

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Raw materials	\$ 16,840	\$ 7,298
Work in process	23,083	18,950
Finished goods	27,386	14,670
Total	\$ 67,309	\$ 40,918

***Other Long-Term Assets***

Other long-term assets consist of the following (in thousands):

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Deferred compensation plan assets	\$ 8,971	\$ 6,084
Prepaid expense	1,370	1,418
Other	1,150	955
Total	\$ 11,491	\$ 8,457

**Accrued Liabilities**

Accrued liabilities consist of the following (in thousands):

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Dividends and dividend equivalents	\$ 8,525	\$ 6,080
Deferred revenue and customer prepayments	4,083	3,908
Stock rotation reserve	2,667	1,757
Commissions	819	767
Sales rebate	446	586
Warranty	268	240
Other	1,895	1,365
Total	\$ 18,703	\$ 14,703

A roll-forward of the warranty reserve is as follows (in thousands):

	<b>Three Months Ended September 30, 2015</b>		<b>Nine Months Ended September 30, 2014</b>	
Balance at beginning of period	\$205	\$290	\$240	\$451
Warranty provision for product sales	91	78	246	207
Settlements made	-	-	(153)	(74 )
Unused warranty provision	(28 )	(128)	(65 )	(344)
Balance at end of period	\$268	\$240	\$268	\$240

**Other Long-Term Liabilities**

Other long-term liabilities consist of the following (in thousands):

<b>September 30,</b>	<b>December 31,</b>
--------------------------	-------------------------



	<b>2015</b>	<b>2014</b>
Deferred compensation plan liabilities	\$ 9,020	\$ 6,177
Contingent consideration	2,507	2,507
Dividend equivalents	1,727	580
Other	863	940
Total	\$ 14,117	\$ 10,204

## 5. GOODWILL AND ACQUISITION-RELATED INTANGIBLE ASSETS, NET

There have been no changes in the balance of goodwill during the three and nine months ended September 30, 2015.

Acquisition-related intangible assets consist of the following (in thousands):

	<b>As of September 30, 2015</b>		
	<b>Gross Amount</b>	<b>Accumulated Amortization</b>	<b>Net Amount</b>
Subject to amortization:			
Know-how	\$1,018	\$ (246 )	\$ 772
Developed technologies	6,466	(1,672 )	4,794
Total	\$7,484	\$ (1,918 )	\$ 5,566

**As of December 31, 2014**

	<b>Gross Amount</b>	<b>Accumulated Amortization</b>	<b>Net Amount</b>
Subject to amortization:			
Know-how	\$1,018	\$ (93 )	\$ 925
Developed technologies	4,421	(579 )	3,842
Not subject to amortization:			
IPR&D	2,045	-	2,045
Total	\$7,484	\$ (672 )	\$ 6,812

During the third quarter of 2015, management determined that the acquired IPR&D from the Sensima acquisition was completed and the products incorporating the technologies are ready to be commercially introduced. Accordingly, the acquired IPR&D was reclassified into developed technologies as a finite-lived intangible asset and is being amortized over its estimated useful life.

Amortization expense is recorded in cost of revenue in the Condensed Consolidated Statements of Operations and totaled \$0.5 million and \$1.2 million for the three and nine months ended September 30, 2015, respectively. Amortization expense totaled \$0.3 million for both the three and nine months ended September 30, 2014.

As of September 30, 2015, the estimated future amortization expense was as follows (in thousands):

2015 (remaining three months)	\$513
2016	2,051
2017	2,051
2018	841
2019	110
Total	\$5,566

**6. NET INCOME PER SHARE**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the potential dilution that would occur if outstanding securities or other contracts to issue common stock were exercised or converted into common stock, and calculated using the treasury stock method.

The Company's outstanding RSUs contain forfeitable rights to receive dividend equivalents, which are accrued quarterly during the vesting periods of the RSUs and are payable to the employees when the awards vest. Dividend equivalents accrued on the RSUs are forfeited if the employees do not fulfill their service requirement during the vesting periods. Accordingly, these awards are not treated as participating securities in the net income per share calculation.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per-share amounts):

	<b>Three Months Ended September 30, 2015</b>		<b>Nine Months Ended September 30, 2014</b>	
Numerator:				
Net income	\$11,201	\$11,221	\$25,063	\$26,635
Denominator:				
Weighted-average outstanding shares used to compute basic net income per share	39,592	38,785	39,422	38,646
Effect of dilutive securities	1,097	942	1,254	972
Weighted-average outstanding shares used to compute diluted net income per share	40,689	39,727	40,676	39,618
Net income per share:				
Basic	\$0.28	\$0.29	\$0.64	\$0.69
Diluted	\$0.28	\$0.28	\$0.62	\$0.67

For the three months ended September 30, 2015, there were no anti-dilutive common stock equivalents. For the nine months ended September 30, 2015, approximately 10,000 common stock equivalents were excluded from the calculation of diluted net income per share because their inclusion would have been anti-dilutive. For the three and nine months ended September 30, 2014, there were no anti-dilutive common stock equivalents.

## 7. SEGMENT AND GEOGRAPHIC INFORMATION

The Company operates in one reportable segment that includes the design, development, marketing and sale of high-performance power solutions for the cloud computing, telecommunications, industrial and automotive, and consumer markets. The Company's chief operating decision maker is its chief executive officer, who reviews financial information presented on a consolidated basis. The Company derives a majority of its revenue from sales to customers located outside North America, with geographic revenue based on the customers' ship-to locations.

The Company sells its products primarily through third-party distributors, value-added resellers and directly to original equipment manufacturers, original design manufacturers, and electronic manufacturing service providers. The following table summarizes those customers with sales greater than 10% of the Company's total revenue:

Customers	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Distributor A	24 %	26 %	24 %	26 %
Distributor B	*	10 %	*	10 %

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\* Represents less than 10%.

The following table summarizes those customers with accounts receivable balances greater than 10% of the Company's total accounts receivable:

Customers	September 30, 2015	December 31, 2014
Distributor A	30 %	31 %

Distributor B 12 % 10 %

Both of the customers are third-party distributors. The Company's agreements with these distributors were made in the ordinary course of business and may be terminated with or without cause by these distributors with advance notice. Although the Company may experience a short-term disruption in the distribution of its products and a short-term decline in revenue if its agreement with either of these distributors was terminated, the Company believes that such termination would not have a material adverse effect on its financial statements because it would be able to engage alternative distributors, resellers and other distribution channels to deliver its products to end customers within a few quarters following the termination of an agreement with the distributor.

The following is a summary of revenue by geographic regions (in thousands):

Country or Region	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
China	\$58,716	\$51,796	\$157,968	\$132,585
Taiwan	10,352	9,379	31,524	28,080
Korea	6,019	4,067	15,373	10,693
Europe	5,956	5,212	16,388	14,377
Southeast Asia	5,764	1,534	12,839	4,955
Japan	2,633	2,221	6,930	6,075
United States	1,673	4,079	4,932	9,913
Other	81	47	194	154
Total	\$91,194	\$78,335	\$246,148	\$206,832

The following is a summary of revenue by product family (in thousands):

<b>Product Family</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
DC to DC products	\$82,718	\$70,196	\$222,210	\$185,304
Lighting control products	8,476	8,139	23,938	21,528
Total	\$91,194	\$78,335	\$246,148	\$206,832

The following is a summary of long-lived assets by geographic regions (in thousands):

<b>Country</b>	<b>September 30, 2015</b>	<b>December 31, 2014</b>
China	\$ 35,085	\$ 37,147
United States	35,966	33,913
Bermuda	12,137	13,383
Other	528	339
Total	\$ 83,716	\$ 84,782

## 8. LITIGATION

The Company and certain of its subsidiaries are parties to actions and proceedings in the ordinary course of business, including litigation regarding its shareholders and its intellectual property, challenges to the enforceability or validity of its intellectual property, claims that the Company's products infringe on the intellectual property rights of others, and employment matters. These proceedings often involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources to prosecute and defend. The Company defends itself vigorously against any such claims.

### *O2 Micro*

In May 2012, the United States District Court for the Northern District of California (the "District Court") issued an order finding O2 Micro International, Ltd. ("O2 Micro") liable for approximately \$9.1 million in attorneys' fees and non-taxable costs, plus interest, in connection with the patent litigation that the Company won in 2010. This award was in addition to the approximately \$0.3 million in taxable costs that the District Court had earlier ordered O2 Micro

to pay to the Company in connection with the same lawsuit. In October 2012, O2 Micro appealed the District Court's judgment to the United States Court of Appeals for the Federal Circuit (the "Federal Circuit"). In August 2013, the Federal Circuit affirmed O2 Micro's liability for the full amount of the award. In September 2013, O2 Micro filed a petition for rehearing of that ruling, but the Federal Circuit denied O2 Micro's petition for rehearing in October 2013.

In November 2013, the Company received a cash payment of \$9.5 million from O2 Micro. In January 2014, O2 Micro filed an appeal with the United States Supreme Court. Had O2 Micro been successful in obtaining a favorable ruling against the Company, the Company could have been liable to return a portion or all of the \$9.5 million to O2 Micro. Accordingly, the Company recorded the \$9.5 million as a current liability as of December 31, 2013.

In March 2014, the Supreme Court declined to hear the case. As O2 Micro had no further legal avenues to appeal, the Company released the current liability of \$9.5 million and recorded the award as a litigation benefit in the Condensed Consolidated Statements of Operations in the first quarter of 2014. In addition, the Company incurred additional legal fees of \$0.5 million in connection with the final resolution of the lawsuit.

**9. CASH, CASH EQUIVALENTS AND INVESTMENTS**

The following is a summary of the Company's cash, cash equivalents and short-term and long-term investments (in thousands):

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Cash, cash equivalents and investments:		
Cash	\$ 45,481	\$ 66,188
Money market funds	31,135	60,078
Certificates of deposit	22,008	22,778
U.S. treasuries and government agency bonds	131,039	89,674
Auction-rate securities backed by student-loan notes	5,364	5,389
Total	\$ 235,027	\$ 244,107

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Reported as:		
Cash and cash equivalents	\$ 76,616	\$ 126,266
Short-term investments	153,047	112,452
Long-term investments	5,364	5,389
Total	\$ 235,027	\$ 244,107

The contractual maturities of the Company's short-term and long-term available-for-sale investments are as follows (in thousands):

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Due in less than 1 year	\$ 120,745	\$ 91,335
Due in 1 - 5 years	32,302	21,117
Due in greater than 5 years	5,364	5,389
Total	\$ 158,411	\$ 117,841

The following tables summarize unrealized gains and losses related to our investments in marketable securities designated as available-for sale (in thousands):



## As of September 30, 2015

	Adjusted Cost	Unrealized Gains	Unrealized Losses	Total Fair Value	Fair Value of Investments in Unrealized Loss Position
Money market funds	\$31,135	\$ -	\$ -	\$31,135	\$ -
Certificates of deposit	22,008	-	-	22,008	-
U.S. treasuries and government agency bonds	130,978	64	(3 )	131,039	23,640
Auction-rate securities backed by student-loan notes	5,570	-	(206 )	5,364	5,364
Total	\$189,691	\$ 64	\$ (209 )	\$189,546	\$ 29,004

## As of December 31, 2014

	Adjusted Cost	Unrealized Gains	Unrealized Losses	Total Fair Value	Fair Value of Investments in Unrealized Loss Position
Money market funds	\$60,078	\$ -	\$ -	\$60,078	\$ -
Certificates of deposit	22,778	-	-	22,778	-
U.S. treasuries and government agency bonds	89,689	14	(29 )	89,674	35,062
Auction-rate securities backed by student-loan notes	5,570	-	(181 )	5,389	5,389
Total	\$178,115	\$ 14	\$ (210 )	\$177,919	\$ 40,451

**10. FAIR VALUE MEASUREMENTS**

The following table details the fair value measurement of the financial assets and liabilities (in thousands):

	<b>Fair Value Measurement at September 30, 2015</b>			
	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets Level 1</b>	<b>Significant Other Observable Inputs Level 2</b>	<b>Significant Unobservable Inputs Level 3</b>
<b>Assets:</b>				
Money market funds	\$31,135	\$ 31,135	\$ -	\$ -
Certificates of deposit	22,008	-	22,008	-
U.S. treasuries and government agency bonds	131,039	-	131,039	-
Auction-rate securities backed by student-loan notes	5,364	-	-	5,364
Mutual funds under deferred compensation plan	3,502	3,502	-	-
<b>Total</b>	<b>\$193,048</b>	<b>\$ 34,637</b>	<b>\$ 153,047</b>	<b>\$ 5,364</b>
<b>Liabilities:</b>				
Contingent consideration	\$2,507	\$ -	\$ -	\$ 2,507
<b>Total</b>	<b>\$2,507</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 2,507</b>

	<b>Fair Value Measurement at December 31, 2014</b>			
	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets Level 1</b>	<b>Significant Other Observable Inputs Level 2</b>	<b>Significant Unobservable Inputs Level 3</b>
<b>Assets:</b>				
Money market funds	\$60,078	\$ 60,078	\$ -	\$ -
Certificates of deposit	22,778	-	22,778	-
U.S. treasuries and government agency bonds	89,674	-	89,674	-
Auction-rate securities backed by student-loan notes	5,389	-	-	5,389
Mutual funds under deferred compensation plan	2,236	2,236	-	-
<b>Total</b>	<b>\$180,155</b>	<b>\$ 62,314</b>	<b>\$ 112,452</b>	<b>\$ 5,389</b>
<b>Liabilities:</b>				

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Contingent consideration	\$2,507	\$ -	\$ -	\$ 2,507
Total	\$2,507	\$ -	\$ -	\$ 2,507

The Company's level 3 assets consist of government-backed student loan auction-rate securities, with interest rates that reset through a Dutch auction every 7 to 35 days and which became illiquid in 2008. The following table provides a rollforward of the fair value of the auction-rate securities (in thousands):

Balance at January 1, 2015	\$5,389
Change in unrealized loss included in other comprehensive income	(25 )
Ending balance at September 30, 2015	\$5,364

The Company determined the fair value of the auction-rate securities using a discounted cash flow model with the following assumptions:

	<b>September 30, 2015</b>		<b>December 31, 2014</b>
Time-to-liquidity (months)	24		24
Expected return	2.5%		2.9%
Discount rate	3.9% - 6.9%		4.0% - 7.0%

The Company's level 3 liabilities consist of the contingent consideration related to the acquisition of Sensima in July 2014. The arrangement requires the Company to pay up to \$8.9 million to Sensima's former shareholders if Sensima achieves a new product introduction as well as certain product revenue and direct margin targets in 2016. The fair value of the contingent consideration at the Acquisition Date was \$2.5 million, which was estimated based on a probability-weighted analysis of possible future cash flow outcomes. Based on management's assessment, there were no changes in the fair value of the contingent consideration for the three and nine months ended September 30, 2015.

## 11. DEFERRED COMPENSATION PLAN

The Company has a non-qualified, unfunded deferred compensation plan, which provides certain key employees, including executive management, with the ability to defer the receipt of compensation in order to accumulate funds for retirement on a tax deferred basis. The Company does not make contributions to the plan or guarantee returns on the investments. The Company is responsible for the plan's administrative expenses. Participants' deferrals and investment gains and losses remain as the Company's liabilities and the underlying assets are subject to claims of general creditors. As of September 30, 2015 and December 31, 2014, the plan assets totaled \$9.0 million and \$6.1 million, and the plan liabilities totaled \$9.0 million and \$6.2 million, respectively.

## 12. INCOME TAXES

The income tax provision for the three months ended September 30, 2015 was \$2.1 million, or 15.8% of pre-tax income. The effective tax rate differed from the federal statutory rate primarily because foreign income was taxed at lower rates, and because of the benefit that the Company realized from stock option exercises and the release of RSUs. In addition, the effective tax rate was impacted by changes in the valuation allowance and true-up adjustments.

The income tax provision for the nine months ended September 30, 2015 was \$5.1 million, or 16.9% of pre-tax income. The Company recorded a one-time net charge of \$2.7 million to the income tax provision related to the resolution of the income tax audits in the second quarter of 2015 (see "Income Tax Audits" below for further discussion). In addition to the impact of this charge, the effective tax rate differed from the federal statutory rate primarily because foreign income was taxed at lower rates, and because of the benefit that the Company realized from stock option exercises and the release of RSUs, and from the release of an income tax reserve where the statute of limitations expired. In addition, the effective tax rate was impacted by changes in the valuation allowance and true-up adjustments.

The income tax provision (benefit) for the three and nine months ended September 30, 2014 was \$(0.6) million, or (5.4)% of pre-tax income, and \$0.2 million, or 0.7% of pre-tax income, respectively. The effect tax rate differed from the federal statutory rate primarily because foreign income was taxed at lower rates, and because of the benefit that the

Company realized from the release of a reserve where the statute of limitations expired, and from the benefit realized as a result of stock option exercises and the release of RSUs.

On July 27, 2015, in *Altera Corp. v. Commissioner*, the U.S. Tax Court issued an opinion related to the treatment of stock-based compensation expense in an intercompany cost-sharing arrangement. A final decision has yet to be issued by the Tax Court due to other outstanding issues related to the case. At this time, the U.S. Department of the Treasury has not withdrawn the requirement from its regulations to include stock-based compensation. Due to the uncertainty surrounding the status of the current regulations, questions related to the scope of potential benefits, and the risk of the Tax Court's decision being overturned upon appeal, the Company has not recorded any adjustments as of September 30, 2015. The Company will continue to monitor developments related to this opinion and the potential impact on its financial statements.

### ***Unrecognized Tax Benefits***

As of September 30, 2015, the Company had \$11.2 million of unrecognized tax benefits, \$2.4 million of which would affect its effective tax rate if recognized after considering the valuation allowance. As of December 31, 2014, the Company had \$16.4 million of unrecognized tax benefits, \$4.8 million of which would affect its effective tax rate if recognized after considering the valuation allowance.

Uncertain tax positions relate to the allocation of income and deductions among the Company's global entities and to the determination of the research and development tax credit. It is reasonably possible that over the next twelve-month period, the Company may experience increases or decreases in its unrecognized tax benefits. However, it is not possible to determine either the magnitude or the range of increases or decreases at this time.

The Company recognizes interest and penalties, if any, related to uncertain tax positions in its income tax provision. As of September 30, 2015 and December 31, 2014, the Company has approximately \$0.1 million and \$0.5 million of accrued interest related to uncertain tax positions, respectively, which were recorded in long-term tax liabilities in the Condensed Consolidated Balance Sheets.

### *Income Tax Audits*

The Company is subject to examination of its income tax returns by the IRS and other tax authorities. The Company's U.S. Federal income tax returns for the years ended December 31, 2005 through December 31, 2007 were under examination by the IRS. In April 2011, the Company received from the IRS a Notice of Proposed Adjustment ("NOPA") relating to a cost-sharing agreement entered into by the Company and its international subsidiaries on January 1, 2004. In the NOPA, the IRS objected to the Company's allocation of certain litigation expenses between the Company and its international subsidiaries and the amount of "buy-in payments" made by the international subsidiaries to the Company in connection with the cost-sharing agreement, and proposed to increase the Company's U.S. taxable income according to a few alternative methodologies. In February 2012, the Company received a revised NOPA from the IRS ("Revised NOPA"). In this Revised NOPA, the IRS raised the same issues as in the NOPA issued in April 2011 but under a different methodology. Under the Revised NOPA, the largest potential federal income tax payment, if the IRS were to prevail on all matters in dispute, was \$10.5 million, plus interest and penalties, if any. The Company responded to the Revised NOPA in May 2012. In June 2013, the IRS responded and continued to disagree with the Company's rebuttal. The Company met with the IRS Office of Appeals in 2014 and both parties engaged in continuous discussions for a resolution of the matter in the first quarter of 2015. Meanwhile, the Company granted the IRS an extension of the statute of limitations for taxable years 2005 through 2007 to September 30, 2015.

The IRS also audited the research and development credits carried forward into year 2005 and the credits generated in the years 2005 through 2007. The Company received a NOPA from the IRS in February 2011, proposing to reduce the research and development credits generated in years 2005 through 2007 and the carryforwards, which would then reduce the value of such credits carried forward to subsequent tax years.

In April 2015, the Company reached a final resolution with the IRS in connection with the income tax audits for the years 2005 through 2007. Under the agreement, the Company made a one-time buy-in payment of \$1.2 million for taxes related primarily to the revaluation of a license for certain intellectual property rights of the Company to one of its international subsidiaries. This buy-in payment is final and no additional payment will be required with respect to the intellectual property license for the years under examination or for a previous or subsequent tax year. In addition, the Company made an interest payment of \$1.0 million as well as a tax payment of \$0.1 million for the tax years 2008 to 2013 in the third quarter of 2015. There were no penalties assessed on the Company as a result of the audits.

For the second quarter of 2015, the Company's income tax provision included a one-time net charge of approximately \$2.7 million reflecting the taxes and interest, partially offset by the reversal of previously accrued tax liabilities and

valuation allowances. Of the \$2.7 million charge, approximately \$1.6 million was related to taxes and \$1.1 million was related to interest.

**13. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following table summarizes the changes in accumulated other comprehensive income (in thousands):

	<b>Unrealized Losses on Auction-Rate Securities</b>	<b>Unrealized Gains (Losses) on Other Available-for-Sale Securities</b>	<b>Foreign Currency Translation Adjustments</b>	<b>Total</b>
Balance as of January 1, 2015	\$ (181 )	\$ (15 )	\$ 6,007	\$5,811
Other comprehensive income before reclassifications	5	32	249	286
Amounts reclassified from accumulated other comprehensive income	-	(1 )	-	(1 )
Net current period other comprehensive income	5	31	249	285
Balance as of March 31, 2015	(176 )	16	6,256	6,096
Other comprehensive income (loss) before reclassifications	(19 )	7	105	93
Amounts reclassified from accumulated other comprehensive income	-	(3 )	-	(3 )
Net current period other comprehensive income (loss)	(19 )	4	105	90
Balance as of June 30, 2015	(195 )	20	6,361	6,186
Other comprehensive income (loss) before reclassifications	(11 )	42	(3,132 )	(3,101)
Amounts reclassified from accumulated other comprehensive income	-	(1 )	-	(1 )
Net current period other comprehensive income (loss)	(11 )	41	(3,132 )	(3,102)
Balance as of September 30, 2015	\$ (206 )	\$ 61	\$ 3,229	\$3,084

The amounts reclassified from accumulated other comprehensive income were recorded in interest and other income (expense), net, in the Condensed Consolidated Statement of Operations.

**14. STOCK REPURCHASE PROGRAM**

In July 2013, the Board of Directors approved a stock repurchase program that authorizes the Company to repurchase up to \$100 million in the aggregate of its common stock through June 30, 2015. In April 2015, the Board of Directors approved an extension of the program through December 31, 2015. All shares are retired upon repurchase. The following table summarizes the repurchase activities under the program (in thousands, except per-share amounts):

<b>Shares</b>	<b>Total</b>
---------------	--------------



	<b>Repurchased</b>	<b>Average Price</b>	<b>Amount</b>
		<b>Per Share</b>	
Cumulative balance at January 1, 2015	1,715	\$ 36.04	\$61,813
Repurchases	203	\$ 51.33	10,405
Cumulative balance at March 31, 2015	1,918	\$ 37.66	72,218
Repurchases	148	\$ 52.19	7,724
Cumulative balance at June 30, 2015	2,066	\$ 38.70	79,942
Repurchases	284	\$ 47.93	13,606
Cumulative balance at September 30, 2015	2,350	\$ 39.82	\$93,548

As of September 30, 2015, \$6.5 million remained available for future repurchases under the program.

## 15. DIVIDENDS AND DIVIDEND EQUIVALENTS

In June 2014, the Board of Directors approved a dividend program pursuant to which the Company intends to pay quarterly cash dividends on its common stock. Stockholders of record as of the last day of the quarter are entitled to receive the quarterly cash dividends when and if declared by the Board of Directors, which are generally payable on the 15th of the following month. The Board of Directors declared the following cash dividends in 2015 (in thousands, except per-share amounts):

	<b>Dividend Declared per Share</b>	<b>Total Amount</b>
First quarter	\$ 0.20	\$ 7,854
Second quarter	\$ 0.20	\$ 7,925
Third quarter	\$ 0.20	\$ 7,901

As of September 30, 2015, accrued dividends totaled \$7.9 million. The dividends were paid to stockholders on October 15, 2015.

The declaration of any future cash dividends is at the discretion of the Board of Directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interests of the Company's stockholders. The Company anticipates that the cash used for future dividends will come from its current domestic cash and cash generated from ongoing U.S. operations. If cash held by the Company's international subsidiaries is needed for the payment of dividends, the Company may be required to accrue and pay U.S. taxes to repatriate the funds.

Under the Company's stock plans, outstanding RSU awards contain rights to receive cash dividend equivalents, which entitle employees who hold RSUs to the same dividend value per share as holders of common stock. The dividend equivalents are accrued quarterly during the vesting periods of the RSUs and are payable to the employees when the awards vest. Dividend equivalents accrued on the outstanding RSUs are forfeited if the employees do not fulfill their service requirement during the vesting periods. As of September 30, 2015 and December 31, 2014, accrued dividend equivalents totaled \$2.3 million and \$0.8 million, respectively, which will be paid to the employees when the related RSUs vest.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that have been made pursuant to and in reliance on the provisions of the Private Securities Litigation Reform Act of 1995. These statements include among other things, statements concerning:

• the above-average industry growth of product and market areas that we have targeted,

• our plan to increase our revenue through the introduction of new products within our existing product families as well as

• in new product categories and families,

• our intention to exercise our purchase option with respect to our manufacturing facility in Chengdu, China,

• our belief that we will continue to incur significant legal expenses that vary with the level of activity in each of our legal proceedings,

• the effect that liquidity of our investments has on our capital resources,

• the continuing application of our products in the communications, storage and computing, consumer and industrial markets, which account for a majority of our revenue,

• estimates of our future liquidity requirements,

• the cyclical nature of the semiconductor industry,

• protection of our proprietary technology,

• near-term business outlook for the remainder of 2015 and beyond,

• the factors that we believe will impact our ability to achieve revenue growth,

- the percentage of our total revenue from various market segments,
- our ability to identify, acquire and integrate acquisitions and achieve the anticipated benefits from such acquisitions,
- our intention and ability to continue our stock repurchase program and pay future cash dividends, and
- the factors that differentiate us from our competitors.

In some cases, words such as “would,” “could,” “may,” “should,” “predict,” “potential,” “targets,” “continue,” “anticipate,” “expect,” “intend,” “plan,” “believe,” “seek,” “estimate,” “project,” “forecast,” “will,” the negative of these terms or other variations of such terms and similar expressions relating to the future identify forward-looking statements. All forward-looking statements are based on our current outlook, expectations, estimates, projections, beliefs and plans or objectives about our business and our industry. These statements are not guarantees of future performance and are subject to risks and uncertainties. Actual events or results could differ materially and adversely from those expressed in any such forward-looking statements. Risks and uncertainties that could cause actual results to differ materially include those set forth throughout this Quarterly Report on Form 10-Q and, in particular, Part II. Other Information, “Item 1A. Risk Factors.” Except as required by law, we disclaim any duty to and undertake no obligation to update any forward-looking statements, whether as a result of new information relating to existing conditions, future events or otherwise or to release publicly the results of any future revisions we may make to forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Readers are cautioned not to place undue reliance on such statements, which speak only as of the date of this Quarterly Report on Form 10-Q. Readers should carefully review future reports and documents that we file from time to time with the Securities and Exchange Commission, such as our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

The following management's discussion and analysis should be read in connection with the information presented in our unaudited condensed consolidated financial statements and related notes for the three and nine months ended September 30, 2015 included in this report and our audited consolidated financial statements and related notes for the year ended December 31, 2014 included in our Annual Report on Form 10-K.

## Overview

We are a leading company in high performance power solutions. Founded in 1997, we provide small, highly energy efficient, easy-to-use power solutions for systems found in industrial applications, telecom infrastructures, cloud computing, automotive, and consumer applications. Our mission is to reduce total energy consumption in our customers' systems with green, practical, compact solutions. We believe that we differentiate ourselves by offering solutions that are more highly integrated, smaller in size, more energy efficient, more accurate with respect to performance specifications and, consequently, more cost-effective than many competing solutions. We plan to continue to introduce new products within our existing product families, as well as in new innovative product categories.

We operate in the cyclical semiconductor industry where there is seasonal demand for certain products. We are not and will not be immune from current and future industry downturns, but we have targeted product and market areas that we believe have the ability to offer above average industry performance.

We work with third parties to manufacture and assemble our integrated circuits ("ICs"). This has enabled us to limit our capital expenditures and fixed costs, while focusing our engineering and design resources on our core strengths.

Following the introduction of a product, our sales cycle generally takes a number of quarters after we receive an initial customer order for a new product to ramp up. Typical lead time for orders is fewer than 90 days. These factors, combined with the fact that orders in the semiconductor industry can typically be cancelled or rescheduled without significant penalty to the customer, make the forecasting of our orders and revenue difficult.

We derive most of our revenue from sales through distribution arrangements and direct sales to customers in Asia, where the products we produce are incorporated into end-user products. Our revenue from direct or indirect sales to customers in Asia was 92% and 88% for the three months ended September 30, 2015 and 2014, and 91% and 88% for the nine months ended September 30, 2015 and 2014, respectively. We derive a majority of our revenue from the sales of our DC to DC converter product family which services the communications, storage and computing, consumer and industrial markets. We believe our ability to achieve revenue growth will depend, in part, on our ability to develop new products, enter new market segments, gain market share, manage litigation risk, diversify our customer base and successfully secure manufacturing capacity.

### **Critical Accounting Policies and Estimates**

There have been no significant changes in our critical accounting policies and estimates used in the preparation of our financial statements during the three and nine months ended September 30, 2015, as compared to those disclosed in the Annual Report on Form 10-K for the year ended December 31, 2014.

## Results of Operations

The table below sets forth the data in the Condensed Consolidated Statement of Operations as a percentage of revenue:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015		2014		2015		2014	
	(in thousands, except percentages)							
Revenue	\$91,194	100.0%	\$78,335	100.0%	\$246,148	100.0%	\$206,832	100.0%
Cost of revenue	41,754	45.8	35,872	45.8	112,896	45.9	95,173	46.0
Gross profit	49,440	54.2	42,463	54.2	133,252	54.1	111,659	54.0
Operating expenses:								
Research and development	17,272	18.9	14,679	18.7	49,053	19.9	43,649	21.1
Selling, general and administrative	18,722	20.5	17,006	21.8	54,204	22.0	49,968	24.1
Litigation expense (benefit), net	136	0.2	332	0.4	717	0.3	(8,093 )	(3.9 )
Total operating expenses	36,130	39.6	32,017	40.9	103,974	42.2	85,524	41.3
Income from operations	13,310	14.6	10,446	13.3	29,278	11.9	26,135	12.7
Interest and other income (expense), net	(6 )	(0.0 )	202	0.3	871	0.4	686	0.3
Income before income taxes	13,304	14.6	10,648	13.6	30,149	12.3	26,821	13.0
Income tax provision (benefit)	2,103	2.3	(573 )	(0.7 )	5,086	2.1	186	0.1
Net income	\$11,201	12.3 %	\$11,221	14.3 %	\$25,063	10.2 %	\$26,635	12.9 %

## Revenue

The following table shows our revenue by product family:

<u>Product Family</u>	Three Months Ended September 30,				Change	Nine Months Ended September 30,				
	2015	% of Revenue	2014	% of Revenue		2015	% of Revenue	2014	% of Revenue	
	(in thousands, except percentages)									
DC to DC products	\$82,718	90.7 %	\$70,196	89.6 %	17.8 %	\$222,210	90.3 %	\$185,304	89.6 %	19.9 %
Lighting control products	8,476	9.3 %	8,139	10.4 %	4.1 %	23,938	9.7 %	21,528	10.4 %	11.2 %
Total	\$91,194	100.0 %	\$78,335	100.0 %	16.4 %	\$246,148	100.0 %	\$206,832	100.0 %	19.0 %

Revenue for the three months ended September 30, 2015 was \$91.2 million, an increase of \$12.9 million, or 16.4%, from \$78.3 million for the three months ended September 30, 2014. This increase was due to higher sales of both DC to DC and lighting control products, as unit shipments increased 9% due to higher market demand with current customers and additional design wins with new customers, coupled with an increase of 7% in average sales prices. Revenue from our DC to DC products was \$82.7 million for the three months ended September 30, 2015, an increase of \$12.5 million, or 17.8%, from the same period in 2014. This increase was primarily due to higher sales of our DC to DC converters and battery chargers, which were offset in part by lower sales of our Mini-Monsters products. Revenue from our lighting control products was \$8.5 million for the three months ended September 30, 2015, an increase of \$0.4 million, or 4.1%, compared with the same period in 2014.

Revenue for the nine months ended September 30, 2015 was \$246.1 million, an increase of \$39.3 million, or 19.0%, from \$206.8 million for the nine months ended September 30, 2014. This increase was due to higher sales of both DC to DC and lighting control products, as unit shipments increased 19% due to higher market demand with current customers and additional design wins with new customers, partially offset by a decrease of 1% in average sales prices. Revenue from our DC to DC products was \$222.2 million for the nine months ended September 30, 2015, an increase of \$36.9 million, or 19.9%, from the same period in 2014. This increase was primarily due to higher sales of our DC to DC converters and battery chargers, which were offset in part by lower sales of our Mini-Monsters products. Revenue from our lighting control products was \$23.9 million for the nine months ended September 30, 2015, an increase of \$2.4 million, or 11.2%, compared with the same period in 2014.

### *Cost of Revenue and Gross Margin*

Cost of revenue consists primarily of costs incurred to manufacture, assemble and test our products, as well as warranty costs, inventory-related and other overhead costs, and stock-based compensation expenses. In addition, cost of revenue includes amortization of intangible assets from the Sensima acquisition beginning in the third quarter of 2014.

	<b>Three Months Ended September 30,</b>			<b>Nine Months Ended September 30,</b>		
	<b>2015</b>	<b>2014</b>	<b>Change</b>	<b>2015</b>	<b>2014</b>	<b>Change</b>
	(in thousands, except percentages)					
Cost of revenue	\$41,754	\$35,872	16.4 %	\$112,896	\$95,173	18.6 %
Cost of revenue as a percentage of revenue	45.8 %	45.8 %		45.9 %	46.0 %	
Gross profit	\$49,440	\$42,463	16.4 %	\$133,252	\$111,659	19.3 %
Gross margin	54.2 %	54.2 %		54.1 %	54.0 %	



Cost of revenue was \$41.8 million, or 45.8% of revenue, for the three months ended September 30, 2015, and \$35.9 million, or 45.8% of revenue, for the three months ended September 30, 2014. The \$5.9 million increase in cost of revenue was primarily due to a 9% increase in unit shipments, coupled with a 10% increase in the average direct cost of units shipped.

Gross profit as a percentage of revenue, or gross margin, was 54.2% for the three months ended September 30, 2015, compared to 54.2% for the three months ended September 30, 2014. For the three months ended September 30, 2015, gross margin was favorably impacted by lower labor and overhead costs as a percentage of revenue, partially offset by increased sales of lower margin products.

Cost of revenue was \$112.9 million, or 45.9% of revenue, for the nine months ended September 30, 2015, and \$95.2 million, or 46.0% of revenue, for the nine months ended September 30, 2014. The \$17.7 million increase in cost of revenue was primarily due to a 19% increase in unit shipments, coupled with a 3% increase in the average direct cost of units shipped. In addition, the increase in cost of revenue was driven by additional amortization of intangible assets of \$0.9 million.

Gross margin was 54.1% for the nine months ended September 30, 2015, compared to 54.0% for the nine months ended September 30, 2014. For the nine months ended September 30, 2015, gross margin was favorably impacted by lower labor and overhead costs as a percentage of revenue, partially offset by increased sales of lower margin products and higher amortization of intangible assets.

### ***Research and Development***

Research and development expenses primarily consist of salary and benefit expenses, bonuses and stock-based compensation expenses for design and product engineers, expenses related to new product development and supplies, and facility costs.

	<b>Three Months Ended September 30,</b>			<b>Nine Months Ended September 30,</b>		
	<b>2015</b>	<b>2014</b>	<b>Change</b>	<b>2015</b>	<b>2014</b>	<b>Change</b>
	<i>(in thousands, except percentages)</i>					
Research and development ("R&D")	\$17,272	\$14,679	17.7 %	\$49,053	\$43,649	12.4 %
R&D as a percentage of revenue	18.9 %	18.7 %		19.9 %	21.1 %	

R&D expenses were \$17.3 million, or 18.9% of revenue, for the three months ended September 30, 2015 and \$14.7 million, or 18.7% of revenue, for the three months ended September 30, 2014. The \$2.6 million increase in R&D expenses was primarily due to an increase of \$1.8 million in cash compensation expenses, which include salary, benefits and bonuses, an increase of \$0.5 million in stock-based compensation expenses primarily associated with the performance-based equity awards, and an increase of \$0.4 million in new product development expenses. These increases were partially offset by a decrease of \$0.2 million related to the change in the values of the employee deferred compensation plan liabilities. Our R&D headcount was 505 employees as of September 30, 2015, compared with 457 employees as of September 30, 2014.

R&D expenses were \$49.1 million, or 19.9% of revenue, for the nine months ended September 30, 2015 and \$43.6 million, or 21.1% of revenue, for the nine months ended September 30, 2014. The \$5.5 million increase in R&D expenses was primarily due to an increase of \$2.2 million in cash compensation expenses, which include salary, benefits and bonuses, an increase of \$1.4 million in stock-based compensation expenses primarily associated with the performance-based equity awards, an increase of \$1.0 million in new product development expenses, and an increase of \$0.4 million in manufacturing and laboratory supplies. These increases were partially offset by a decrease of \$0.2 million related to the change in the values of the employee deferred compensation plan liabilities.

### ***Selling, General and Administrative***

Selling, general and administrative expenses primarily include salary and benefit expenses, bonuses and stock-based compensation expenses for sales, marketing and administrative personnel, sales commissions, travel expenses, facilities costs, and professional service fees.

	Three Months Ended			Nine Months Ended		
	September 30,			September 30,		
	2015	2014	Change	2015	2014	Change
	(in thousands, except percentages)					
Selling, general and administrative ("SG&A")	\$18,722	\$17,006	10.1 %	\$54,204	\$49,968	8.5 %
SG&A as a percentage of revenue	20.5 %	21.8 %		22.0 %	24.1 %	

SG&A expenses were \$18.7 million, or 20.5% of revenue, for the three months ended September 30, 2015 and \$17.0 million, or 21.8% of revenue, for the three months ended September 30, 2014. The \$1.7 million increase in SG&A expenses was primarily due to an increase of \$1.0 million in cash compensation expenses, which include salary, benefits and bonuses, and an increase of \$1.0 million in stock-based compensation expenses primarily associated with the performance-based equity awards. These increases were partially offset by a decrease of \$0.2 million related to the change in the values of the employee deferred compensation plan liabilities, and a decrease of \$0.1 million in professional service fees primarily due to the transaction costs incurred in the Sensima acquisition for the three months ended September 30, 2014, but not in 2015. Our SG&A headcount was 291 employees as of September 30, 2015, compared with 270 employees as of September 30, 2014.

SG&A expenses were \$54.2 million, or 22.0% of revenue, for the nine months ended September 30, 2015 and \$50.0 million, or 24.1% of revenue, for the nine months ended September 30, 2014. The \$4.2 million increase in SG&A expenses was primarily due to an increase of \$2.7 million in stock-based compensation expenses primarily associated with the performance-based equity awards, an increase of \$1.5 million in cash compensation expenses, which include salary, benefits and bonuses, and an increase of \$0.2 million in depreciation. These increases were partially offset by a decrease of \$0.6 million in professional service fees primarily due to the transaction costs incurred in the Sensima acquisition for the nine months ended September 30, 2014, but not in 2015, and a decrease of \$0.2 million related to the change in the values of the employee deferred compensation plan liabilities.

#### ***Litigation Expense (Benefit), Net***

For the three months ended September 30, 2015, litigation expense was \$0.1 million, compared with \$0.3 million for the three months ended September 30, 2014. For the nine months ended September 30, 2015, litigation expense was \$0.7 million, compared with a net litigation benefit of \$8.1 million for the nine months ended September 30, 2014. The net litigation benefit for the nine months ended September 30, 2014 included the recognition of a \$9.5 million award from the O2 Micro litigation, partially offset by \$0.5 million of additional legal fees incurred in connection with the final resolution of the litigation. See Note 8 to our Condensed Consolidated Financial Statements for further discussion of this litigation.

#### ***Interest and Other Income (Expense), Net***

For the three months ended September 30, 2015, interest and other expense, net, was \$7,000, compared with interest and other income, net, of \$0.2 million for the three months ended September 30, 2014. The decrease was primarily driven by higher expenses related to the change in the values of the employee deferred compensation plan assets, partially offset by higher foreign currency exchange gains and an increase in interest income.

For the nine months ended September 30, 2015, interest and other income, net, was \$0.9 million, compared with \$0.7 million for the nine months ended September 30, 2014. The increase was primarily due to higher foreign currency exchange gains and an increase in interest income, partially offset by higher expenses related to the change in the values of the employee deferred compensation plan assets.

### ***Income Tax Provision (Benefit)***

The income tax provision for the three months ended September 30, 2015 was \$2.1 million, or 15.8% of pre-tax income. The effective tax rate differed from the federal statutory rate primarily because foreign income was taxed at lower rates, and because of the benefit that we realized from stock option exercises and the release of RSUs. In addition, the effective tax rate was impacted by changes in the valuation allowance and true-up adjustments.

The income tax provision for the nine months ended September 30, 2015 was \$5.1 million, or 16.9% of pre-tax income. We recorded a one-time net charge of \$2.7 million to the income tax provision related to the resolution of the income tax audits in the second quarter of 2015 (see "Income Tax Audits" in Note 12 to Notes to Condensed Consolidated Financial Statements for further discussion). In addition to the impact of this charge, the effective tax rate differed from the federal statutory rate primarily because foreign income was taxed at lower rates, and because of the benefit that we realized from stock option exercises and the release of RSUs, and from the release of an income tax reserve where the statute of limitations expired. In addition, the effective tax rate was impacted by changes in the valuation allowance and true-up adjustments.

The income tax provision (benefit) for the three and nine months ended September 30, 2014 was \$(0.6) million, or (5.4)% of pre-tax income, and \$0.2 million, or 0.7% of pre-tax income, respectively. The effective tax rate differed from the federal statutory rate primarily because foreign income was taxed at lower rates, and because of the benefit that we realized from the release of a reserve where the statute of limitations expired, and from the benefit realized as a result of stock option exercises and the release of RSUs.

On July 27, 2015, in *Altera Corp. v. Commissioner*, the U.S. Tax Court issued an opinion related to the treatment of stock-based compensation expense in an intercompany cost-sharing arrangement. A final decision has yet to be issued by the Tax Court due to other outstanding issues related to the case. At this time, the U.S. Department of the Treasury has not withdrawn the requirement from its regulations to include stock-based compensation. Due to the uncertainty surrounding the status of the current regulations, questions related to the scope of potential benefits, and the risk of the Tax Court's decision being overturned upon appeal, we have not recorded any adjustments as of September 30, 2015. We will continue to monitor developments related to this opinion and the potential impact on our financial statements.

## Liquidity and Capital Resources

	<b>September 30, 2015</b>	<b>December 31, 2014</b>		
	(in thousands)			
Cash and cash equivalents	\$76,616	\$ 126,266		
Short-term investments	153,047	112,452		
Total cash, cash equivalents and short-term investments	\$229,663	\$ 238,718		
Percentage of total assets	54.7	%	59.8	%
Total current assets	\$ 329,968	\$ 308,146		
Total current liabilities	(48,620 )	(36,861 )		
Working capital	\$281,348	\$ 271,285		

As of September 30, 2015, we had cash and cash equivalents of \$76.6 million and short-term investments of \$153.0 million, compared with cash and cash equivalents of \$126.3 million and short-term investments of \$112.5 million as of December 31, 2014. As of September 30, 2015, \$36.4 million of cash and cash equivalents and \$40.4 million of short-term investments were held by our international subsidiaries. If these funds are needed for our operations in the U.S., we may be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to indefinitely reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

The significant components of our working capital are cash and cash equivalents, short-term investments, accounts receivable, inventories, prepaid expenses and other current assets, reduced by accounts payable, accrued compensation

and related benefits, and other accrued liabilities. As of September 30, 2015, we had working capital of \$281.3 million, compared with working capital of \$271.3 million as of December 31, 2014. The \$10.0 million increase in working capital was due to a \$21.8 million increase in current assets, partially offset by an \$11.8 million increase in current liabilities. The increase in current assets was primarily due to an increase in short-term investments, accounts receivable and inventories, partially offset by a decrease in cash and cash equivalents. The increase in current liabilities was due to an increase in accrued compensation and related benefits, accounts payable and other accrued liabilities.

*Summary of Cash Flows*

The following table summarizes our cash flow activities:

	<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>
	(in thousands)	
Net cash provided by operating activities	\$45,399	\$53,597
Net cash used in investing activities	(53,491)	(26,134)
Net cash used in financing activities	(40,414)	(26,562)
Effect of exchange rate changes on cash and cash equivalents	(1,144 )	(302 )
Net increase (decrease) in cash and cash equivalents	\$(49,650)	\$599

For the nine months ended September 30, 2015, net cash provided by operating activities was \$45.4 million, primarily due to our net income adjusted for certain non-cash items, including depreciation and amortization and stock-based compensation, and a net decrease of \$16.0 million from the changes in our operating assets and liabilities. The increase in accounts receivable was primarily driven by increased sales. The increase in inventories was primarily due to an increase in strategic wafer and die bank inventories as well as an increase in finished goods necessary to meet anticipated future demand. The increase in accounts payable was primarily driven by increased inventory and capital asset purchases to meet anticipated future demand. The increase in accrued liabilities was primarily driven by an increase in employee contributions to the deferred compensation plan. For the nine months ended September 30, 2014, net cash provided by operating activities was \$53.6 million, primarily due to our net income adjusted for certain non-cash items, including depreciation and amortization and stock-based compensation, and a net decrease of \$7.8 million from the changes in our operating assets and liabilities. The increase in inventories was primarily due to an increase in strategic wafer and die bank inventories as well as an increase in finished goods necessary to meet anticipated future demand. The increase in accounts payable was primarily driven by increased inventory purchases to meet anticipated future demand. The decrease in accrued compensation and related benefits was primarily due to the payment of bonuses accrued as of December 31, 2013. The decrease in accrued liabilities was primarily driven by the release of the liability related to the O2 Micro litigation, partially offset by an increase in employee contributions to the deferred compensation plan.

For the nine months ended September 30, 2015, net cash used in investing activities was \$53.5 million, primarily due to net purchases of investments of \$41.6 million and purchases of property and equipment of \$8.4 million. For the nine months ended September 30, 2014, net cash used in investing activities was \$26.1 million, primarily due to \$11.6 million paid to acquire Sensima, purchases of property and equipment of \$7.7 million, and net purchases of investments of \$6.8 million.

For the nine months ended September 30, 2015, net cash used in financing activities was \$40.4 million, primarily reflecting \$31.7 million used in repurchases of our common stock pursuant to our stock repurchase program and \$21.9 million used to pay dividends to our stockholders and dividend equivalents to our employees who hold RSUs, partially offset by \$9.1 million of cash proceeds from stock option exercises and issuance of shares through our employee stock purchase plan. For the nine months ended September 30, 2014, net cash used in financing activities was \$26.6 million, primarily reflecting \$33.0 million used in repurchases of our common stock pursuant to our stock repurchase program and \$5.8 million used to pay dividends to stockholders and dividend equivalents to our employees who hold RSUs, partially offset by \$12.5 million of cash proceeds from stock option exercises and issuance of shares through our employee stock purchase plan.

In July 2013, our Board of Directors approved a stock repurchase program that authorizes us to repurchase up to \$100 million in the aggregate of our common stock through June 30, 2015. In April 2015, our Board of Directors approved an extension of the program through December 31, 2015. All shares are retired upon repurchase. For the nine months ended September 30, 2015, we repurchased a total of 0.6 million shares for \$31.7 million, at an average price of \$50.01 per share. For the nine months ended September 30, 2014, we repurchased a total of 0.9 million shares for \$33.0 million, at an average price of \$38.45 per share. As of September 30, 2015, \$6.5 million remained available for future repurchases under the program.

In June 2014, our Board of Directors approved a dividend program pursuant to which we intend to pay quarterly cash dividends on our common stock, beginning in July 2014. In addition, RSU awards contain rights to receive dividend equivalents, which entitle employees who hold RSUs to the same dividend value per share as holders of common stock. The dividend equivalents are accrued quarterly during the vesting periods of the RSUs and are payable to the employees when the awards vest. Dividend equivalents accrued on the RSUs are forfeited if the employees do not fulfill their service requirement during the vesting periods. For the nine months ended September 30, 2015, we paid dividends and dividend equivalents totaling \$21.9 million. For the nine months ended September 30, 2014, we paid dividends and dividend equivalents totaling \$5.8 million.



Although cash requirements will fluctuate based on the timing and extent of many factors such as those discussed above, we believe that cash generated from operations, together with the liquidity provided by existing cash balances and short-term investments, will be sufficient to satisfy our liquidity requirements for the next 12 months. We anticipate the cash used for future dividends, dividend equivalents and the stock repurchase program will come from our current domestic cash and cash generated from ongoing U.S. operations. If cash held by our international subsidiaries is needed for these payments, we may be required to accrue and pay U.S. taxes to repatriate these funds.

In the future, in order to strengthen our financial position, in the event of unforeseen circumstances, or in the event we need to fund our growth in future financial periods, we may need to raise additional funds by any one or a combination of the following: issuing equity securities, issuing debt or convertible debt securities, incurring indebtedness secured by our assets, or selling certain product lines and/or portions of our business. There can be no guarantee that we will be able to raise additional funds on terms acceptable to us, or at all.

From time to time, we have engaged in discussions with third parties concerning potential acquisitions of product lines, technologies, businesses and companies, and we continue to consider potential acquisition candidates. Any such transactions could involve the issuance of a significant number of new equity securities, assumptions of debt, and/or payment of cash consideration. We may also be required to raise additional funds to complete any such acquisitions, through either the issuance of equity and debt securities or incurring indebtedness secured by our assets. If we raise additional funds or acquire businesses or technologies through the issuance of equity securities or convertible debt securities, our existing stockholders may experience significant dilution.

### ***Contractual Obligations***

We lease our research and development and sales offices in the United States, Europe, Japan, China, Taiwan and Korea. Certain of our facility leases provide for periodic rent increases. Currently, we are leasing a manufacturing facility in Chengdu, China. We have an option to acquire this manufacturing facility for approximately \$1.7 million, which consists of total construction cost incurred minus total rent paid by us during the lease term. This option became exercisable in March 2011. We may exercise the purchase option and enter into a purchase agreement for this facility in the future.

Our outstanding purchase commitments primarily consist of wafer purchases from our foundries and assembly services. As of September 30, 2015, the outstanding balance under our purchase commitments was \$31.4 million, compared with \$44.2 million as of December 31, 2014.

Our other contractual obligations have not changed significantly from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2014.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

For a discussion of market risks, refer to Item 7A, “Quantitative and Qualitative Disclosures about Market Risk” in our Annual Report on Form 10-K for the year ended December 31, 2014. During the three and nine months ended September 30, 2015, there were no material changes or developments that would materially alter the market risk assessment performed as of December 31, 2014.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934 as of the end of the period covered by this Quarterly Report on Form 10-Q.

Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of September 30, 2015, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

## **Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

We completed the acquisition of Sensima Technology SA (“Sensima”) in July 2014. We intend to include the acquired entity in our assessment of the effectiveness of internal control over financial reporting as of December 31, 2015.

## **Limitations on Effectiveness of Controls and Procedures**

In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

We and certain of our subsidiaries are parties to actions and proceedings in the ordinary course of business, including litigation regarding our shareholders and our intellectual property, challenges to the enforceability or validity of our intellectual property, claims that our products infringe on the intellectual property rights of others, and employment matters. These proceedings often involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources to prosecute and defend. We defend ourselves vigorously against any such claims.

As of September 30, 2015, there were no material pending legal proceedings to which we were a party.

## ITEM 1A. RISK FACTORS

Our business involves risks and uncertainties. You should carefully consider the risks described below, together with all of the other information in this Quarterly Report on Form 10-Q and other filings with the Securities and Exchange Commission in evaluating our business. If any of the following risks actually occur, our business, financial condition, operating results, and growth prospects would likely be materially and adversely affected. In such an event, the trading price of our common stock could decline, and you could lose all or part of your investment in our common stock. Our past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods. These risks involve forward-looking statements and our actual results may differ substantially from those discussed in these forward-looking statements.

### **The future trading price of our common stock could be subject to wide fluctuations in response to a variety of factors.**

The future trading price of our common stock is likely to be highly volatile and could be subject to wide fluctuations in response to various factors, many of which are beyond our control, including:

- our results of operations and financial performance;
- general economic, industry and market conditions worldwide;
- our ability to outperform the market, and outperform at a level that meets or exceeds our investors' expectations;
- whether our forward guidance meets the expectations of our investors;
- the depth and liquidity of the market for our common stock;
- developments generally affecting the semiconductor industry;
- commencement of or developments relating to our involvement in litigation;



- investor perceptions of us and our business strategies;
- changes in securities analysts' expectations or our failure to meet those expectations;
- actions by institutional or other large stockholders;
- terrorist acts or acts of war;
- actual or anticipated fluctuations in our results of operations;
- actual or anticipated manufacturing capacity limitations;
- developments with respect to intellectual property rights;
- introduction of new products by us or our competitors;
- our sale of common stock or other securities in the future;
- conditions and trends in technology industries;
- our loss of key customers;
- changes in market valuation or earnings of our competitors;
- any mergers, acquisitions or divestitures of assets undertaken by us;
- government debt default;
- our ability to develop new products, enter new market segments, gain market share, manage litigation risk, diversify our customer base and successfully secure manufacturing capacity;
- our ability to increase our gross margins;

- market reactions to guidance from other semiconductor companies or third-party research groups;
- market reactions to merger and acquisition activities in the semiconductor industry, and rumors or expectations of further consolidation in the industry;
- investments in sales and marketing resources to enter new markets;
- costs of increasing wafer capacity and qualifying additional third-party wafer fabrication facilities;
- our ability to continue the stock repurchase program and pay quarterly cash dividends to stockholders; and
- changes in the estimation of the future size and growth rate of our markets.

In addition, the stock market often experiences substantial volatility that is seemingly unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

**We expect our operating results to fluctuate from quarter to quarter and year to year, which may make it difficult to predict our future performance and could cause our stock price to decline and be volatile.**

Our revenue, expenses, and results of operations are difficult to predict, have varied significantly in the past and will continue to fluctuate significantly in the future due to a number of factors, many of which are beyond our control. We expect fluctuations to continue for a number of reasons, including:

- changes in general demand for electronic products as a result of worldwide macro-economic conditions;
- changes in business conditions at our distributors, value-added resellers and/or end-customers;
- changes in general economic conditions in the countries where our products are sold or used;
- the timing of developments and related expenses in our litigation matters;
- the loss of key customers or our inability to attract new customers due to customer and prospective customer concerns about being litigation targets;
- continued dependence on turns business (orders received and shipped within the same fiscal quarter);
- continued dependence on the Asian markets for our customer base;
- increases in assembly costs due to commodity price increases, such as the price of gold;
- the timing of new product introductions by us and our competitors;
- changes in our revenue mix between original equipment manufacturers (“OEMs”), original design manufacturers (“ODMs”), distributors and value-added resellers;
- changes in product mix, product returns, and actual and potential product liability;
- the acceptance of our new products in the marketplace;



- our ability to develop new process technologies and achieve volume production;
- our ability to meet customer product demand in a timely manner;
- the scheduling, rescheduling, or cancellation of orders by our customers;
- the cyclical nature of demand for our customers' products;
- fluctuations in our estimate for stock rotation reserves;
- our ability to manage our inventory levels, including the levels of inventory held by our distributors;
- product obsolescence;
- seasonality and variability in the storage and computing, consumer electronics, industrial and communications markets;
- the availability of adequate manufacturing capacity from our outside suppliers;
- increases in prices for finished wafers due to general capacity shortages;
- the potential loss of future business resulting from capacity issues;
- changes in manufacturing yields;
- movements in foreign exchange rates, interest rates or tax rates; and
- accounting charges resulting from equity awards granted to our employees.

Due to the factors noted above and other risks described in this section, many of which are beyond our control, you should not rely on quarter-to-quarter or year-over-year comparisons to predict our future financial performance. Unfavorable changes in any of the above factors may seriously harm our business and results of operations, and may cause our stock price to decline and be volatile.



**Our business has been and may continue to be significantly impacted by worldwide economic conditions, and uncertainty in the outlook for the global economy makes it more likely that our actual results will differ materially from expectations.**

In recent years, global credit and financial markets experienced disruptions, and may continue to experience disruptions in the future, including diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increases in unemployment rates, and continued uncertainty about economic stability. These economic uncertainties affect businesses such as ours in a number of ways, making it difficult to accurately forecast and plan our future business activities. The continued or further tightening of credit in financial markets may lead consumers and businesses to postpone spending, which may cause our customers to cancel, decrease or delay their existing and future orders with us. In addition, financial difficulties experienced by our suppliers or distributors could result in product delays, increased accounts receivable defaults and inventory challenges. Volatility in the credit markets could severely diminish liquidity and capital availability. Demand for consumer electronics is a function of the health of the economies in the United States, Europe, China and the rest of the world. We cannot predict the timing, strength or duration of any economic disruption or subsequent economic recovery worldwide, in the United States, in our industry, or in the consumer electronics market. These and other economic factors have had, and may in the future have, a material adverse effect on demand for our products and on our financial condition and operating results.

**We may not be profitable on a quarterly or annual basis.**

Our profitability is dependent on many factors, including:

- our sales, which because of our turns business (i.e., orders received and shipped within the same fiscal quarter), are difficult to accurately forecast;

- the cancellation or rescheduling of our customers' orders, which may occur without significant penalty to our customers;

- changes in general demand for electronic products as a result of worldwide macro-economic conditions;

- changes in revenue mix between OEMs, ODMs, distributors and value-added resellers;

- changes in product mix, and actual and potential product liability;

changes in revenue mix between end market segments (i.e. communication, storage and computing, consumer and industrial);

our competition, which could adversely impact our selling prices and our potential sales;

our manufacturing costs, including our ability to negotiate with our vendors and our ability to efficiently run our test facility in China;

manufacturing capacity constraints;

stock-based compensation accounting charges; and

our operating expenses, including general and administrative expenses, selling and marketing expenses, and research and development expenses relating to products that will not be introduced and will not generate revenue until later periods, if at all.

We may not achieve profitability on a quarterly or annual basis in the future. Unfavorable changes in our operations, including any of the factors noted above, may have a material adverse effect on our quarterly or annual profitability.

**We may not experience growth rates comparable to past years.**

In the past, our revenue increased significantly in certain years due to increased sales of certain of our products. Due to various factors, including increased competition, loss of certain of our customers, unfavorable changes in our operations, reduced global electronics demand, end-customer market downturn, market acceptance and penetration of our current and future products and ongoing litigation, we may not experience growth rates comparable to past periods, which could materially and adversely affect our stock price and results of operations.

**There can be no assurance that we will continue to declare cash dividends at all or in any particular amounts.**

In June 2014, the Board of Directors approved a dividend program pursuant to which we intend to pay quarterly cash dividends on our common stock. We anticipate the cash used for future dividends will come from our current domestic cash and cash generated from ongoing U.S. operations. If cash held by our international subsidiaries is needed for the payment of dividends, we may be required to accrue and pay U.S. taxes to repatriate these funds, which may have a material adverse effect on our financial condition and results of operations.

The declaration of cash dividends on our common stock is at the discretion of our Board of Directors. Any future decision to declare and pay a cash dividend on our common stock will be subject to, among other things, our results of operations, cash balances and future cash requirements, financial condition, statutory requirements of Delaware law, compliance with the terms of future indebtedness and credit facilities, and other factors that our Board of Directors may deem relevant. Our dividend payments may change from time to time, and we cannot provide assurance that we will continue to declare dividends at all or in any particular amounts. A reduction in or elimination of our dividend payments could have a negative effect on the price of our common stock.

**We may be unsuccessful in developing and selling new products with margins similar to or better than what we have experienced in the past, which would impact our overall gross margin and financial performance.**

Our success depends on products that are differentiated in the market, which result in gross margins that have historically been above industry averages. Should we fail to improve our gross margin in the future, and accordingly develop and introduce sufficiently differentiated products that result in higher gross margins than industry averages, our financial condition and results of operations could be materially and adversely affected.

**The highly cyclical nature of the semiconductor industry, which has produced significant and sometimes prolonged downturns, could materially adversely affect our operating results, financial condition and cash flows.**

Historically, the semiconductor industry has been highly cyclical and, at various times, has experienced significant downturns and wide fluctuations in supply and demand. These conditions have caused significant variances in product demand and production capacity, as well as rapid erosion of average selling prices. The industry may experience severe or prolonged downturns in the future, which could result in downward pressure on the price of our products as well as lower demand for our products. Because significant portions of our expenses are fixed in the short term or incurred in advance of anticipated sales, we may not be able to decrease our expenses in a timely manner to offset any sales shortfall. These conditions could have a material adverse effect on our operating results, financial condition and cash flows.

**If demand for our products declines in the major end markets that we serve, our revenue will decrease and our results of operations and financial condition would be materially and adversely affected.**

We believe that the application of our products in the storage and computer, consumer electronics, communications and industrial markets will continue to account for the majority of our revenue. If the demand for our products declines in the major end markets that we serve, our revenue will decrease and our results of operations and financial condition would be materially and adversely affected. In addition, as technology evolves, the ability to integrate the functionalities of various components, including our discrete semiconductor products, onto a single chip and/or onto other components of systems containing our products increases. Should our customers require integrated solutions that we do not offer, demand for our products could decrease, and our business and results of operations would be materially and adversely affected.

**We may be unsuccessful in developing and selling new products or in penetrating new markets required to maintain or expand our business.**

Our competitiveness and future success depend on our ability to design, develop, manufacture, assemble, test, market, and support new products and enhancements on a timely and cost-effective basis. A fundamental shift in technologies in any of our product markets could have a material adverse effect on our competitive position within these markets. Our failure to timely develop new technologies or to react quickly to changes in existing technologies could materially delay our development of new products, which could result in product obsolescence, decreased revenue, and/or a loss of market share to competitors.

As we develop new product lines, we must adapt to market conditions that are unfamiliar to us, such as competitors and distribution channels that are different from those we have known in the past. Some of our new product lines require us to re-equip our labs to test parameters we have not tested in the past. If we are unable to adapt rapidly to these new and additional conditions, we may not be able to successfully penetrate new markets.

The success of a new product depends on accurate forecasts of long-term market demand and future technological developments, as well as on a variety of specific implementation factors, including:

- timely and efficient completion of process design and device structure improvements;

- timely and efficient implementation of manufacturing, assembly, and test processes;

- the ability to secure and effectively utilize fabrication capacity in different geometries;

- product performance;

- product availability;

- product quality and reliability; and

- effective marketing, sales and service.

To the extent that we fail to timely introduce new products or to quickly penetrate new markets, our revenue and financial condition could be materially adversely affected.

**We derive most of our revenue from direct or indirect sales to customers in Asia and have significant operations in Asia, which may expose us to political, cultural, regulatory, economic, foreign exchange, and operational risks.**

We derive most of our revenue from customers located in Asia through direct sales or indirect sales through distribution arrangements and value-added reseller agreements with parties located in Asia. As a result, we are subject to increased risks due to this geographic concentration of business and operations. For the three and nine months ended September 30, 2015, approximately 92% and 91% of our revenue was from customers in Asia, respectively.

There are risks inherent in doing business in Asia, and internationally in general, including:

- changes in, or impositions of, legislative or regulatory requirements, including tax laws in the United States and in the countries in which we manufacture or sell our products;

- trade restrictions, including restrictions imposed by the United States on trading with parties in foreign countries;

- currency exchange rate fluctuations impacting intra-company transactions;

- the fluctuations in the value of the U.S. Dollar relative to other foreign currencies, which could affect the competitiveness of our products;

- transportation delays;

- changes in tax regulations in China that may impact our tax status in Chengdu, where we have significant operations;

- multi-tiered distribution channels that lack visibility to end customer pricing and purchase patterns;

- international political relationships and threats of war;

- terrorism and threats of terrorism;

- epidemics and illnesses;

- work stoppages and infrastructure problems due to adverse weather conditions or natural disasters;



work stoppages related to employee dissatisfaction;

economic, social and political instability;

longer accounts receivable collection cycles and difficulties in collecting accounts receivables;

enforcing contracts generally; and

less effective protection of intellectual property and contractual arrangements.

If we fail to expand our customer base and significantly reduce the geographic concentration of our customers, we will continue to be subject to the foregoing risks, which could materially and adversely affect our revenue and financial condition.

**We depend on a limited number of customers, including distributors, for a significant percentage of our revenue.**

Historically, we have generated most of our revenue from a limited number of customers, including distributors. For example, sales to our largest distributor accounted for approximately 24% of our total revenue for both the three and nine months ended September 30, 2015. We continue to rely on a limited number of customers for a significant portion of our revenue. Because we rely on a limited number of customers for significant percentages of our revenue, a decrease in demand for our products from any of our major customers for any reason (including due to market conditions, catastrophic events or otherwise) could have a materially adverse impact on our financial conditions and results of operations.

**We are subject to anti-corruption laws in the jurisdictions in which we operate, including the U.S. Foreign Corrupt Practices Act, or the FCPA. Our failure to comply with these laws could result in penalties which could harm our reputation and have a material adverse effect on our business, results of operations and financial condition.**

We are subject to the FCPA, which generally prohibits companies and their intermediaries from making improper payments to foreign officials for the purpose of obtaining or keeping business and/or other benefits, along with various other anti-corruption laws. Although we have implemented policies and procedures designed to ensure that we, our employees and other intermediaries comply with the FCPA and other anti-corruption laws to which we are subject, there is no assurance that such policies or procedures will work effectively all of the time or protect us against

liability under the FCPA or other laws for actions taken by our employees and other intermediaries with respect to our business or any businesses that we may acquire. We have significant operations in Asia, which places us in frequent contact with persons who may be considered “foreign officials” under the FCPA, resulting in an elevated risk of potential FCPA violations. If we are not in compliance with the FCPA and other laws governing the conduct of business with government entities (including local laws), we may be subject to criminal and civil penalties and other remedial measures, which could have an adverse impact on our business, financial condition, results of operations and liquidity. Any investigation of any potential violations of the FCPA or other anti-corruption laws by U.S. or foreign authorities could harm our reputation and have an adverse impact on our business, financial condition and results of operations.

**We receive a significant portion of our revenue from distribution arrangements, value-added resellers and direct customers, and the loss of any one of these distributors, value-added resellers or direct customers or failure to collect a receivable from them could adversely affect our operations and financial position.**

We market our products through distribution arrangements and value-added resellers and through our direct sales and applications support organization to customers that include OEMs, ODMs and electronic manufacturing service providers (“EMSs”). Receivables from our customers are generally not secured by any type of collateral and are subject to the risk of being uncollectible. Sales to our largest distributor accounted for approximately 24% of our total revenue for both the three and nine months ended September 30, 2015. Significant deterioration in the liquidity or financial condition of any of our major customers or any group of our customers could have a material adverse impact on the collectability of our accounts receivable and our future operating results. We primarily conduct our sales on a purchase order basis, and we do not have any long-term supply commitments.

Moreover, we believe a high percentage of our products are eventually sold to a number of OEMs. Although we communicate with OEMs in an attempt to achieve “design wins,” which are decisions by OEMs and/or ODMs to incorporate our products, we do not have purchase commitments from these end users. Therefore, there can be no assurance that the OEMs and/or ODMs will continue to incorporate our ICs into their products. OEM technical specifications and requirements can change rapidly, and we may not have products that fit new specifications from an end-customer for whom we have had previous design wins. We cannot be certain that we will continue to achieve design wins from large OEMs, that our direct customers will continue to be successful in selling to the OEMs, or that the OEMs will be successful in selling products which incorporate our ICs. The loss of any significant customer, any material reduction in orders by any of our significant customers or by their OEM customers, the cancellation of a significant customer order, or the cancellation or delay of a customer’s or OEM’s significant program or product could reduce our revenue and adversely affect our results of operations and financial condition.

**Due to the nature of our business as a component supplier, we may have difficulty both in accurately predicting our future revenue and appropriately managing our expenses.**

Because we provide components for end products and systems, demand for our products is influenced by our customers’ end product demand. As a result, we may have difficulty in accurately forecasting our revenue and expenses. Our revenue depends on the timing, size, and speed of commercial introductions of end products and systems that incorporate our products, all of which are inherently difficult to forecast, as well as the ongoing demand for previously introduced end products and systems. In addition, demand for our products is influenced by our customers’ ability to manage their inventory. Our sales to distributors are subject to higher volatility because they service demand from multiple levels of the supply chain which, in itself, is inherently difficult to forecast. If our customers, including distributors, do not manage their inventory correctly or misjudge their customers’ demand, our shipments to and orders from our customers may vary significantly on a quarterly basis.

**Our ability to increase product sales and revenue may be constrained by the manufacturing capacity of our suppliers.**

Although we provide our suppliers with rolling forecasts of our production requirements, their ability to provide wafers to us is limited by the available capacity, particularly capacity in the geometries we require, at the facilities in which they manufacture wafers for us. As a result, this lack of capacity has at times constrained our product sales and revenue growth. In addition, an increased need for capacity to meet internal demands or demands of other customers could cause our suppliers to reduce capacity available to us. Our suppliers may also require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions in order to acquire the wafer supply necessary to meet our customer requirements. If our suppliers extend lead times, limit supplies or the types of capacity we require, or increase prices due to capacity constraints or other factors, our revenue and gross margin may materially decline. In addition, if we experience supply delays or limitations, our customers may reduce their purchase levels with us and/or seek alternative solutions to meet their demand, which could materially and adversely impact our business and results of operations. Delays in increasing third-party manufacturing capacity may also limit our ability to meet customer demand.

**We currently depend on third-party suppliers to provide us with wafers for our products. If any of our wafer suppliers become insolvent or capacity constrained and are unable and/or fail to provide us sufficient wafers at acceptable yields and at anticipated costs, our revenue and gross margin may decline or we may not be able to fulfill our customer orders.**

We have a supply arrangement with certain suppliers for the production of wafers. Should any of our suppliers become insolvent or capacity constrained, we may not be able to fulfill our customer orders, which would likely cause a decline in our revenue.

While certain aspects of our relationship with these suppliers are contractual, many important aspects of this relationship depend on our suppliers' continued cooperation and our management of relationships. In addition, the fabrication of ICs is a highly complex and precise process. Problems in the fabrication process can cause a substantial percentage of wafers to be rejected or numerous ICs on each wafer to be non-functional. This could potentially reduce yields. The failure of our suppliers to supply us wafers at acceptable yields could prevent us from fulfilling our customer orders for our products and would likely cause a decline in our revenue.

Further, as is common in the semiconductor industry, our customers may reschedule or cancel orders on relatively short notice. If our customers cancel orders after we submit a committed forecast to our suppliers for the corresponding wafers, we may be required to purchase wafers that we may not be able to resell, which would adversely affect our operating results, financial condition, and cash flows.

**We might not be able to deliver our products on a timely basis if our relationships with our assembly and test subcontractors are disrupted or terminated.**

We do not have direct control over product delivery schedules or product quality because all of our products are assembled by third-party subcontractors and a portion of our testing is currently performed by third-party subcontractors. Also, due to the amount of time typically required to qualify assembly and test subcontractors, we could experience delays in the shipment of our products if we were forced to find alternate third parties to assemble or test our products. In addition, events such as global economic crises may materially impact our assembly suppliers' ability to operate. Any future product delivery delays or disruptions in our relationships with our subcontractors could have a material adverse effect on our operating results, financial condition, and cash flows.

**There may be unanticipated costs associated with adding to or supplementing our third-party suppliers' manufacturing capacity.**

We anticipate that future growth of our business will require increased manufacturing capacity on the part of third-party supply foundries, assembly shops, and testing facilities for our products. In order to facilitate such growth, we may need to enter into strategic transactions, investments and other activities. Such activities are subject to a number of risks, including:

• the costs and expense associated with such activities;

• the availability of modern foundries to be developed, acquired, leased or otherwise made available to us or our third-party suppliers;

• the ability of foundries and our third-party suppliers to obtain the advanced equipment used in the production of our products;

• delays in bringing new foundry operations online to meet increased product demand; and

- unforeseen environmental, engineering or manufacturing qualification problems relating to existing or new foundry facilities, including delays in qualification of new foundries by our customers.

These and other risks may affect the ultimate cost and timing of any expansion of our third-party suppliers' capacity.

**We purchase inventory in advance based on expected demand for our products, and if demand is not as expected, we may have insufficient or excess inventory, which could adversely impact our financial position.**

As a fabless semiconductor company, we purchase our inventory from third party manufacturers in advance of selling our product. We place orders with our manufacturers based on existing and expected orders from our customers for particular products. While most of our contracts with our customers and distributors include lead time requirements and cancellation penalties that are designed to protect us from misalignment between customer orders and inventory levels, we must nonetheless make some predictions when we place orders with our manufacturers. In the event that our predictions are inaccurate due to unexpected increases in orders or unavailability of product within the timeframe that is required, we may have insufficient inventory to meet our customer demands. In the event that we order products that we are unable to sell due to a decrease in orders, unexpected order cancellations, injunctions due to patent litigation, or product returns, we may have excess inventory which, if not sold, may need to be disposed of or would result in a decrease in our revenue in future periods as the excess inventory at our distributors is sold. If any of these situations were to arise, it could have a material impact on our business and financial position.

**Changes in effective tax rates or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.**

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws, regulations, accounting principles or interpretations thereof and discrete items such as future exercises or dispositions of stock options and restricted stock releases. In addition, we are subject to the continuous examination of our income tax returns by the IRS and other tax authorities. For example, our U.S. federal income tax returns for the years ended December 31, 2005 through December 31, 2007 were examined by the IRS. We reached a resolution on the audits in April 2015 and recorded a one-time net charge of \$2.7 million to our income tax provision in the second quarter of 2015. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from any examinations will not have an adverse effect on our operating results and financial condition.

**The complexity of calculating our tax provision may result in errors that could result in restatements of our financial statements.**

Due to the complexity associated with the calculation of our tax provision, we have hired independent tax advisors to assist us in the calculation. If we or our independent tax advisors fail to resolve or fully understand certain issues that we may have had in the past and issues that may arise in the future, we could be subject to errors, which, if material, would result in us having to restate our financial statements. Restatements are generally costly and could adversely impact our results of operations and/or have a negative impact on the trading price of our common stock.

**If we experience security breaches of our information technology systems that materially damage sensitive information on our networks, our business partner and customer relationships may be harmed, and our business and operating results may be adversely impacted.**

In the ordinary course of business, we store sensitive data on our internal systems, network and servers, such as proprietary business and financial information, and confidential data pertaining to our customers, suppliers and business partners. The secure maintenance of sensitive information on our networks and the protection features of our solutions are both critical to our operations and business strategy. We devote significant resources to network security, data encryption, and other security measures to protect our systems and data. However, these security measures cannot provide absolute security. Although we make significant efforts to maintain the security and integrity of our systems and solutions, any destructive or intrusive breach could compromise our networks, creating system disruptions or slowdowns, and the information stored on our networks could be accessed, publicly disclosed, lost or stolen. If any of these types of security breaches were to occur and we were unable to protect sensitive data, our relationships with our business partners and customers could be materially damaged, our reputation could be materially harmed, and we could be exposed to a risk of litigation and possible significant liability.

**If we are unsuccessful in legal proceedings brought against us or any of our customers, we could be prevented from selling many of our products and/or be required to pay substantial damages. An unfavorable outcome or an additional award of damages, attorneys' fees or an injunction could cause our revenue to decline significantly and could severely harm our business and operating results.**

From time to time we are party to various legal proceedings. If we are not successful in litigation that could be brought against us or our customers, we could be ordered to pay monetary fines and/or damages. If we are found liable for willful patent infringement, damages could be significant. We and/or our customers could also be prevented from selling some or all of our products. Moreover, our customers and end-users could decide not to use our products, and our products and our customers' accounts payable to us could be seized. Finally, interim developments in these proceedings could increase the volatility in our stock price as the market assesses the impact of such developments on the likelihood that we will or will not ultimately prevail in these proceedings.

**Given our inability to control the timing and nature of significant events in our legal proceedings that either have arisen or may arise, our legal expenses are difficult to forecast and may vary substantially from our publicly disclosed forecasts with respect to any given quarter, which could contribute to increased volatility in our stock price and financial condition.**

Historically, we have incurred significant expenses in connection with various legal proceedings that vary with the level of activity in the proceeding. It is difficult for us to forecast our legal expenses for any given quarter, which adversely affects our ability to forecast our expected results of operations in general. We may also be subject to unanticipated legal proceedings, which would result in our incurrance of unexpected legal expenses. If we fail to meet the expectations of securities or industry analysts as a result of unexpected changes in our legal expenses, our stock price could be materially impacted.

**Future legal proceedings may divert our financial and management resources.**

The semiconductor industry is characterized by frequent claims of infringement and litigation regarding patent and other intellectual property rights. Patent infringement is an ongoing risk, in part because other companies in our industry could have patent rights that may not be identifiable when we initiate development efforts. Litigation may be necessary to enforce our intellectual property rights, and we may have to defend ourselves against additional infringement claims. Such litigation is very costly. In the event any third party makes a new infringement claim against us or our customers, we could incur additional ongoing legal expenses. In addition, in connection with these legal proceedings, we may be required to post bonds to defend our intellectual property rights in certain countries for an indefinite period of time, until such dispute is resolved. If our legal expenses materially increase or exceed anticipated amounts, our capital resources and financial condition could be adversely affected. Further, if we are not successful in any of our intellectual property defenses, our financial condition could be adversely affected and our business could be harmed. Our management team may also be required to devote a great deal of time, effort and energy to these legal proceedings, which could divert management's attention from focusing on our operations and adversely affect our business.



**We will continue to vigorously defend and enforce our intellectual property rights around the world, especially as it relates to patent litigation.**

From time to time, we are faced with having to defend our intellectual property rights throughout the world. Should we become engaged in such proceedings, it could divert management's attention from focusing on and implementing our business strategy. Further, should we not be successful in any of our intellectual property enforcement actions, our revenue may be affected and our business could be harmed.

**Failure to protect our proprietary technologies or maintain the right to certain technologies may negatively affect our ability to compete.**

We rely heavily on our proprietary technologies. Our future success and competitive position depend in part upon our ability to obtain and maintain protection of certain proprietary technologies used in our products. We pursue patents for some of our new products and unique technologies, and we also rely on a combination of nondisclosure agreements and other contractual provisions, as well as our employees' commitment to confidentiality and loyalty, to protect our technology, know-how, and processes. Despite the precautions we take, it may be possible for unauthorized third parties to copy aspects of our current or future technologies or products or to obtain and use information that we regard as proprietary. We intend to continue to protect our proprietary technologies, including through patents. However, there can be no assurance that the steps we take will be adequate to protect our proprietary rights, that our patent applications will lead to issued patents, that others will not develop or patent similar or superior products or technologies, or that our patents will not be challenged, invalidated, or circumvented by others. Furthermore, the laws of the countries in which our products are or may be developed, manufactured, or sold may not protect our products and intellectual property rights to the same extent as laws in the United States. Our failure to adequately protect our proprietary technologies would materially harm our business.

**A downgrade of the credit rating for U.S. long-term sovereign debt and that of certain Eurozone countries could affect global and domestic financial markets, which may affect our business, financial condition and liquidity.**

Although a downgrade of long-term sovereign credit ratings is not unprecedented, a downgrade of the U.S. credit rating is, and the potential impact is uncertain. Management will continue to monitor the situation and there could be future changes in capital requirements or a rebalancing of investment portfolios in response to management's assessment of the related risk weightings. At this time, however, U.S. treasuries continue to trade in active markets, and the yield curve on U.S. treasuries remains an appropriate basis for determining risk-free rates.

Should there be a deterioration of the global and financial markets as a result of the downgraded credit rating for U.S. long-term sovereign debt, and that of certain Eurozone countries, our business, financial condition and liquidity could be adversely affected.

**The market for government-backed student loan auction-rate securities has suffered a decline in liquidity which may impact the liquidity and potential value of our investment portfolio.**

The market for government-backed student loan auction-rate securities with interest rates that reset through a Dutch auction every 7 to 35 days became illiquid in 2008. We experienced our first failed auction in mid-February 2008. Since 2008, we have redeemed 87% of the original portfolio at par. At September 30, 2015, \$5.6 million of our auction-rate securities have failed to reset through successful auctions and it is unclear as to when these investments will regain their liquidity. The underlying maturity of these auction-rate securities is up to 33 years.

We recorded temporary and other-than-temporary impairment charges on these investments. The valuation is subject to fluctuations in the future, which will depend on many factors, including the quality of underlying collateral, estimated time for liquidity including potential to be called or restructured, underlying final maturity, insurance guaranty and market conditions, among others.

Should there be further deterioration in the market for auction-rate securities, the value of our portfolio may decline, which may have an adverse impact on our cash position and our earnings. If the accounting rules for these securities change, there may be an adverse impact on our earnings.

**We face risks in connection with our internal control over financial reporting.**

Effective internal control over financial reporting is necessary for us to provide reliable and accurate financial reports. If we cannot provide reliable financial reports or prevent fraud or other financial misconduct, our business and operating results could be harmed. Our failure to implement and maintain effective internal control over financial reporting could result in a material misstatement of our financial statements or otherwise cause us to fail to meet our financial reporting obligations. This, in turn, could result in a loss of investor confidence in the accuracy and completeness of our financial reports, which could have an adverse effect on our results of operations and/or have a negative impact on the trading price of our common stock, and could subject us to stockholder litigation. In addition, we cannot assure you that we will not in the future identify material weaknesses in our internal control over financial reporting that we have not discovered to date, which may impact the reliability of our financial reporting and financial statements.

**Our products must meet specifications, and undetected defects and failures may occur, which may cause customers to return or stop buying our products and may expose us to product liability risk.**

Our customers generally establish demanding specifications for quality, performance, and reliability that our products must meet. Integrated circuits as complex as ours often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments, which might require product replacement or recall. Further, our third-party manufacturing processes or changes thereof, or raw material used in the manufacturing processes may cause our products to fail. We have from time to time in the past experienced product quality, performance or reliability problems. Our standard warranty period is generally one to two years, which exposes us to significant risks of claims for defects and failures. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, cancellations or rescheduling of orders or shipments, and product returns or discounts, any of which would harm our operating results.

In addition, product liability claims may be asserted with respect to our technology or products. Although we currently have insurance, there can be no assurance that we have obtained a sufficient amount of insurance coverage, that asserted claims will be within the scope of coverage of the insurance, or that we will have sufficient resources to satisfy any asserted claims.

**The price and availability of commodities (e.g., gold, copper and silicon) may adversely impact our ability to deliver our products in a timely and cost-effective manner, and may adversely affect our business and results of operations.**

Our products incorporate commodities such as gold, copper and silicon. An increase in the price or a decrease in the availability of these commodities and similar commodities that we use could negatively impact our business and results of operations.

**Fluctuations in the value of the U.S. Dollar relative to other foreign currencies, including the Renminbi, may adversely affect results of operations.**

Our manufacturing and packaging suppliers are and will continue to be primarily located in China for the foreseeable future. If the value of the Renminbi rises against the U.S. Dollar, there could be an increase in our manufacturing costs relative to competitors who have manufacturing facilities located in the U.S., which could adversely affect our operations. In addition, our sales are primarily denominated in the U.S. Dollar. If the value of the U.S. Dollar rises against other currencies, it may adversely affect the demand for our products in international markets, which could negatively impact our business and results of operations.

We incur foreign currency exchange gains or losses related to the timing of payments between the U.S. and our foreign subsidiaries, which are reported in interest and other income. Fluctuations in the value of the U.S. Dollar relative to the foreign currencies could increase the amount of foreign currency exchange losses we record, which could have an adverse impact on our results of operations.

**We and our manufacturing partners are or will be subject to extensive Chinese government regulation, and the benefit of various incentives from Chinese governments that we and our manufacturing partners receive may be reduced or eliminated, which could increase our costs or limit our ability to sell products and conduct activities in China.**

Most of our manufacturing partners are located in China. In addition, we have established manufacturing and testing facilities in China. The Chinese government has broad discretion and authority to regulate the technology industry in China. China's government has implemented policies from time to time to regulate economic expansion in China. It also exercises significant control over China's economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. New regulations or the readjustment of previously implemented regulations could require us and our manufacturing partners to change our business plans, increase our costs, or limit our ability to sell products and conduct activities in China, which could adversely affect our business and operating results.

In addition, the Chinese government and provincial and local governments have provided, and continue to provide, various incentives to encourage the development of the semiconductor industry in China. Such incentives include tax rebates, reduced tax rates, favorable lending policies and other measures, some or all of which may be available to our manufacturing partners and to us with respect to our facilities in China. Any of these incentives could be reduced or eliminated by governmental authorities at any time. Any such reduction or elimination of incentives currently provided to our manufacturing partners could adversely affect our business and operating results.

**There are inherent risks associated with the operation of our manufacturing and testing facilities in China, which could increase product costs or cause a delay in product shipments.**

We have manufacturing and testing facilities in China that began operations in 2006. We face the following risks, among others, with respect to our operations in China:

- inability to hire and maintain a qualified workforce;
- inability to maintain appropriate and acceptable manufacturing controls; and
- higher than anticipated overhead and other costs of operation.

If we are unable to maintain our facilities in China at fully operational status with qualified workers, appropriate manufacturing controls and reasonable cost levels, we may incur higher costs than our current expense levels, which

would affect our gross margins. In addition, if capacity restraints result in significant delays in product shipments, our business and results of operations would be adversely affected.

**The average selling prices of products in our markets have historically decreased over time and will likely do so in the future, which could harm our revenue and gross profits.**

Average selling prices of semiconductor products in the markets we serve have historically decreased over time. Our gross profits and financial results will suffer if we are unable to offset any reductions in our average selling prices by reducing our costs, developing new or enhanced products on a timely basis with higher selling prices or gross profits, or increasing our sales volumes. Additionally, because we do not operate our own wafer manufacturing or assembly facilities, we may not be able to reduce our costs as rapidly as companies that operate their own facilities, and our costs may even increase, which could also reduce our profit margins.

**Because of the lengthy sales cycles for our products and the fixed nature of a significant portion of our expenses, we may incur substantial expenses before we earn associated revenue and may not ultimately achieve our forecasted sales for our products.**

The introduction of new products presents significant business challenges because product development plans and expenditures may be made up to two years or more in advance of any sales. It generally takes us up to 12 months or more to design and manufacture a new product prototype. Only after we have a prototype do we introduce the product to the market and begin selling efforts in an attempt to achieve design wins. This sales process requires us to expend significant sales and marketing resources without any assurance of success. Volume production of products that use our ICs, if any, may not be achieved for an additional period of time after an initial sale. Sales cycles for our products are lengthy for a number of reasons, including:

- our customers usually complete an in-depth technical evaluation of our products before they place a purchase order;
- the commercial adoption of our products by OEMs and ODMs is typically limited during the initial release of their product to evaluate product performance and consumer demand;
- our products must be designed into our customers' products or systems; and
- the development and commercial introduction of our customers' products incorporating new technologies frequently are delayed.



As a result of our lengthy sales cycles, we may incur substantial expenses before we earn associated revenue because a significant portion of our operating expenses is relatively fixed and based on expected revenue. The lengthy sales cycles of our products also make forecasting the volume and timing of orders difficult. In addition, the delays inherent in lengthy sales cycles raise additional risks that customers may cancel or change their orders. Our sales are made by purchase orders. Because industry practice allows customers to reschedule or cancel orders on relatively short notice, backlog is not always a good indicator of our future sales. If customer cancellations or product changes occur, we could lose anticipated sales and not have sufficient time to reduce our inventory and operating expenses.

**Our success depends on our investment of significant resources in research and development. We may have to invest more resources in research and development than anticipated, which could increase our operating expenses and negatively impact our operating results.**

Our success depends on us investing significant amounts of resources into research and development. We expect to have to continue to invest heavily in research and development in the future in order to continue to innovate and come to market with new products in a timely manner and increase our revenue and profitability. If we have to invest more resources in research and development than we anticipate, we could see an increase in our operating expenses which may negatively impact our operating results. Also, if we are unable to properly manage and effectively utilize our research and development resources, we could see material adverse effects on our business, financial condition and operating results.

In addition, if new competitors, technological advances by existing competitors, our entry into new markets, or other competitive factors require us to invest significantly greater resources than anticipated in our research and development efforts, our operating expenses would increase. If we are required to invest significantly greater resources than anticipated in research and development efforts without a corresponding increase in revenue, our operating results could decline. Research and development expenses are likely to fluctuate from time to time to the extent we make periodic incremental investments in research and development and these investments may be independent of our level of revenue which could negatively impact our financial results. In order to remain competitive, we anticipate that we will continue to devote substantial resources to research and development, and we expect these expenses to increase in absolute dollars in the foreseeable future due to the increased complexity and the greater number of products under development.

**The loss of any of our key personnel or the failure to attract or retain specialized technical and management personnel could impair our ability to grow our business.**

Our future success depends upon our ability to attract and retain highly qualified technical and managerial personnel. We are particularly dependent on the continued services of our key executives, including Michael Hsing, our President and Chief Executive Officer, who founded our company and developed our proprietary process technology. In addition, personnel with highly skilled analog and mixed-signal design engineering expertise are scarce and



competition for personnel with these skills is intense. There can be no assurance that we will be able to retain existing key employees or that we will be successful in attracting, integrating or retaining other highly qualified personnel with critical capabilities in the future. If we are unable to retain the services of existing key employees or are unsuccessful in attracting new highly qualified employees quickly enough to meet the demands of our business, including design cycles, our business could be harmed.

**If we fail to retain key employees in our sales, applications, finance and legal staff or to make continued improvements to our internal systems, particularly in the accounting and finance area, our business may suffer.**

If we fail to continue to adequately staff our sales, applications, financial and legal staff, maintain or upgrade our business systems and maintain internal control that meet the demands of our business, our ability to operate effectively will suffer. The operation of our business also depends upon our ability to retain these employees, as these employees hold a significant amount of institutional knowledge about us and our products, and, if they were to terminate their employment, our sales and internal control over financial reporting could be adversely affected.

**We intend to continue to expand our operations, which may strain our resources and increase our operating expenses.**

We plan to continue to expand our domestic and foreign operations through internal growth, strategic relationships, and/or acquisitions. We expect that any such expansion will strain our systems and operational and financial controls. In addition, we are likely to incur significantly higher operating costs. To manage our growth effectively, we must continue to improve and expand our systems and controls, as well as hire experienced administrative and financial personnel. If we fail to do so, our growth will be limited. If we fail to effectively manage our planned expansion of operations, our business and operating results may be harmed.

**We may not realize the anticipated benefits of any company or business that we acquire. In addition, acquisitions could result in diluting the ownership interests of our stockholders, reduce our cash balances, and cause us to incur debt or to assume contingent liabilities, which could adversely affect our business.**

As a part of our business strategy, from time to time we review acquisition prospects that would complement our current product offerings, enhance our design capability or offer other competitive opportunities. For example, we completed our acquisition of Sensima Technology SA in July 2014 to further our diversification strategy and create new opportunities with key customers. As a result of completing acquisitions, we could use a significant portion of our available cash, cash equivalents and short-term investments, issue equity securities that would dilute current stockholders' percentage ownership, incur substantial debt or contingent liabilities, and incur impairment charges related to goodwill or other intangibles. Such actions could impact our operating results and the price of our common stock. For example, as part of the contingent consideration arrangement that was part of our acquisition of Sensima, we may have to pay up to an additional \$8.9 million to former Sensima shareholders if Sensima achieves a new product introduction as well as certain product revenue and direct margin targets in 2016. The fair value of the contingent consideration at the acquisition date of \$2.5 million was recorded in other long-term liabilities in our financial statements and is remeasured at the end of each reporting period. Any subsequent adjustments are recorded in earnings, which could have a material effect on our operating results and financial position.

In addition, we may be unable to identify or complete prospective acquisitions for various reasons, including competition from other companies in the semiconductor industry, the valuation expectations of acquisition candidates and applicable antitrust laws or related regulations. If we are unable to identify and complete acquisitions, we may not be able to successfully expand our business and product offerings.

We cannot guarantee that the Sensima acquisition or any future acquisitions will improve our results of operations or that we will otherwise realize the anticipated benefits of any acquisitions. In addition, if we are unsuccessful in integrating any acquired company or business into our operations or if integration is more difficult than anticipated, we may experience disruptions that could harm our business and result in our failure to realize the anticipated benefits

of the acquisitions. Some of the risks that may adversely affect our ability to integrate or realize any anticipated benefits from the acquired companies, businesses or assets include those associated with:

- unexpected losses of key employees or customers of the acquired companies or businesses;
- conforming the acquired company's standards, processes, procedures and controls with our operations;
- coordinating new product and process development;
- hiring additional management and other critical personnel;
- increasing the scope, geographic diversity and complexity of our operations;
- difficulties in consolidating facilities and transferring processes and know-how;
- other difficulties in the assimilation of acquired operations, technologies or products;
- the risk of undisclosed liabilities of the acquired businesses and potential legal disputes with founders or stockholders of acquired companies;
- our inability to commercialize acquired technologies;
- the risk that the future business potential as projected is not realized and as a result, we may be required to take a charge to earnings that would impact our profitability;

•the need to take impairment charges or write-downs with respect to acquired assets and technologies;

•diversion of management's attention from other business concerns; and

•adverse effects on existing business relationships with customers.

**We compete against many companies with substantially greater financial and other resources, and our market share may be reduced if we are unable to respond to our competitors effectively.**

The analog and mixed-signal semiconductor industry is highly competitive, and we expect competitive pressures to continue. Our ability to compete effectively and to expand our business will depend on our ability to continue to recruit applications and design talent, our ability to introduce new products, and our ability to maintain the rate at which we introduce these new products. We compete with domestic and non-domestic semiconductor companies, many of which have substantially greater financial and other resources with which to pursue engineering, manufacturing, marketing, and distribution of their products. We are in direct and active competition, with respect to one or more of our product lines, with at least 10 manufacturers of such products, of varying size and financial strength. The number of our competitors has grown due to the expansion of the market segments in which we participate.

We cannot assure you that our products will continue to compete favorably or that we will be successful in the face of increasing competition from new products and enhancements introduced by existing competitors or new companies entering this market, which would materially and adversely affect our results of operations and our financial condition.

**If securities or industry analysts downgrade our stock or do not continue to publish research or reports about our business, our stock price and trading volume could decline.**

The trading market for our common stock will depend, in part, on the research and reports that industry or securities analysts publish about us or our business. We do not have any control over these analysts. If one or more of the analysts who cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of us or fail to regularly publish reports on us, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

**Major earthquakes or other natural disasters and resulting systems outages may cause us significant losses.**

Our corporate headquarters, the production facilities of our third-party wafer suppliers, our IC testing and manufacturing facilities, a portion of our assembly and research and development activities, and certain other critical business operations are located in or near seismically active regions and are subject to periodic earthquakes. We do not maintain earthquake insurance and could be materially and adversely affected in the event of a major earthquake. Much of our revenue, as well as our manufacturers and assemblers, are concentrated in Asia, particularly in China. Such concentration increases the risk that other natural disasters, labor strikes, terrorism, war, political unrest, epidemics, and/or health advisories could disrupt our operations. In addition, we rely heavily on our internal information and communications systems and on systems or support services from third parties to manage our operations efficiently and effectively. Any of these are subject to failure due to a natural disaster or other disruption. System-wide or local failures that affect our information processing could have material adverse effects on our business, financial condition, operating results, and cash flows.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities**

Stock repurchase activities during the three months ended September 30, 2015 were as follows (in thousands, except per share amounts):

	<b>Total Number of Shares Purchased (a)</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Program</b>	<b>Dollar Value of Shares That May Yet Be Purchased Under the Program</b>
July 1 - July 31	32	\$ 48.76	32	
August 1 - August 31	188	\$ 47.69	188	
September 1 - September 30	64	\$ 48.24	64	
Total	284	\$ 47.93	284	\$ 6,452

In July 2013, the Board of Directors approved a stock repurchase program that authorizes us to repurchase up to \$100 million in the aggregate of our common stock through June 30, 2015. In April 2015, the Board of Directors (a) approved an extension of the program through December 31, 2015. Under the program, shares may be repurchased in privately negotiated or open market transactions, including under a Rule 10b5-1 plan. Shares are retired upon repurchase.

**ITEM 6. EXHIBITS**

- 31.1 Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance
- 101.SCHXBRL Taxonomy Extension Schema
- 101.CALXBRL Taxonomy Extension Calculation
- 101.DEF XBRL Taxonomy Extension Definition

101.LABXBRL Taxonomy Extension Labels

101.PREXBRL Taxonomy Extension Presentation

\* This exhibit shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that Section, nor shall it be deemed incorporated by reference in any filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

**MONOLITHIC POWER SYSTEMS, INC**

**SIGNATURES**

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

MONOLITHIC POWER SYSTEMS, INC.

Dated: October 28, 2015

/s/ MEERA RAO

Meera Rao

Chief Financial Officer

(Duly Authorized Officer and Principal Financial and Accounting Officer)



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