VICOR CORP
Form 10-Q
October 29, 2014
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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

# FORM 10-Q

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

**For the quarterly period ended September 30, 2014**

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

**For the transition period from ___________________________**

**Commission File Number 0-18277**

**VICOR CORPORATION**

**(Exact name of registrant as specified in its charter)**

| **Delaware** | **04-2742817** |
|---|---|
| **(State of Incorporation)** | **(I.R.S. Employer Identification No.)** |

**25 Frontage Road, Andover, Massachusetts 01810**

**(Address of Principal Executive Office)**

**(978) 470-2900**

**(Registrant s telephone number)**

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

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

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

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

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

The number of shares outstanding of each of the issuer s classes of Common Stock as of **September 30, 2014** was:

| | |
|---|---|
| Common Stock, $.01 par value | 26,804,362 |
| Class B Common Stock, $.01 par value | 11,758,218 |

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VICOR CORPORATION

Condensed Consolidated Balance Sheets

(In thousands)

(Unaudited)

Item 1. Financial Statements

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 53,186 | $ 56,339 |
| Short-term investments | 541 | 463 |
| Accounts receivable, less allowance of $210 in 2014 and $198 in 2013 | 27,347 | 27,683 |
| Inventories, net | 28,119 | 29,696 |
| Deferred tax assets | 131 | 131 |
| Other current assets | 4,934 | 4,212 |
| Total current assets | 114,258 | 118,524 |
| Long-term investments, net | 5,134 | 5,188 |
| Property, plant and equipment, net | 37,601 | 40,092 |
| Other assets | 1,726 | 1,836 |
| Total assets | $ 158,719 | $ 165,640 |
| Liabilities and Equity | | |
| Current liabilities: | | |
| Accounts payable | $ 9,336 | $ 8,677 |
| Accrued compensation and benefits | 9,687 | 8,055 |
| Accrued expenses | 4,602 | 2,841 |
| Accrued severance charges | 1,933 | 49 |
| Income taxes payable | 6 | 15 |
| Deferred revenue | 1,732 | 1,018 |
| Total current liabilities | 27,296 | 20,655 |
| Long-term deferred revenue | 703 | 974 |
| Long-term income taxes payable | 801 | 1,339 |
| Deferred income taxes payable | 335 | 335 |
| Total liabilities | 29,135 | 23,303 |
| Commitments and contingencies (Note 11) | | |
| Equity: | | |

| | | |
|---|---|---|
| Vicor Corporation stockholders equity: | | |
| Class B Common Stock | 118 | 118 |
| Common Stock | 392 | 392 |
| Additional paid-in capital | 170,790 | 169,474 |
| Retained earnings | 94,758 | 108,645 |
| Accumulated other comprehensive loss | (555) | (526) |
| Treasury stock, at cost | (138,927) | (138,927) |
| Total Vicor Corporation stockholders equity | 126,576 | 139,176 |
| Noncontrolling interest | 3,008 | 3,161 |
| Total equity | 129,584 | 142,337 |
| Total liabilities and equity | $ 158,719 | $ 165,640 |

See accompanying notes.

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VICOR CORPORATION

Condensed Consolidated Statements of Operations

(In thousands, except per share amounts)

(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net revenues | $ 58,402 | $ 55,091 | $ 164,996 | $ 143,902 |
| Cost of revenues | 32,852 | 32,111 | 93,992 | 85,854 |
| Gross margin | 25,550 | 22,980 | 71,004 | 58,048 |
| Operating expenses: | | | | |
| Selling, general and administrative | 17,354 | 14,478 | 52,367 | 43,820 |
| Research and development | 10,345 | 9,857 | 31,239 | 29,700 |
| Severance and other charges | 1,983 | | 1,983 | 1,361 |
| Total operating expenses | 29,682 | 24,335 | 85,589 | 74,881 |
| Loss from operations | (4,132) | (1,355) | (14,585) | (16,833) |
| Other income (expense), net: | | | | |
| Total unrealized gains on available-for-sale securities, net | 60 | 65 | 139 | 103 |
| Portion of gains recognized in other comprehensive income (loss) | (41) | (64) | (100) | (181) |
| Net credit gains (losses) recognized in earnings | 19 | 1 | 39 | (78) |
| Other income (expense), net | (83) | 50 | 9 | 90 |
| Total other income (expense), net | (64) | 51 | 48 | 12 |
| Loss before income taxes | (4,196) | (1,304) | (14,537) | (16,821) |
| Benefit for income taxes | (527) | (406) | (510) | (6,337) |
| Consolidated net loss | (3,669) | (898) | (14,027) | (10,484) |
| Less: Net income (loss) attributable to noncontrolling interest | 5 | 34 | (140) | 54 |
| Net loss attributable to Vicor Corporation | $ (3,674) | $ (932) | $ (13,887) | $ (10,538) |
| Net loss per common share attributable to Vicor Corporation: | | | | |
| Basic | $ (0.10) | $ (0.02) | $ (0.36) | $ (0.27) |
| Diluted | $ (0.10) | $ (0.02) | $ (0.36) | $ (0.27) |
| Shares used to compute net loss per share attributable to Vicor Corporation: | | | | |

| | | | | |
|---|---|---|---|---|
| Basic | 38,552 | 38,538 | 38,545 | 39,414 |
| Diluted | 38,552 | 38,538 | 38,545 | 39,414 |

See accompanying notes.

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VICOR CORPORATION

Condensed Consolidated Statements of Comprehensive Income (Loss)

(In thousands)

(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Consolidated net loss | $ (3,669) | $ (898) | $ (14,027) | $ (10,484) |
| Foreign currency translation gains (losses), net of tax provision (benefit) (1) | (285) | 22 | (137) | (381) |
| Unrealized gains on available-for-sale securities, net of tax (2) | 39 | 61 | 95 | 176 |
| Other comprehensive income (loss) | (246) | 83 | (42) | (205) |
| Consolidated comprehensive loss | (3,915) | (815) | (14,069) | (10,689) |
| Less: Comprehensive income (loss) attributable to noncontrolling interest | (18) | 36 | (153) | 11 |
| Comprehensive loss attributable to Vicor Corporation | $ (3,897) | $ (851) | $ (13,916) | $ (10,700) |

(1) Net of tax provision of $0 and $12 for the three months ended September 30, 2014 and 2013, respectively. Net of tax benefit of $0 and $(205) for the nine months ended September 30, 2014 and 2013, respectively.

(2) The deferred tax assets associated with the unrealized gains on available-for-sale securities are completely offset by a tax valuation allowance as of September 30, 2014 and 2013. Therefore, there is no net income tax provision (benefit) recognized for the three and nine months ended September 30, 2014 and 2013.

See accompanying notes.

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VICOR CORPORATION

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| Operating activities: | | |
| Consolidated net loss | $ (14,027) | $ (10,484) |
| Adjustments to reconcile consolidated net loss to net cash provided by (used for) operating activities: | | |
| Depreciation and amortization | 7,313 | 7,555 |
| Stock-based compensation expense | 1,173 | 1,893 |
| Provision for doubtful accounts | 30 | 230 |
| Decrease in long-term deferred revenue | (104) | (104) |
| Deferred income taxes | | (5,491) |
| Excess tax benefit of stock-based compensation | | (53) |
| Gain on disposal of equipment | (6) | (3) |
| Credit (gain) loss on available-for-sale securities | (39) | 78 |
| (Decrease) increase in long-term income taxes payable | (538) | 33 |
| Change in current assets and liabilities, net | 7,649 | 3,666 |
| Net cash provided by (used for) operating activities | 1,451 | (2,680) |
| Investing activities: | | |
| Additions to property, plant and equipment | (4,859) | (4,027) |
| Sales and maturities of investments | 190 | 603 |
| Purchases of investments | (80) | |
| Proceeds from sale of equipment | 6 | 3 |
| (Increase) decrease in other assets | (37) | 49 |
| Net cash used for investing activities | (4,780) | (3,372) |
| Financing activities: | | |
| Proceeds from issuance of Common Stock | 143 | 58 |
| Purchases of Common Stock | | (17,100) |
| Excess tax benefit of stock-based compensation | | 53 |
| Net cash provided by (used for) financing activities | 143 | (16,989) |
| Effect of foreign exchange rates on cash | 33 | (325) |
| Net decrease in cash and cash equivalents | (3,153) | (23,366) |

| | | |
|---|---|---|
| Cash and cash equivalents at beginning of period | 56,339 | 84,554 |
| Cash and cash equivalents at end of period | $ 53,186 | $ 61,188 |

See accompanying notes.

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VICOR CORPORATION

Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Vicor Corporation (the Company ) have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, these interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for any other interim period or the year ending December 31, 2014. The balance sheet at December 31, 2013 presented herein has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2013 (File No. 0-18277) filed by the Company with the Securities and Exchange Commission.

2. Short-Term and Long-Term Investments

As of September 30, 2014, the Company held auction rate securities that had experienced failed auctions totaling $6,000,000 at par value, all of which had been purchased through and are held by a broker-dealer affiliate of Bank of America, N.A. (the Failed Auction Securities ). The Failed Auction Securities held by the Company are Aaa/AA+/A3/BBB rated by major credit rating agencies, collateralized by student loans, and guaranteed by the U.S. Department of Education under the Federal Family Education Loan Program. Management is not aware of any reason to believe any of the issuers of the Failed Auction Securities are presently at risk of default. Through September 30, 2014, the Company has continued to receive interest payments on the Failed Auction Securities in accordance with the terms of their respective indentures. Management believes the Company ultimately should be able to liquidate all of the Failed Auction Securities without significant loss primarily due to the overall quality of the issues held and the collateral securing the substantial majority of the underlying obligations. However, current conditions in the auction rate securities market have led management to conclude the recovery period for the Failed Auction Securities exceeds 12 months. As a result, the Company continued to classify the Failed Auction Securities as long-term as of September 30, 2014.

The following is a summary of available-for-sale securities (in thousands):

| September 30, 2014 | Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Failed Auction Securities | $ 6,000 | $ | $ 1,036 | $ 4,964 |
| Brokered certificates of deposit | 710 | 1 | | 711 |
| | $ 6,710 | $ 1 | $ 1,036 | $ 5,675 |

| December 31, 2013 | Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Failed Auction Securities | $ 6,000 | $ | $ 1,175 | $ 4,825 |
| Brokered certificates of deposit | 820 | 6 | | 826 |
| | $ 6,820 | $ 6 | $ 1,175 | $ 5,651 |

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September 30, 2014

(unaudited)

All of the Failed Auction Securities as of September 30, 2014 have been in an unrealized loss position for greater than 12 months.

The amortized cost and estimated fair value of available-for-sale securities on September 30, 2014, by contractual maturities, are shown below (in thousands):

| | Cost | Estimated Fair Value |
|---|---|---|
| Due in one year or less | $ 540 | $ 541 |
| Due in two to ten years | 170 | 170 |
| Due in ten to twenty years | | |
| Due in twenty to forty years | 6,000 | 4,964 |
| | $ 6,710 | $ 5,675 |

Based on the fair value measurements described in Note 3, the fair value of the Failed Auction Securities on September 30, 2014, with a par value of $6,000,000, was estimated by the Company to be approximately $4,964,000, an increase in fair value of $139,000 from December 31, 2013. The gross unrealized loss of $1,036,000 on the Failed Auction Securities consists of two types of estimated loss: an aggregate credit loss of $356,000 and an aggregate temporary impairment of $680,000. In determining the amount of credit loss, the Company compared the present value of cash flows expected to be collected to the amortized cost basis of the securities, considering credit default risk probabilities and changes in credit ratings as significant inputs, among other factors (See Note 3).

The following table represents a rollforward of the activity related to the credit (gain) loss recognized in earnings on available-for-sale auction rate securities held by the Company for the nine months ended September 30 (in thousands):

| | 2014 | 2013 |
|---|---|---|
| Balance at the beginning of the period | $ 395 | $ 317 |
| Changes in the amount related to credit (gain) loss for which other-than-temporary impairment was not previously recognized | (39) | 85 |
| Reduction for security sold during the period | | (7) |
| Balance at the end of the period | $ 356 | $ 395 |

At this time, the Company has no intent to sell any of the impaired Failed Auction Securities and does not believe it is more likely than not the Company will be required to sell any of these securities. If current market conditions deteriorate further, the Company may be required to record additional unrealized losses. If the credit rating of the security deteriorates, the Company may be required to adjust the carrying value of these investments through impairment charges recorded in the Condensed Consolidated Statements of Operations, and any such impairment adjustments may be material.

Based on the Company s ability to access cash and cash equivalents and its expected operating cash flows, management does not anticipate the current lack of liquidity associated with the Failed Auction Securities held will affect the Company s ability to execute its current operating plan.

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Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

3. Fair Value Measurements

The Company accounts for certain financial assets at fair value, defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions market participants would use in pricing an asset or liability. A three-level hierarchy is used to show the extent and level of judgment used to estimate fair value measurements.

Assets measured at fair value on a recurring basis include the following as of September 30, 2014 (in thousands):

| | Quoted Prices in Active Markets (Level 1) | Using Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value as of September 30, 2014 |
|---|---|---|---|---|
| Cash Equivalents: | | | | |
| Money market funds | $ 11,861 | $ | $ | $ 11,861 |
| Short-term investments: | | | | |
| Brokered certificates of deposit | | 541 | | 541 |
| Long-term investments: | | | | |
| Failed Auction Securities | | | 4,964 | 4,964 |
| Brokered certificates of deposit | | 170 | | 170 |

Assets measured at fair value on a recurring basis include the following as of December 31, 2013 (in thousands):

| | Quoted Prices in Active Markets (Level 1) | Using Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value as of December 31, 2013 |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Cash Equivalents: | | | | |
| Money market funds | $ 12,407 | $ | $ | $ 12,407 |
| Short-term investments: | | | | |
| Brokered certificates of deposit | | 463 | | 463 |
| Long-term investments: | | | | |
| Failed Auction Securities | | | 4,825 | 4,825 |
| Brokered certificates of deposit | | 363 | | 363 |

The Company has brokered certificates of deposit classified as Level 2 because the fair value for these investments has been determined utilizing observable inputs from non-active markets. The fair values fluctuate with changes in market interest rates obtained from information available in publicly quoted markets. Management tested the reported fair values by comparing them to net present value calculations utilizing a discount rate based on U.S. Treasury bill and bond yields for similar maturities.

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VICOR CORPORATION

Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

As of September 30, 2014, there was insufficient observable auction rate security market information available to determine the fair value of the Failed Auction Securities using Level 1 or Level 2 inputs. As such, the Company s investments in Failed Auction Securities were deemed to require valuation using Level 3 inputs. Management, after consulting with advisors, valued the Failed Auction Securities using analyses and pricing models similar to those used by market participants (i.e., buyers, sellers, and the broker-dealers responsible for execution of the Dutch auction pricing mechanism by which each issue s interest rate was set). Management utilized a probability weighted discounted cash flow ( DCF ) model to determine the estimated fair value of these securities as of September 30, 2014. The major assumptions used in preparing the DCF model included: estimates for the amount and timing of future interest and principal payments based on default probability assumptions used to measure the credit loss of 5.9%; the rate of return required by investors to own these securities in the current environment, which management estimates to be 5.0% above the risk free rate of return; and an estimated timeframe of three to five years for successful auctions for these securities to occur. In making these assumptions, management considered relevant factors including: the formula applicable to each security defining the interest rate paid to investors in the event of a failed auction (the Penalty Rate ); forward projections of the interest rate benchmarks specified in such formulas; the likely timing of principal repayments; the probability of full repayment considering the guarantees by the U.S. Department of Education of the underlying student loans, guarantees by other third parties, and additional credit enhancements provided through other means; and publicly available pricing data for recently issued student loan asset-backed securities not subject to auctions. In developing its estimate of the rate of return required by investors to own these securities, management compared the Penalty Rates of the Failed Auction Securities with yields of actively traded long-term bonds with similar characteristics and, reflecting the limited liquidity for auction rate securities and the discounts to par value seen in recent tender offers by issuers and arms length market transactions between informed buyers and sellers, estimated the implied yield (i.e., the discount to par value) necessary to complete a sale of the Failed Auction Securities. Management has calculated an increase or decrease in the liquidity risk premium of 5.0% referenced above of 1.0% (i.e., 100 basis points) as used in the model, would decrease or increase, respectively, the fair value of the Failed Auction Securities by approximately $300,000.

For purposes of the valuation process for the Failed Auction Securities, management consists of senior members of the Company s finance department. The fair value measurements for the Failed Auction Securities are reviewed and updated on a quarterly basis. The calculations are prepared by the Company s Corporate Controller, in conjunction with information provided by its valuation advisors, and include the development and substantiation of the unobservable inputs. The methodology, assumptions, and calculations are reviewed and approved by the Company s Chief Financial Officer and Chief Accounting Officer.

The significant unobservable inputs used in the fair value measurement of the Company s Failed Auction Securities are the cumulative probability of earning the maximum rate until maturity, the cumulative probability of principal return prior to maturity, the cumulative probability of default, the liquidity risk premium, and the recovery rate in default. Significant increases (decreases) in any of those inputs in isolation would result in changes in fair value measurement. Significant increases (decreases) in the cumulative probability of earning the maximum rate until

maturity, the cumulative probability of principal return prior to maturity, and the recovery rate in default would result in a higher (lower) fair value measurement, while increases (decreases) in the cumulative probability of default and the liquidity risk premium would result in a lower (higher) fair value measurement.

Generally, the interrelationships are such that a change in the assumption used for the cumulative probability of principal return prior to maturity is accompanied by a directionally similar change in the assumption used for the cumulative probability of earning the maximum rate until maturity and a directionally opposite change in the assumptions used for the cumulative probability of default and the liquidity risk premium. The recovery rate in default is somewhat independent and based upon the securities specific underlying assets and published recovery rate indices.

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Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

Quantitative information about Level 3 fair value measurements as of September 30, 2014 are as follows (dollars in thousands):

| | Fair Value | Valuation Technique | Unobservable Input | Range (Weighted Average) |
|---|---|---|---|---|
| Failed Auction Securities | $ 4,964 | Discounted cash flow | Cumulative probability of earning the maximum rate until maturity | 0.01% - 0.07% (0.04%) |
| | | | Cumulative probability of principal return prior to maturity | 73.05% - 95.15% (84.10%) |
| | | | Cumulative probability of default | 4.84% - 26.88% (15.86%) |
| | | | Liquidity risk premium | 5.00% - 5.00% (5.00%) |
| | | | Recovery rate in default | 40.00% - 40.00% (40.00%) |

The following table summarizes the change in the estimated fair values calculated for those assets valued on a recurring basis utilizing Level 3 inputs (i.e., the Failed Auction Securities) for the nine months ended September 30, 2014 (in thousands):

| | |
|---|---|
| Balance at the beginning of the period | $ 4,825 |
| Credit gain on available-for-sale securities included in Other income (expense), net | 39 |
| Unrealized gain included in Other comprehensive income (loss) | 100 |
| Balance at the end of the period | $ 4,964 |

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the nine months ended September 30, 2014.

4. Stock-Based Compensation

The Company uses the Black-Scholes option pricing model to calculate the fair value of stock option awards as of their grant date. Stock-based compensation expense for the three and nine months ended September 30 was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Cost of revenues | $ 41 | $ 59 | $ 141 | $ 103 |
| Selling, general and administrative | 278 | 348 | 842 | 1,529 |
| Research and development | 83 | 84 | 190 | 261 |
| Total stock-based compensation | $ 402 | $ 491 | $ 1,173 | $ 1,893 |

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Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

Stock-based compensation was lower during the three and nine months ended September 30, 2014, compared to the same periods in 2013, due to the completion of an exchange of outstanding employee stock options in the second quarter of 2013.

On December 31, 2010, the Company granted 2,984,250 non-qualified stock options under the VI Chip 2007 Stock Option and Incentive Plan with performance-based vesting provisions tied to achievement of certain margin targets by the VI Chip subsidiary. As of December 31, 2010, the Company determined it was probable the margin targets could be achieved and, accordingly, began recording stock-based compensation expense relating to these options beginning January 1, 2011. This determination remains the same as of September 30, 2014 and, accordingly, expense has been recorded through that date. The unrecognized compensation expense for these performance-based options was approximately $649,000 as of September 30, 2014.

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VICOR CORPORATION

Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

5. Net Loss per Share

The following table sets forth the computation of basic and diluted loss per share for the three and nine months ended September 30 (in thousands, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Numerator: | | | | |
| Net loss attributable to Vicor Corporation | $ (3,674) | $ (932) | $ (13,887) | $ (10,538) |
| Denominator: | | | | |
| Denominator for basic loss per share-weighted average shares (1) | 38,552 | 38,538 | 38,545 | 39,414 |
| Effect of dilutive securities: | | | | |
| Employee stock options (2) | | | | |
| Denominator for diluted loss per share adjusted weighted-average shares and assumed conversions | 38,552 | 38,538 | 38,545 | 39,414 |
| Basic loss per share | $ (0.10) | $ (0.02) | $ (0.36) | $ (0.27) |
| Diluted loss per share | $ (0.10) | $ (0.02) | $ (0.36) | $ (0.27) |

(1) Denominator represents weighted average number of shares of Common Stock and Class B Common Stock outstanding.

(2) Options to purchase 2,001,175 shares of Common Stock for the three and nine months ended September 30, 2014 were not included in the calculation of net loss per share as the effect would have been antidilutive. Options to purchase 1,142,576 and 1,098,473 shares of Common Stock for the three and nine months ended September 30, 2013, respectively, were not included in the calculation of net loss per share as the effect would have been antidilutive.

6. Inventories

Inventories are valued at the lower of cost (determined using the first-in, first-out method) or net realizable value. Fixed production overhead is allocated to the inventory cost per unit based on the normal capacity of the production facilities. Abnormal production costs, including fixed cost variances from normal production capacity, if any, are charged to cost of revenues in the period incurred. All shipping and handling costs incurred in connection with the sale of products are included in cost of revenues.

The Company provides reserves for inventories estimated to be excess, obsolete or unmarketable. The Company s estimation process for assessing net realizable value is based upon its known backlog, projected future demand and expected market conditions, and historical usage. If the Company s estimated demand and/or market expectation were to change or if product sales were to decline, the Company s estimation process may cause larger inventory reserves to be recorded, resulting in larger charges to cost of revenues.

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VICOR CORPORATION

Notes to Condensed Consolidated Financial Statements

September 30, 2014

(unaudited)

Inventories were as follows (in thousands):

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Raw materials | $ 19,921 | $ 19,744 |
| Work-in-process | 3,224 | 3,979 |
| Finished goods | 4,974 | 5,973 |
| Net balance | $ 28,119 | $ 29,696 |

7. Other Investments

The Company s gross investment in non-voting convertible preferred stock of Great Wall Semiconductor Corporation ( GWS ) totaled $5,000,000 as of September 30, 2014 and December 31, 2013, giving the Company an approximately 27% ownership interest in GWS. GWS and its subsidiary design and sell semiconductors, conduct research and development activities, develop and license patents, and litigate against those who infringe upon its patented technologies. A director of the Company is the founder, Chairman of the Board, President and Chief Executive Officer ( CEO ), as well as the majority voting shareholder, of GWS. The Company and GWS are parties to an intellectual property cross-licensing agreement, a license agreement and two supply agreements under which the Company purchases certain components from GWS. Purchases from GWS totaled approximately $1,698,000 and $831,000 for the nine months ended September 30, 2014, and 2013, respectively. The Company owed GWS approximately $17,000 and $152,000 as of September 30, 2014 and December 31, 2013, respectively.

The Company accounts for its investment in GWS under the equity method of accounting. The Company has determined that, while GWS is a variable interest entity, the Company is not the primary beneficiary. The key factors in the Company s assessment were that the CEO of GWS has: (i) the power to direct the activities of GWS that most significantly impact its economic performance, and (ii) an obligation to absorb losses or the right to receive benefits from GWS, respectively, that could potentially be significant to GWS.

The balance in the Company s net investment in GWS was zero as of September 30, 2014 and December 31, 2013.

8. Severance and Other Charges

In July 2014, the Company s management authorized an action to consolidate the manufacturing of Westcor division products, of the Brick Business Unit segment, by transferring those operations from Westcor s Sunnyvale, California facility to the Company s primary manufacturing facility in Andover, Massachusetts, by the end of 2014. As a result, the Company recorded a pre-tax charge of $1,983,000 in the third quarter of 2014, primarily for the cost of severance

and other employee-related costs involving cash payments based on each employee s respective length of service. The Company will also incur other costs related to the relocation of the manufacturing operations, primarily freight costs for the transfer of inventories and equipment, and employee travel expenses, of which approximately $50,000 was expensed in the third quarter of 2014. The severance payments will commence in January 2015. These charges were recorded as Severance and other charges in the Condensed Consolidated Statements of Operations. The related liability is presented as Accrued severance charges in the Condensed Consolidated Balance Sheets.

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A summary of the activity related to the third quarter of 2014 severance charges, is as follows (in thousands):

| | |
|---|---|
| Balance as of December 31, 2013 | $ |
| Charges | 1,933 |
| Payments | |
| Balance as of September 30, 2014 | $ 1,933 |

9. Product Warranties

The Company generally offers a two-year warranty for all of its products. The Company provides for the estimated cost of product warranties at the time product revenue is recognized. Factors that affect the Company s warranty reserves include the number of units sold, historical and anticipated rates of warranty returns, and the cost per return. The Company assesses the adequacy of the warranty reserves and adjusts the amounts as necessary. Warranty obligations are included in Accrued expenses in the accompanying Condensed Consolidated Balance Sheets.

Product warranty activity for the three and nine months ended September 30, was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at the beginning of the period | $ 225 | $ 329 | $ 283 | $ 364 |
| Accruals for warranties for products sold in the period | 76 | 127 | 159 | 228 |
| Fulfillment of warranty obligations | (98) | (110) | (230) | (220) |
| Revisions of estimated obligations | (1) | 1 | (10) | (25) |
| Balance at the end of the period | $ 202 | $ 347 | $ 202 | $ 347 |

10. Income Taxes

The tax provision is based on the estimated annual effective tax rate for the year, which includes estimated federal, state and foreign income taxes (benefit) on the Company s projected annual pre-tax income (loss) and estimated federal and state income taxes for certain noncontrolling interest subsidiaries that are not part of the Company s consolidated income tax returns.

The benefit for income taxes and the effective income tax rate for the three and nine months ended September 30, were as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Benefit for income taxes | $ (527) | $ (406) | $ (510) | $ (6,337) |
| Effective income tax rate | (12.6%) | (31.1%) | (3.5%) | (37.7%) |

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For the three and nine months ended September 30, 2014, no tax benefit could be recognized for the majority of the Company s losses due to a full valuation allowance against all domestic deferred tax assets. The Company did recognize a tax benefit of approximately $552,000 as a discrete item in the third quarter of 2014 for the release of certain income tax reserves, due to the completion of an Internal Revenue Service examination of its 2010 and 2011 federal corporate income tax returns during the quarter (see below). For the three and nine months ended September 30, 2013, a net income tax benefit was recorded primarily due to an increase in net federal deferred tax assets not covered by a valuation allowance at that time. In addition, for the nine months ended September 30, 2013, additional net tax benefits were recorded for a potential net operating loss carryback for federal income tax purposes and the recognition of a benefit from the federal research tax credit for 2012 of $549,000, as a discrete item in the first quarter of 2013. The federal research tax credit for 2012 and 2013 was extended on January 2, 2013 pursuant to the American Taxpayer Relief Act of 2012.

As of September 30, 2014, the Company has a valuation allowance of approximately $20,179,000 primarily against all domestic net deferred tax assets, for which realization cannot be considered more likely than not at this time. Management assesses the need for the valuation allowance on a quarterly basis. In assessing the need for a valuation allowance, the Company considers all positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies, and past financial performance. In 2013, the Company recorded an increase to the valuation allowance of approximately $10,241,000 for all remaining domestic net deferred tax assets not previously covered by a valuation allowance due to the following factors: (1) the Company s forecast of future taxable income, of the appropriate nature, based on its quarterly assessment was not sufficient to support the recoverability of the remaining domestic deferred tax assets; (2) recent cumulative losses and the Company s projection of continued losses into 2014; (3) while the Company has the ability to carryback federal net operating losses or credits to utilize against federal taxable income, it would generate only $1,600,000 in cash refunds; and (4) the lack of prudent and feasible tax planning strategies. These assessment factors remain unchanged, as does management s conclusion concerning the need for a full valuation allowance against all domestic net deferred tax assets, as of September 30, 2014. The valuation allowance against these deferred tax assets may require adjustment in the future based on changes in the mix of temporary differences, changes in tax laws, and operating performance. If and when management determines the valuation allowance should be released, the adjustment would result in a tax benefit in the Condensed Consolidated Statements of Operations and may include a portion to be accounted for through Additional paid-in capital , a component of Stockholders Equity. The amount of the tax benefit to be recorded in a particular quarter could be material.

In August 2013, the Company received notice from the Internal Revenue Service that its federal corporate tax returns for the tax years 2010 and 2011 had been selected for examination. The examination was completed resulting in a net refund due the Company of approximately $17,000, which was received and recorded as a discrete benefit in the third quarter of 2014.

The Company s subsidiary in Italy, Vicor Italy S.r.l. ( Vicor Italy ), recently underwent a tax inspection for tax years 2009 2013, covering corporation, regional and value added taxes. Vicor Italy received a preliminary tax audit report dated June 30, 2014. The Company filed a response to the preliminary tax audit report in the third quarter of 2014. While management believes it is too early to determine the likelihood or amount of potential liability at this time, it does not believe the ultimate impact of this matter will be material to the Company s financial statements.

There are no other income tax examinations or audits currently in process.

11. Commitments and Contingencies

At September 30, 2014, the Company had approximately $468,000 of capital expenditure commitments.

On January 28, 2011, SynQor, Inc. ( SynQor ) filed a complaint for patent infringement against Ericsson, Inc. ( Ericsson ), Cisco Systems, Inc. ( Cisco ) and the Company in U.S. District Court for the Eastern District of Texas ( the Texas Action ). This immediately followed a complaint filed by the Company on January 26, 2011, in U.S. District Court for the District of Massachusetts, in which the Company sought a declaratory judgment that its bus converter products do not infringe any valid claim of certain of SynQor s U.S. patents, and that the claims of those patents are invalid. SynQor and Ericsson subsequently entered into a definitive settlement agreement in May 2011 in which they, among other terms and conditions, agreed to mutual

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releases and a dismissal with prejudice of all claims asserted against each other in the litigation. With respect to the Company, SynQor s complaint alleges the Company s products, including, but not limited to, unregulated bus converters used in intermediate bus architecture power supply systems, infringe certain SynQor patents. SynQor seeks, among other items, an injunction against further infringement and an award of unspecified compensatory and enhanced damages, interest, costs and attorney fees. On February 8, 2011, SynQor filed a motion for preliminary injunction seeking an order enjoining the Company from manufacturing, using, selling, and offering for sale in the United States and/or importing into the United States certain identified unregulated bus converters, as well as any other bus converters not significantly different from those products. On February 17, 2011, the Company withdrew its Massachusetts action without prejudice to allow the litigation to proceed in Texas. On May 16, 2011, SynQor announced it was withdrawing its motion for preliminary injunction against the Company. On September 16, 2011, the U.S. District Court for the Eastern District of Texas issued an order setting a trial date of July 7, 2014. On September 20, 2011, SynQor filed an amended complaint in the Texas Action. The amended complaint repeated the allegations of patent infringement against the Company contained in SynQor s original complaint, and included additional patent infringement allegations with respect to U.S. Patent No. 8,023,290 ( 290 patent ), which was issued on that day. As with SynQor s original complaint, the amended complaint alleged that the Company s products, including but not limited to the Company s unregulated bus converters used in intermediate bus architecture power supply systems, infringed the asserted patents. On October 4, 2011, the Company filed an answer and counterclaims to SynQor s amended complaint, in which the Company alleges the 290 patent is unenforceable because it was procured through inequitable conduct before the U.S. Patent and Trademark Office and seeks damages against SynQor for SynQor s unfair and deceptive trade practices and tortious interference with prospective economic advantage in connection with SynQor s allegations of patent infringement against the Company. On January 2, 2014, the court issued its claim construction order following a claim construction hearing held on December 17, 2013. On January 16, 2014, the Company filed a motion seeking reconsideration of certain aspects of the court s claim construction ruling. On March 31, 2014, the court issued an order severing the case against the Company and Cisco into two separate matters, with separate trials to be held with respect to SynQor s claims against Cisco and SynQor s claims against the Company. On June 30, 2014, the Company filed a number of motions seeking summary judgment in this matter, which are currently under consideration by the Court. On October 23, 2014, the Court issued an order continuing trial in this matter indefinitely. The Company continues to believe that none of its products, including its unregulated bus converters, infringe any valid claim of the asserted SynQor patents, either alone or when used in an intermediate bus architecture implementation. The Company believes SynQor s claims lack merit and, therefore, continues to vigorously defend itself against SynQor s patent infringement allegations. The Company does not believe a loss is probable for this matter. If a loss were to be incurred, though, the Company cannot estimate the amount of possible loss or range of possible loss at this time.

In addition, the Company is involved in certain other litigation and claims incidental to the conduct of its business. While the outcome of lawsuits and claims against the Company cannot be predicted with certainty, management does not expect any current litigation or claims to have a material adverse impact on the Company s financial position or results of operations.

12. Segment Information

The Company has organized its business segments according to its key product lines. The Brick Business Unit segment ( BBU ) designs, develops, manufactures and markets the Company s modular power converters and configurable products, and also includes the operations of the Company s Westcor division, the six entities comprising Vicor Custom Power, and the BBU operations of Vicor Japan Company, Ltd. ( VJCL ). The VI Chip segment includes VI Chip Corporation, which designs, develops, manufactures and markets the Company s factorized power architecture ( FPA ) products. The VI Chip segment also includes the VI Chip business conducted through VJCL. The Picor segment includes Picor Corporation, which designs, develops, manufactures and markets integrated circuits and related products for use in a variety of power management and power system applications. Picor develops these products to be sold as part of the Company s products or to third parties for separate applications.

The Company s chief operating decision maker evaluates performance and allocates resources based on segment revenues and segment operating income (loss). The operating income (loss) for each segment includes selling, general and administrative and research and development expenses directly attributable to the segment. Certain of the Company s indirect overhead costs, which include corporate selling, general and administrative expenses, are allocated among the segments based upon an estimate of costs

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associated with each segment. Assets allocated to each segment are based upon specific identification of such assets, which include accounts receivable, inventories, fixed assets and certain other assets. The Corporate segment consists of those operations and assets shared by all segments. The costs of certain centralized executive and administrative functions are recorded in this segment, as are certain shared assets, most notably cash and cash equivalents, deferred tax assets, long-term investments, the Company s facilities in Massachusetts, real estate and other assets. The Company s accounting policies and method of presentation for segments are consistent with that used throughout the Condensed Consolidated Financial Statements.

The following table provides significant segment financial data for the three months ended September 30, (in thousands):

| | BBU | VI Chip | Picor | Corporate | Eliminations (1) | Total |
|---|---|---|---|---|---|---|
| 2014: | | | | | | |
| Net revenues | $ 45,972 | $ 10,321 | $ 4,081 | $ | $ (1,972) | $ 58,402 |
| Income (loss) from operations | 2,369 | (6,429) | 156 | (228) | | (4,132) |
| Total assets | 149,125 | 18,876 | 4,945 | 77,397 | (91,624) | 158,719 |
| Depreciation and amortization | 1,155 | 850 | 103 | 351 | | 2,459 |
| 2013: | | | | | | |
| Net revenues | $ 42,331 | $ 12,457 | $ 2,836 | $ | $ (2,533) | $ 55,091 |
| Income (loss) from operations | 5,162 | (5,555) | (696) | (266) | | (1,355) |
| Total assets | 119,739 | 19,898 | 4,345 | 98,614 | (61,718) | 180,878 |
| Depreciation and amortization | 1,296 | 760 | 96 | 375 | | 2,527 |

The following table provides significant segment financial data for the nine months ended September 30, (in thousands):

| | BBU | VI Chip | Picor | Corporate | Eliminations (1) | Total |
|---|---|---|---|---|---|---|
| 2014: | | | | | | |
| Net revenues | $ 137,546 | $ 24,296 | $ 9,698 | $ | $ (6,544) | $ 164,996 |
| Income (loss) from operations | 10,030 | (22,682) | (1,371) | (562) | | (14,585) |
| Total assets | 149,125 | 18,876 | 4,945 | 77,397 | (91,624) | 158,719 |
| Depreciation and amortization | 3,506 | 2,429 | 309 | 1,069 | | 7,313 |
| 2013: | | | | | | |
| Net revenues | $ 120,743 | $ 22,503 | $ 7,426 | $ | $ (6,770) | $ 143,902 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Income (loss) from operations | 9,752 | (23,142) | (2,711) | (732) | | (16,833) |
| Total assets | 119,739 | 19,898 | 4,345 | 98,614 | (61,718) | 180,878 |
| Depreciation and amortization | 3,773 | 2,468 | 315 | 999 | | 7,555 |

(1) The elimination for net revenues is principally related to inter-segment revenues of Picor to BBU and VI Chip and for inter-segment revenues of VI Chip to BBU. The elimination for total assets is principally related to inter-segment accounts receivable due to BBU for the funding of VI Chip and Picor operations.

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13. Risks and Uncertainties

On July 16, 2014, the U.S. Department of the Treasury imposed new economic sanctions against Russian entities, targeting major banks and energy companies and a significant portion of the Russian defense industry, along with certain other parties. Although the Company sells its products in Russia through three independent distributors, against which the sanctions are not applicable, certain end-customers to these independent distributors have been identified as sanctioned entities. The Company is currently not accepting orders from the distributors for end-customers identified as sanctioned entities. As a result, there are no accounts receivable or backlog with any sanctioned end-customers as of September 30, 2014. Management will continue to carefully monitor the compliance of its distribution partners in the Russian market with U.S. trade restrictions, including the recent sanctions.

14. Impact of Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board ( FASB ) issued new guidance for revenue recognition, which will require an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The new guidance will replace most existing revenue recognition guidance in U.S. Generally Accepted Accounting Principles when it becomes effective which, for the Company, will be on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect the new guidance will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

Effective January 1, 2014, the Company adopted new accounting guidance related to the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The guidance requires an unrecognized tax benefit to be presented as a decrease in a deferred tax asset where a net operating loss, a similar tax loss, or a tax credit carryforward exists and certain criteria are met. The adoption of this new guidance did not impact the Company s financial position or results of operations.

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Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations

Except for historical information contained herein, some matters discussed in this report constitute 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. The words believes, expects, anticipates, intend, estimate, plans assumes, may, will, would, should, continue, prospective, project, and other similar expressions identify forward-looking statements. Forward-looking statements also include statements regarding the transition of the Company s business strategically and organizationally from serving a highly diversified customer base to serving an increasing number of large customers; the level of customer orders overall and, in particular, from large customers and the delivery lead times associated therewith; the financial and operational impact of customer changes to shipping schedules; the derivation of a portion of the Company s sales in each quarter from orders booked in the same quarter; the Company s ongoing development of power conversion architectures, switching topologies, packaging technologies, and products; the Company s plans to invest in expanded manufacturing, capacity, and the timing thereof; the Company s belief regarding currency risk being mitigated because of limited foreign exchange fluctuation exposure; the Company s continued success depending in part on its ability to attract and retain qualified personnel; the Company s belief that cash generated from operations and the total of its cash and cash equivalents will be sufficient to fund operations for the foreseeable future; the Company s intentions regarding the declaration and payment of cash dividends; the Company s intentions regarding protecting its rights under its patents; and the Company s expectation that no current litigation or claims will have a material adverse impact on its financial position or results of operations. These statements are based upon the Company s current expectations and estimates as to the prospective events and circumstances which may or may not be within the Company s control and as to which there can be no assurance. Actual results could differ materially from those implied by forward-looking statements as a result of various factors, including the Company s ability to: hire and retain key personnel; develop and market new products and technologies cost effectively, and on a timely basis leverage the Company s new technologies in standard products to promote market acceptance of the Company s new approach to power system architecture; leverage design wins into increased product sales; continue to meet requirements of key customers and prospects; enter into licensing agreements increasing the Company s market opportunity and accelerating market penetration; realize significant royalties under such licensing agreements; achieve sustainable bookings rates for the Company s products across both markets and geographies; improve manufacturing and operating efficiencies; successfully enforce the Company s intellectual property rights; successfully defend outstanding litigation; and maintain an effective system of internal controls over financial reporting, including the Company s ability to obtain required financial information for investments on a timely basis, the Company s ability to assess the value of assets, including illiquid investments, and the accounting therefor. These and other factors that may influence actual results are described in the risk factors set forth in the Company s Annual Report on Form 10-K for the year ended December 31, 2013, under Part I, Item I Business, under Part I, Item 1A Risk Factors, under Part I, Item 3 Legal Proceedings, and under Part II, Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations. The risk factors contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2013 may not be exhaustive. Therefore, the information contained therein should be read together with other reports and documents that the Company files with the Securities and Exchange Commission from time to time, including Forms 10-Q, 8-K and 10-K, which may supplement, modify, supersede or update those risk factors. The Company does not undertake any obligation to update

any forward-looking statements as a result of future events or developments.

Overview

We design, develop, manufacture and market modular power components and complete power systems. We sell our products primarily to customers in the higher-performance, higher-power segments of the power systems market, including aerospace and defense electronics, enterprise and high performance computing, industrial equipment and automation, telecommunications and network infrastructure, and vehicles and transportation.

We have organized our business segments according to our key product lines. The Brick Business Unit segment ( BBU ) designs, develops, manufactures and markets our modular power converters and configurable products, and also includes the operations of our Westcor division, the six entities comprising Vicor Custom Power, and the BBU operations of Vicor Japan Company, Ltd. ( VJCL ). The VI Chip segment includes VI Chip Corporation, which designs, develops, manufactures and markets our factorized power architecture ( FPA ) products. The VI Chip segment also includes the VI Chip business conducted through VJCL. Picor Corporation designs, develops, manufactures and markets integrated circuits and related products for use in a variety of power management and power system applications. Picor develops these products to be sold as part of our products or to third parties for separate applications.

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Our bookings, revenues, and operating results to date in 2014 continue to be negatively influenced by macroeconomic conditions across markets and geographies, the consequences of customer concentration, and slower than anticipated customer adoption of our new products. Additionally, our operating results have been negatively impacted recently by the high cost of litigation. Certain markets in which we have historically focused remain weak, notably defense electronics. Geographically, European demand remains weak due to economic uncertainty across much of the region. Because we are shifting our strategy toward serving fewer, higher volume customers with our innovative new products, we currently are vulnerable to swings in demand from a relatively small number of early adopting customers, although our objective is to diversify our customer base, given the breadth of applications of these new products. However, until customer adoption of these new products accelerates, we may not achieve such customer diversification.

Revenues for the third quarter of 2014 increased by 6.0% to $58,402,000 from $55,091,000 for the corresponding period in 2013, and increased by 9.4% on a sequential basis from $53,361,000 for the second quarter of 2014. Export sales as a percentage of total revenues for the three months ended September 30, 2014 and 2013 were approximately 61% for both periods. Gross margin increased to $25,550,000 for the third quarter of 2014 from $22,980,000 in the third quarter of 2013, and increased on a sequential basis from $22,662,000 for the second quarter of 2014. Gross margin as a percentage of revenue increased to 43.7% for the third quarter of 2014 compared to 41.7% for the third quarter of 2013, and increased on a sequential basis from 42.5% for the second quarter of 2014.

Revenues for the nine months ended September 30, 2014 increased by 14.7% to $164,996,000 from $143,902,000 for the corresponding period in 2013. Export sales as a percentage of total revenues for the nine months ended September 30, 2014 and 2013 were approximately 59% and 58%, respectively. Gross margin increased to $71,004,000 for the nine months ended September 30, 2014 from $58,048,000 for the corresponding period in 2013. Gross margin as a percentage of revenue increased to 43.0% for the nine months ended September 30, 2014 compared to 40.3% for the corresponding period in 2013.

Backlog, representing the total of orders for products for which shipment is scheduled within the next 12 months, was $52,544,000 at the end of the third quarter of 2014, as compared to $45,648,000 at the end of the second quarter of 2014.

Operating expenses for the three months ended September 30, 2014 increased $5,347,000, or 22.0%, to $29,682,000 from $24,335,000 for the corresponding period in 2013, due to an increase in selling, general and administrative expenses of $2,876,000 and research and development expenses of $488,000. During the third quarter of 2014, the Company recorded a pre-tax charge of $1,983,000 for the cost of severance and other associated costs related to our consolidation of the manufacturing of Westcor division products from its facility in Sunnyvale, California to our primary manufacturing facility in Andover, Massachusetts, by the end of 2014. See Note 8 to the Condensed Consolidated Financial Statements for additional details. The primary elements of the increase in selling, general and administrative expenses were legal fees of $2,817,000 and compensation expenses of $481,000, partially offset by

decreases in commissions expense of $349,000, stockholder reporting of $112,000, and depreciation and amortization of $77,000. The increase in legal fees is due to the ongoing litigation with SynQor, Inc. The primary elements of the increase in research and development expenses were compensation expenses of $380,000 and depreciation and amortization of $76,000, partially offset by a decrease in certification expenses of $54,000.

Operating expenses for the nine months ended September 30, 2014 increased $10,708,000, or 14.3%, to $85,589,000 from $74,881,000 for the corresponding period in 2013, primarily due to increases in selling, general and administrative expenses of $8,547,000, research and development expenses of $1,539,000, and severance and other associated costs of $622,000. The primary elements of the increase in selling, general and administrative expenses were legal fees of $7,975,000, compensation expenses of $1,128,000, facilities expenses of $147,000, and bank and franchise tax fees of $123,000, partially offset by decreases in bad debt expense of $259,000, stockholder reporting of $234,000, advertising expenses of $187,000, training and development expenses of $178,000, and commissions expense of $128,000. The increase in legal fees is due to the ongoing litigation with SynQor, Inc. The primary elements of the increase in research and development expenses were compensation expenses of $612,000, project and pre-production materials of $481,000, depreciation and amortization of $199,000, and facilities expenses of $103,000.

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During the first quarter of 2013, we recorded a pre-tax charge of $1,361,000 for severance and other employee-related costs for a workforce reduction initiated and completed in February 2013.

Net loss attributable to Vicor Corporation for the third quarter of 2014 was $(3,674,000), or $(0.10) per share, compared to net loss attributable to Vicor Corporation of $(932,000), or $(0.02) per share, for the third quarter of 2013, and net loss attributable to Vicor Corporation of $(4,835,000), or $(0.13) per share, for the second quarter of 2014.

Net loss attributable to Vicor Corporation for the nine months ended September 30, 2014, was $(13,887,000), or $(0.36) per share, compared to net loss attributable to Vicor Corporation of $(10,538,000), or $(0.27) per share, for the corresponding period in 2013.

For the nine months ended September 30, 2014, depreciation and amortization totaled $7,313,000 and capital additions totaled $4,859,000, compared to $7,555,000 and $4,027,000, respectively, for the first nine months of 2013.

Inventories decreased by approximately $1,577,000 or 5.3% to $28,119,000, compared to $29,696,000 at December 31, 2013. This decrease was primarily associated with decreases in VI Chip and BBU inventories of $810,000 and $743,000, respectively.

On July 16, 2014, the U.S. Department of the Treasury imposed new economic sanctions against Russian entities, targeting major banks and energy companies and a significant portion of the Russian defense industry, along with certain other parties. Although we sell our products in Russia through three independent distributors, against which the sanctions are not applicable, certain end-customers to these independent distributors have been identified as sanctioned entities. We are currently not accepting orders from the distributors for end-customers identified as sanctioned entities. As a result, there are no accounts receivable or backlog with any sanctioned end-customers as of September 30, 2014. We will continue to carefully monitor the compliance of our distribution partners in the Russian market with U.S. trade restrictions, including the recent sanctions.

Critical Accounting Policies and Estimates

Please refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2013 for a summary of the critical accounting policies and estimates.

*Three months ended September 30, 2014, compared to three months ended September 30, 2013*

Net revenues for the third quarter of 2014 were $58,402,000, an increase of $3,311,000 or 6.0% as compared to $55,091,000 for the same period in 2013, and an increase of 9.4% on a sequential basis from the second quarter of 2014.

The components of net revenues for the three months ended September 30 were as follows (dollars in thousands):

| | 2014 | 2013 | Increase (decrease) $ | % |
|---|---|---|---|---|
| BBU | $ 45,972 | $ 42,331 | $ 3,641 | 8.6% |
| VI Chip | 9,949 | 11,947 | (1,998) | (16.7)% |
| Picor | 2,481 | 813 | 1,668 | 205.2% |
| Total | $ 58,402 | $ 55,091 | $ 3,311 | 6.0% |

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The overall increase in net revenues during the third quarter of 2014 compared to 2013 was primarily due to increased BBU component and Picor bookings in the first and second quarters of 2014 compared to the first and second quarters of 2013. Overall bookings during the three months ended September 30, 2014 increased by 14.9% compared to the same period in 2013, and increased sequentially from the second quarter of 2014 by 13.9%. The increase in BBU revenues is primarily attributed to increases in BBU component revenues of approximately $3,439,000. The decline in VI Chip revenues was expected, as the segment s major datacenter customer is transitioning to a new VI Chip product platform. One aspect of the transition is that certain Picor products will be required in the new platform, replacing certain VI Chip products. This product shift was the primary reason for the increase in Picor bookings and shipments in the third quarter of 2014, compared to the same period in 2013. Overall net revenues increased sequentially from the second quarter of 2014 by $5,041,000, or 9.4%.

Gross margin for the third quarter of 2014 increased $2,570,000, or 11.2%, to $25,550,000 from $22,980,000 in the third quarter of 2013. Gross margin as a percentage of net revenues increased to 43.7% from 41.7%. The increase in gross margin and gross margin percentage was primarily due to the increase in net revenues and the shift to a larger proportion of higher margin BBU and Picor products.

Selling, general and administrative expenses were $17,354,000 for the quarter ended September 30, 2014, an increase of $2,876,000, or 19.9%, compared to $14,478,000 for the same period in 2013. Selling, general and administrative expenses as a percentage of net revenues increased to 29.7% from 26.3% for the same period in 2013.

The components of the $2,876,000 increase in selling, general and administrative expenses were as follows (in thousands):

| | Increase (decrease) | | |
|---|---|---|---|
| Legal fees | $ 2,817 | 533.0% | (1) |
| Compensation | 481 | 5.7% | (2) |
| Facilities expenses | 46 | 14.3% | |
| Telephone expenses | 38 | 14.6% | |
| Depreciation and amortization | (77) | (9.7)% | |
| Stockholder reporting | (112) | (75.7)% | (3) |
| Commissions expense | (349) | (23.9)% | (4) |
| Other, net | 32 | 1.3% | |
| | $ 2,876 | 19.9% | |

(1) Increase attributed to legal expenses associated with the ongoing patent infringement claim filed against the Company during the first quarter of 2011 by SynQor, Inc. See Note 11 to the Condensed Consolidated Financial Statements.

(2) Increase primarily attributed to annual compensation adjustments in May 2014.

(3) Decrease primarily attributed to additional expenses incurred in 2013 in connection with the tender offer for shares of our Common Stock and for an exchange of outstanding employee stock options completed in the second quarter of 2013.

(4) Decrease primarily attributed to the decrease in net revenues subject to commissions.

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Research and development expenses were $10,345,000 for the quarter ended September 30, 2014, an increase of $488,000, or 5.0%, compared to $9,857,000 for the same period in 2013. As a percentage of net revenues, research and development expenses decreased to 17.7% from 17.9% for the same period in 2013, due to the increase in net revenues.

The components of the $488,000 increase in research and development expenses were as follows (in thousands):

| | Increase (decrease) | | |
|---|---|---|---|
| Compensation | $ 380 | 5.7% | (1) |
| Depreciation and amortization | 76 | 14.9% | (2) |
| Facilities expenses | 38 | 8.1% | |
| Set-up and tooling expenses | 36 | 39.2% | |
| Certification expenses | (54) | (46.0)% | |
| Other, net | 12 | 0.6% | |
| | $ 488 | 5.0% | |

(1) Increase primarily attributed to annual compensation adjustments in May 2014.

(2) Increase primarily attributed to additions of engineering equipment over the past several quarters for VI Chip.

During the third quarter of 2014, we recorded a pre-tax charge of $1,983,000 for the cost of severance and other associated costs related to our consolidation of the manufacturing of Westcor division products from its facility in Sunnyvale, California to our primary manufacturing facility in Andover, Massachusetts, by the end of 2014.

The significant changes in the components of the Other income (expense), net were as follows (in thousands):

| | 2014 | 2013 | Increase (decrease) |
|---|---|---|---|
| Interest income | $ 24 | $ 27 | $ (3) |
| Foreign currency gains (losses) | (117) | 6 | (123) |

| | | | |
|---|---|---|---|
| Credit gains on available-for-sale securities | 19 | 1 | 18 |
| Other, net | 10 | 17 | (7) |
| | $ (64) | $ 51 | $ (115) |

Our exposure to market risk for fluctuations in foreign currency exchange rates relates primarily to the operations of VJCL, for which the functional currency is the Japanese yen. The functional currency of the Company s subsidiaries in Europe and other subsidiaries in Asia is the U.S. dollar. The decrease in interest income for the period was due to lower average balances on our short-term and long-term investments as well as a general decrease in interest rates.

Loss before income taxes was $(4,196,000) for the third quarter of 2014, as compared to $(1,304,000) for the same period in 2013.

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The benefit for income taxes and the effective income tax rate were as follows (dollars in thousands):

| | 2014 | 2013 |
|---|---|---|
| Benefit for income taxes | $ (527) | $ (406) |
| Effective income tax rate | (12.6%) | (31.1%) |

For the three months ended September 30, 2014, we could not recognize a tax benefit for the majority of our losses due to a full valuation allowance against all domestic deferred tax assets. We did recognize a tax benefit of approximately $552,000 as a discrete item in the third quarter of 2014 for the release of certain income tax reserves, due to the completion of an Internal Revenue Service examination of our 2010 and 2011 federal corporate income tax returns during the quarter. For the three months ended September 30, 2013, we recorded a net income tax benefit primarily due to an increase in net federal deferred tax assets not covered by a valuation allowance at that time.

Net loss per share attributable to Vicor Corporation was $(0.10) for the third quarter of 2014, compared to net loss per share of $(0.02) for the third quarter of 2013.

*Nine months ended September 30, 2014 compared to nine months ended September 30, 2013*

Net revenues for the nine months ended September 30, 2014 were $164,996,000, an increase of $21,094,000, or 14.7%, as compared to $143,902,000 for the same period in 2013.

The components of net revenues for the nine months ended September 30 were as follows (dollars in thousands):

| | | | Increase (decrease) | |
|---|---|---|---|---|
| | 2014 | 2013 | $ | % |
| BBU | $ 137,546 | $ 120,743 | $ 16,803 | 13.9% |
| VI Chip | 22,732 | 21,088 | 1,644 | 7.8% |
| Picor | 4,718 | 2,071 | 2,647 | 127.8% |
| Total | $ 164,996 | $ 143,902 | $ 21,094 | 14.7% |

The overall increase in net revenues for the nine months ended September 30, 2014 was primarily due to an approximately 4% increase in bookings for the nine months ended September 30, 2014 compared to the same period in 2013 and, particularly, a 14.9% increase in booking in the third quarter of 2014 compared to the same period in 2013. The increase in BBU revenues is primarily attributed to increases in BBU component revenues of

approximately $11,259,000, Vicor Custom Power revenues of approximately $4,512,000, VJCL revenues of approximately $902,000, and Westcor revenues of approximately $146,000. The increase in Picor revenues was due to strong sequential bookings in the second and third quarters of 2014, representing a nearly five-fold increase compared to the same period in 2013, due to the product shift from certain VI Chip to Picor products, as a result of our major datacenter customer s transition to a new VI Chip product platform, as discussed above.

Gross margin for the first nine months of 2014 increased $12,956,000, or 22.3%, to $71,004,000 from $58,048,000 in the same period in 2013. Gross margin as a percentage of net revenues increased to 43.0% from 40.3%. The increase in gross margin and gross margin percentage was primarily due to the increase in net revenues and to the shift to a larger proportion of higher margin BBU products.

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Selling, general and administrative expenses were $52,367,000 for the nine months ended September 30, 2014, an increase of $8,547,000, or 19.5%, compared to $43,820,000 for the same period in 2013. Selling, general and administrative expenses as a percentage of net revenues increased to 31.7% from 30.5% for the same period in 2013.

The components of the $8,547,000 increase in selling, general and administrative expenses were as follows (in thousands):

| | Increase (decrease) | | |
|---|---|---|---|
| Legal fees | $ 7,975 | 539.0% | (1) |
| Compensation | 1,128 | 4.4% | (2) |
| Facilities expenses | 147 | 15.7% | |
| Bank and franchise fees | 123 | 49.2% | |
| Computer expenses | 59 | 8.5% | |
| Audit, tax, and accounting fees | 43 | 3.3% | |
| Commissions expense | (128) | (3.5)% | (3) |
| Training and professional development | (178) | (78.9)% | (4) |
| Advertising expenses | (187) | (9.9)% | (5) |
| Stockholder reporting | (234) | (58.7)% | (6) |
| Bad debt expense | (259) | (91.2)% | (7) |
| Other, net | 58 | 0.9% | |
| | $ 8,547 | 19.5% | |

(1) Increase attributed to legal expenses associated with the ongoing patent infringement claim filed against the Company during the first quarter of 2011 by SynQor, Inc. See Note 11 to the Condensed Consolidated Financial Statements.

(2) Increase primarily attributed to annual compensation adjustments in May 2014.

(3) Decrease primarily attributed to a decrease in net revenues subject to commissions.

(4) Decrease primarily attributed to lower corporate management and sales personnel training expenses relative to 2013.

(5) Decrease primarily attributed to decreases in sales support expenses, direct mailings, and advertising in trade publications.

(6) Decrease primarily attributed to additional expenses incurred in 2013 in connection with the tender offers for shares of our Common Stock completed in the first and second quarters of 2013, and for an exchange of outstanding employee stock options completed in the second quarter of 2013.

(7) Decrease attributed to additional expense recognized in the second quarter of 2013 pertaining to one customer, without a comparable increase in 2014.

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