

SIPEX CORP
Form 10-Q
November 12, 2004

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 2, 2004

or

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

For the transition period from to

Commission file number: 0-27892

SIPEX Corporation

(Exact Name of Registrant as Specified in its Charter)

**Delaware
(State or Other Jurisdiction of
Incorporation or Organization)**

**04-6135748
(I.R.S. Employer
Identification No.)**

**233 South Hillview Drive, Milpitas, California
(Address of principal executive offices)**

**95035
(Zip Code)**

(408) 934-7500

Registrant's telephone number, including area code

Former name, former address and former fiscal year if changed since last report.

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

There were 34,137,432 shares of the Registrant's Common Stock issued and outstanding as of November 5, 2004.

SIPEX CORPORATION
FORM 10-Q
THREE AND NINE MONTHS ENDED OCTOBER 2, 2004

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SIPEX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)
(Unaudited)

	October 2, 2004	December 31, 2003
	<hr/>	<hr/>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 9,946	\$ 18,185
Restricted cash	565	
Short-term investment securities	2,995	2,994
Accounts receivable less allowances of \$575 and \$353 at October 2, 2004 and December 31, 2003, respectively	7,539	8,793
Accounts receivable, net, related party (Note 3)	803	2,054
Inventories	19,772	15,956
Prepaid expenses and other current assets	1,508	1,434
	<hr/>	<hr/>
Total current assets	43,128	49,416
Property, plant, and equipment, net	46,713	51,778
Restricted cash	1,272	
Other assets	234	410
	<hr/>	<hr/>
Total assets	\$ 91,347	\$ 101,604
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 9,598	\$ 11,340
Accrued expenses	4,135	4,087
Current portion of restructuring costs	672	422
Deferred income, related party (Note 3)	4,643	4,636
	<hr/>	<hr/>
Total current liabilities	19,048	20,485
Restructuring costs	1,447	535
Long-term debt, related party (Note 3)		21,323
	<hr/>	<hr/>

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Total liabilities	<u>20,495</u>	<u>42,343</u>
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, \$0.01 par value, 1,000 shares authorized and no shares issued or outstanding		
Common stock, \$0.01 par value, 60,000 shares authorized; 34,078 shares issued and outstanding at October 2, 2004 and 28,426 shares issued and outstanding at December 31, 2003		
	341	284
Additional paid-in capital	219,060	194,786
Accumulated deficit	(148,530)	(135,802)
Accumulated other comprehensive loss	<u>(19)</u>	<u>(7)</u>
Total stockholders' equity	<u>70,852</u>	<u>59,261</u>
Total liabilities and stockholders' equity	<u>\$ 91,347</u>	<u>\$ 101,604</u>

See accompanying notes to condensed consolidated financial statements

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SIPEX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
		(As Restated, See Note 10)		(As Restated, See Note 10)
Net sales	\$ 11,644	\$ 10,462	\$ 30,018	\$ 31,273
Net sales, related party (includes \$1,214 charge in 2003 for debt conversion rights see Note 3)	<u>7,138</u>	<u>4,736</u>	<u>22,597</u>	<u>13,933</u>
Total net sales	<u>18,782</u>	<u>15,198</u>	<u>52,615</u>	<u>45,206</u>
Cost of sales	8,895	8,534	24,300	28,637
Cost of sales, related party (Note 3)	5,113	4,403	14,870	13,147
Restructuring costs	<u> </u>	<u> </u>	<u> </u>	<u>(37)</u>
Total cost of sales	<u>14,008</u>	<u>12,937</u>	<u>39,170</u>	<u>41,747</u>
Gross profit	4,774	2,261	13,445	3,459
Operating expenses:				
Research and development	4,060	3,377	11,659	9,737
Marketing and selling	1,976	1,759	6,129	5,127
General and administrative	2,238	1,525	6,677	5,589
Restructuring	<u>1,882</u>	<u>(29)</u>	<u>1,941</u>	<u>(329)</u>
Total operating expenses	<u>10,156</u>	<u>6,632</u>	<u>26,406</u>	<u>20,124</u>
Loss from operations	(5,382)	(4,371)	(12,961)	(16,665)
Other income (expense):				
Interest income	39	31	121	95
Interest expense	(12)	(302)	(117)	(799)
Other income, net	<u>53</u>	<u>16</u>	<u>160</u>	<u>133</u>

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Total other income (expense), net	80	(255)	164	(571)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Loss before income taxes	(5,302)	(4,626)	(12,797)	(17,236)
Income tax expense (benefit)	<u> </u>	<u> </u>	<u> </u>	<u> </u>
	27	(69)	291	291
Net loss	<u>\$ (5,302)</u>	<u>\$ (4,653)</u>	<u>\$ (12,728)</u>	<u>\$ (17,527)</u>
Net loss per common share basic and diluted	<u>\$ (0.16)</u>	<u>\$ (0.17)</u>	<u>\$ (0.39)</u>	<u>\$ (0.62)</u>
Weighted average common shares outstanding basic and diluted	<u>33,707</u>	<u>28,145</u>	<u>32,461</u>	<u>28,077</u>

See accompanying notes to condensed consolidated financial statements

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SIPEX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Nine Months ended	
	October 2, 2004	September 27, 2003
		(As Restated See Note 10)
Operating activities:		
Net loss	\$(12,728)	\$ (17,527)
Adjustments to reconcile net loss to net cash used in operating activities:		
Fair value of debt conversion rights		1,214
Depreciation	5,501	6,448
Provision (reversal) for uncollectible receivables and returns and allowances	995	(604)
Amortization of discount and issuance costs on notes payable	57	242
Restructuring charges (reversal)	1,941	(366)
Loss on disposal of fixed assets	28	196
Compensation from acceleration of stock vesting	44	61
Changes in assets and liabilities:		
Accounts receivable	1,510	(2,717)
Inventories	(3,816)	600
Prepaid expenses and other current assets	(74)	903
Other assets	(28)	(138)
Accounts payable	(1,742)	(1,244)
Accrued expenses	48	1,158
Accrued restructuring costs	(332)	(389)
Deferred income, related party	7	2,623
	(8,589)	(9,540)
Investing activities:		
Restricted cash	(1,837)	
Proceeds from maturity of short-term investment securities	6,000	10,963
Purchase of short-term investment securities	(6,001)	(7,469)
Purchase of property, plant & equipment	(912)	(1,413)
	(2,750)	2,081
Financing activities:		
Proceeds from issuance of convertible debt, net of issuance costs		10,432

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Proceeds from exercise of warrants	2,651	
Legal fees for conversion of convertible debt to common stock	(42)	
Proceeds from issuance of common stock under employee stock plans	503	687
	<u> </u>	<u> </u>
Net cash provided by financing activities	3,112	11,119
	<u> </u>	<u> </u>
Effect of foreign currency exchange rate changes on cash and cash equivalents	(12)	57
	<u> </u>	<u> </u>
Increase (decrease) in cash and cash equivalents	(8,239)	3,717
Cash and cash equivalents at beginning of period	18,185	6,489
	<u> </u>	<u> </u>
Cash and cash equivalents at end of period	\$ 9,946	\$ 10,206
	<u> </u>	<u> </u>
Supplemental cash flow information:		
Cash paid during the period for:		
Income taxes	\$ 25	\$ 143
	<u> </u>	<u> </u>
Interest	\$	\$
	<u> </u>	<u> </u>
Non-cash financing activities:		
Conversion of convertible debt to common stock	\$ 21,176	\$
	<u> </u>	<u> </u>

See accompanying notes to condensed consolidated financial statements

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SIPEX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 Description of Business and Basis of Presentation

Description of Business

Sipex Corporation (Sipex or the Company) is a semiconductor company that designs, manufactures and markets high performance, value-added analog integrated circuits (ICs) that are used primarily by original equipment manufacturers (OEMs) operating in the computing, communications and networking infrastructure markets.

While advances in digital technology have fueled the demand for digital integrated circuits, they have also created a rapidly growing demand for more precise, faster and more power efficient analog ICs. Sipex possesses a broad portfolio of analog ICs, organized into three product families: power management, serial interface and optical storage. Sipex uses its wafer fabrication facility in Milpitas, California and a number of third party vendors to fabricate, package and test its ICs. Sipex s products are sold either directly to customers or through a global network of manufacturers representatives and distributors.

Basis of Presentation

The accompanying consolidated unaudited financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been omitted pursuant to such rules and regulations. In the opinion of management, the consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation of the Company s financial position and the operating results and cash flows for the periods presented. Actual results could differ materially from those estimates. Interim information is unaudited; however, in the opinion of the Company s management, all adjustments considered necessary for a fair presentation of interim periods have been included. The results for interim periods are not necessarily indicative of results to be expected for the entire year.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Sipex GmbH and Sipex Nippon. All significant intercompany accounts and transactions have been eliminated in consolidation.

These consolidated financial statements and accompanying notes should be read in conjunction with the Company s audited consolidated financial statements and notes thereto included in its Annual Report on Form 10-K for fiscal year ended December 31, 2003, filed with the SEC. Certain prior period amounts have been reclassified to conform to the current period presentation.

The condensed consolidated balance sheet at December 31, 2003 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

Effective January 1, 2004, the Company s fiscal year has changed from calendar year end to a 52 or a 53 week fiscal year, which ends on the Saturday closest to December 31. As a result of the change in the fiscal reporting period, the first quarter of fiscal year 2004 covered 94 days from January 1, 2004 to April 3, 2004, the second quarter covered 91 days from April 4, 2004 to July 3, 2004, and the third quarter covered 91 days from July 4, 2004 to

October 2, 2004.

Table of Contents***Restricted Cash***

Restricted cash consists of \$1.8 million held in a certificate of deposit as a guarantee of payment to fulfill the terms of a software license agreement. The agreement expires on November 2, 2007.

Stock-Based Compensation

The Company measures compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company applies the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-based Compensation Transition and Disclosure* as if the fair value-based method had been applied in measuring compensation expense. Under APB Opinion No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized. In certain situations, under these plans, options to purchase shares of common stock may be granted at less than fair market value, which results in compensation expense equal to the difference between the market value on the date of grant and the purchase price. This expense is recognized over the vesting period of the options on a straight-line basis and included in operations.

As required under SFAS No. 123 and SFAS No. 148, the pro forma effects of stock-based compensation on net income (loss) and earnings per common share for employee stock options granted and employee stock purchase plan share purchases have been estimated at the date of grant and beginning of the period, respectively, as if the Company had accounted for such awards under the fair value method of SFAS No. 123 using the Black-Scholes option-pricing model. For purposes of pro forma disclosures, the estimated fair value of the options and shares is amortized to pro forma net income (loss) over the vesting period.

The Company's pro forma information for the three and nine months ended October 2, 2004 and September 27, 2003 is as follows (in thousands, except per share data):

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Net loss as reported	\$ (5,302)	\$ (4,653)	\$ (12,728)	\$ (17,527)
Add: Stock-based employee compensation included in reported net loss		6	44	61
Less: Stock-based employee compensation determined under the fair value method for all awards	(1,650)	(1,362)	(5,032)	(4,523)
Pro forma net loss	<u>\$ (6,952)</u>	<u>\$ (6,009)</u>	<u>\$ (17,716)</u>	<u>\$ (21,989)</u>

Net loss per share

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Basic and diluted	as reported	\$ (0.16)	\$ (0.17)	\$ (0.39)	\$ (0.62)
Basic and diluted	pro forma	\$ (0.21)	\$ (0.21)	\$ (0.55)	\$ (0.78)

For pro forma net loss computation, the fair value for each option grant was estimated at the date of grant using the Black-Scholes option-pricing model. The assumptions used to value the option grants are as follows:

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Expected life of options	5 years	5 years	5 years	5 years
Volatility	61%	95%	61%	109%
Risk-free interest rate	3.5%	3.2%	3.4%	2.9%
Dividend yield				
Weighted -average fair value of options granted	\$ 2.43	\$ 4.97	\$ 3.48	\$ 3.65

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There were no purchases of common stock made under Employee Stock Purchase Plan (ESPP) in the third quarter of 2004.

Note 2 Net Loss Per Share

Basic net loss per share is based upon the weighted average number of common shares outstanding. Diluted net loss per share is based upon the weighted average number of common and common equivalent shares outstanding assuming dilution. Common equivalent shares, consisting of outstanding stock options, convertible debt and warrants, are included in the per share calculations where the effect of their inclusion would be dilutive. As the Company had net losses for the three and nine months ended October 2, 2004 and September 27, 2003, respectively, the weighted average number of common shares outstanding equals the weighted average number of common and common equivalent shares assuming dilution.

Antidilutive potential common shares excluded from the dilution calculation represented 1,727,000 and 3,329,000 potential common shares for three months ended October 2, 2004 and September 27, 2003, respectively, and 3,503,000 and 7,495,000 potential common shares for the nine months ended October 2, 2004 and September 27, 2003, respectively.

Note 3 Related Party Transactions

The Company has a distributor agreement with Future that provides for Future to act as the Company's exclusive distributor within North America and Europe. During 2003, Future increased its ownership of the Company's capital stock and became a related party. On September 27, 2002, Sipex sold a convertible secured note (the First Note) with an attached warrant to purchase 900,000 shares of Sipex common stock to an affiliate of Future for an aggregate cash amount of \$12.0 million. The Company recorded the First Note at \$10.4 million and the warrant at \$1.6 million (recorded to additional paid-in capital) based upon their estimated fair values at the date of issuance using the Black-Scholes option pricing model. The First Note paid a 5.75% coupon and was convertible after one year into Sipex common stock at a conversion price of \$7.50 per share. Following the one year anniversary of the issuance of the First Note, the Company could require the conversion of the First Note in installments if for a period of time Sipex common stock traded at a price in excess of 150% of the conversion price of \$7.50. The attached warrant was exercisable for a two-year period beginning on the one-year anniversary of the date of issuance. The exercise price for the warrant was \$2.9458. The First Note was secured by a Deed of Trust on the Company's land and building at Milpitas, California.

On June 20, 2003, Sipex sold a second convertible secured note (the Second Note) to an affiliate of Future for \$10.6 million. The Second Note paid a 1.5% coupon rate per annum. The principal amount of the Second Note was contingently convertible into a maximum of 3.0 million shares of Sipex common stock at a conversion price of \$3.52 per share, subject to Future attaining predetermined annual and/or cumulative sales levels over a three-year period. In accordance with Emerging Issues Task Force (EITF) Issue No. 01-1, *Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash*, the Company was required to recognize non-cash charges against net sales for the fair value of these conversion rights earned by Future each period relative to the sales target. The fair value of the conversion rights has been measured pursuant to FASB No. 123, *Accounting for Stock-Based Compensation* and EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. The Second Note was secured by a Deed of Trust on the Company's land and building

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at Milpitas, California as well as all other assets of the Company, except for the Company's intellectual property. In connection with the issuance of the Second Note, the Company entered into a standstill agreement with affiliates of Future, pursuant to which these security holders agreed not to acquire more than 35% of the Company's common stock on a fully diluted basis. Also, Sipex entered into a voting agreement with an affiliate of Future, pursuant to which this security holder agreed that the additional shares of the Company's common stock issuable upon conversion of the Second Note (i) will not be voted or (ii) will be voted in the same proportion as the votes cast by all stockholders of Sipex.

During the fourth quarter of 2003, Sipex entered into an agreement with the affiliates of Future to convert the First Note and Second Note into common stock subject to obtaining regulatory approval. In connection with the agreement, the Company accelerated the conversion rights of the Second Note and received \$3.0 million and forgiveness of interest on both notes of \$411,000. As a consequence, non-cash charges of \$14.1 million had been recognized against sales in the second half of 2003 representing the fair value of the conversion rights earned by Future during this period as well as the net cost from terminating the sales incentive feature of the Second Note (thereby vesting the conversion rights). As of December 31, 2003, affiliates of Future held approximately 8.5 million shares of the Company's common shares or approximately 30%.

In February 2004, upon the receipt of regulatory approval, the affiliates of Future exercised their conversion rights to exchange both the First Note and the Second Note for 4.6 million common shares of Sipex, bringing their ownership to approximately 40% of our outstanding capital stock. As a result of the conversion, all the related collateral and sales incentives have been waived. On August 5, 2004, affiliates of Future exercised the outstanding warrant to purchase 900,000 shares of Sipex's common stock at an exercise price of \$2.9458 per share for a total of \$2,651,000. In connection with the warrant exercise, Sipex agreed to modify the standstill restrictions on the affiliates of Future to enable them to hold the lesser of (i) 49% of the Company's issued and outstanding voting capital stock and (ii) 42.5% of the Company's issued and outstanding voting capital stock, measured on a Fully Diluted Basis, as defined using the following equation: The numerator includes all voting capital stock and securities convertible into or exercisable for voting capital stock held by the affiliates of Future and the denominator is the greater of (i) all shares of the Company's voting capital stock outstanding or issuable upon the exercise or conversion of vested securities convertible into or exercisable for voting capital stock and (ii) 40,000,000 (as adjusted for stock dividends, splits or like transactions). On August 9, 2004, affiliates of Future purchased 2.5 million shares of the Company's common stock on the open market bringing their aggregate ownership to approximately 48% of the Company's issued and outstanding voting capital stock as of October 2, 2004.

Future has historically accounted for a significant portion of the Company's revenues and is the Company's largest distributor worldwide. Revenue from Future accounted for 38% and 31% of total net sales for the three months ended October 2, 2004 and September 27, 2003, respectively, and 43% and 31% of total net sales for the nine months ended October 2, 2004 and September 27, 2003, respectively. The Company anticipates that sales of its products to Future will continue to account for a significant portion of its sales.

Note 4 Restructuring

In October 2003, the Company established a restructuring reserve of \$1.1 million for the unused portion of its Billerica facility in Massachusetts. For the nine months ended October 2, 2004, the Company utilized \$323,000 of the restructuring reserve for payments of the Company's Billerica, Massachusetts facility lease. During the third quarter of 2004, Sipex incurred \$1.9 million in additional restructuring accrual which reflects the Company's ongoing plan to move the remaining operations to Milpitas, California and consisted of \$1.4 million for future lease payments, \$447,000 write-off of leasehold improvements and \$32,000 for severance payments. The balance of the restructuring accrual as of October 2, 2004 consisted principally of facility lease costs, and is expected to be paid over the next three years and four months.

Below is a summary of the activities related to restructuring and impairment charges for the three and nine months ended October 2, 2004 (in thousands):

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	Facility	Severance	Total Restructuring Charges
Accrual balance, December 31, 2003	\$ 957	\$	\$ 957
Charges utilized	(111)		(111)
Adjustments to accrual	5		5
	<hr/>	<hr/>	<hr/>
Accrual balance, April 3, 2004	851		851
Charges utilized	(112)		(112)
Adjustments to accrual	54		54
	<hr/>	<hr/>	<hr/>
Accrual balance, July 3, 2004	793		793
Incurred in 2004	1,841	32	1,873
Charges utilized	(547)		(547)
	<hr/>	<hr/>	<hr/>
Accrual balance, October 2, 2004	\$2,087	\$ 32	\$ 2,119
	<hr/>	<hr/>	<hr/>

Note 5 Comprehensive Loss

Comprehensive income (loss) is the total of net income (loss) and all other revenue, expenses, gains and losses recorded directly in equity. Sipex's other comprehensive loss consists of foreign currency translation adjustments. There was no significant tax effect on the components of other comprehensive loss for the three and nine months ended October 2, 2004 and September 27, 2003.

The following table provides the comprehensive loss information (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Net loss	\$(5,302)	\$ (4,653)	\$(12,728)	\$ (17,527)
Other comprehensive loss:				
Foreign currency translation adjustment		14	(12)	57
	<hr/>	<hr/>	<hr/>	<hr/>
Comprehensive loss	\$(5,302)	\$ (4,639)	\$(12,740)	\$ (17,470)
	<hr/>	<hr/>	<hr/>	<hr/>

Note 6 Segment Information and Major Customers

The Company's Chief Executive Officer (CEO) is considered to be the Company's chief operating decision maker. The Company has organized its operations based on a single operating segment: the development and delivery of high performance analog integrated circuits that are used primarily by original equipment manufacturers operating in the computing, communications and networking infrastructure markets. The CEO reviews financial information presented on a consolidated basis accompanied by disaggregated information about revenues by product family and geographic region for purposes of making operating decisions and assessing financial performance. The Company has aligned its organization with the primary management objective of increasing overall sales unit volume, regardless of whether a distributor or the Company is the seller. The disaggregated revenue information reviewed on a product family basis by the CEO includes the interface, power management and optical storage families along with other legacy product families.

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The disaggregated sales information reviewed on a product line basis by the CEO is as follows (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Interface	\$ 8,344	\$ 8,451	\$28,781	\$ 24,276
Power Management	5,575	3,877	15,515	11,138
Optical Storage	4,863	2,748	8,319	7,386
Other (Legacy/EL)		122		2,406
	<hr/>	<hr/>	<hr/>	<hr/>
Total net sales	\$18,782	\$ 15,198	\$52,615	\$ 45,206
	<hr/>	<hr/>	<hr/>	<hr/>

The Company markets its products primarily from its operations in the United States. International sales are made primarily to customers in Europe and Asia. Information regarding the Company's net sales derived from products shipped to different geographic regions is as follows (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
United States	\$ 3,587	\$ 2,459	\$11,516	\$ 8,300
Singapore	2,552	1,508	7,457	4,414
United Kingdom	2,303	1,279	7,182	3,862
Japan	5,523	4,030	11,246	10,520
Taiwan	2,288	2,574	6,910	7,883
Asia, other than Japan, Taiwan, & Singapore	1,305	2,154	5,038	6,047
Rest of the world	1,224	1,194	3,266	4,180
	<hr/>	<hr/>	<hr/>	<hr/>
Total net sales	\$18,782	\$ 15,198	\$52,615	\$ 45,206
	<hr/>	<hr/>	<hr/>	<hr/>

Substantially all the Company's operations and long-lived assets reside in the United States although Sipex has operations in Malaysia, China, Taiwan, Japan, Germany and Belgium.

Information on major customers which accounted for 10% or more of the Company's total net sales and total gross accounts receivable is as follows:

	<u>% of Total Net Sales</u>		<u>% of Total Net Sales</u>		<u>% of Total Gross</u>	
	<u>For the Three Months Ended</u>		<u>For the Nine Months Ended</u>		<u>Accounts Receivable</u>	
	<u>October 2, 2004</u>	<u>September 27, 2003</u>	<u>October 2, 2004</u>	<u>September 27, 2003</u>	<u>October 2, 2004</u>	<u>December 31, 2003</u>
Future, a related party	38%	31%	43%	31%	*%	18%
Microtek, Inc.	25	23	14	19	30	23
Prohubs International	*	*	*	*	*	10

* Less than 10%

Note 7 Inventories

Inventories were as follows (in thousands):

	<u>October 2, 2004</u>	<u>December 31, 2003</u>
Raw materials	\$ 368	\$ 424
Work-in-process	12,438	8,684
Finished goods	6,966	6,848
	<u> </u>	<u> </u>
Total	<u>\$19,772</u>	<u>\$15,956</u>

Table of Contents**Note 8 Accrued Warranty**

Products are generally sold with a one-year warranty. Reserve requirements are recorded in the period of sale and are based on an assessment of the products sold with warranty and historical warranty costs incurred. The Company also assesses its pre-existing warranty obligations and may adjust the amounts based on actual experience or changes in future expectations.

The following table summarizes the activity in the warranty reserve for the nine months ended October 2, 2004 and September 27, 2003 (in thousands):

	For the Nine Months Ended	
	October 2, 2004	September 27, 2003
Beginning accrued warranty	\$ 195	\$ 69
Warranty claims	(148)	(40)
Accruals for the period	236	175
	<hr/>	<hr/>
Ending accrued warranty	\$ 283	\$ 204

Note 9 Commitments and Contingencies**Commitments**

On August 21, 2003, Sipex announced an exclusive sourcing agreement with PolarFab, a US-based, semiconductor foundry. This arrangement provides Sipex with favorable delivery terms and engineering support from PolarFab in return for exclusive manufacturing rights for certain products. The Company is under obligation to make minimum purchase commitments based on quarterly rolling forecasts extending out one year. The initial term of the agreement is five years with renewals on a negotiated basis. As of October 2, 2004, the minimum purchase commitment with PolarFab was approximately \$3.8 million for the following twelve months.

On July 2, 2004, the Company entered into an agreement to use certain licensed tools for circuit design and development as well as maintenance support for a total future payment commitment of \$2.5 million over the next three and one-half years. The contract requires the Company to deposit 75% of the total commitment in a certificate of deposit account. As of October 2, 2004, Sipex recorded \$1.8 million as restricted cash, which is included in the condensed consolidated balance sheet.

In October 2004, the Company received a notice of intent from one of its Japanese distributors, Microtek, to terminate its distribution agreement with Sipex at the end of March 2005. This distributor markets the Company's custom optical storage products along with other standard products of Sipex. Microtek accounted for 25% and 14% of the Company's total net sales for the three and nine months ended October 2, 2004, respectively, and 23% and 19% of the Company's total net sales for the three and nine months ended September 27, 2003, respectively. In certain circumstances upon termination of the distributor relationship, the distributors may return some portion of their prior

purchases. The Company does not believe it is probable that it will be obligated to repurchase a material portion of this distributor's prior product purchases. The Company also believes that it will be able to secure another distribution partner in Japan to replace the terminated relationship, and the transition will not have a material impact on the Company's financial position or results of operations or cash flows.

Contingencies

Under the terms and conditions of the Company's sale agreement, Sipex has offered limited intellectual property indemnification to its customers. The indemnity limits the time within which an indemnification claim can be made and the amount of the claim. It is not possible to determine the maximum potential amount due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular situation. Historically, payments made by the Company for this type of claim have not had a material impact on its operating results or financial position.

Table of Contents**Note 10 Restatement**

Subsequent to the issuance of the Company's interim financial statements for the quarter ended September 27, 2003, the Company determined that certain errors occurred in the costing of inventory held at subcontractors and in cut off associated with the accrual of returned products. As a result, the operating results presented below for the three and nine months ended September 27, 2003 have been restated (in thousands).

	For the Three Months Ended September 27, 2003		For the Nine Months Ended September 27, 2003	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Cost of sales	\$11,629	\$12,937	\$ 39,424	\$ 41,747
Gross profit	3,569	2,261	5,781	3,459
Net loss	(3,345)	(4,653)	(15,205)	(17,527)
Net loss per share	(0.12)	(0.17)	(0.54)	(0.62)

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

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can also be identified by words such as anticipates, expects, believes, plans, predicts, and similar terms. Forward-looking statements are not guarantees of future performance and the Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled Factors That May Affect Future Results and Financial Condition below. The following discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2003 and the condensed consolidated financial statements and notes thereto included elsewhere in this Form 10-Q. All information is based on the Company's fiscal calendar. Unless otherwise stated, references in this report to particular years or quarters refer to the Company's fiscal years ended in December and the associated quarters of those fiscal years. The Company assumes no obligation to revise or update any forward-looking statements for any reason, except as required by law.

Available Information

The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available on its website at www.sipex.com/investor when such reports are available on the Securities and Exchange Commission (SEC) website. The public may read and copy any materials filed by the Company with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>. The contents of these websites are not incorporated into this filing. Further, the Company's references to the Uniform Resource Locators (URLs) for these websites are intended to be inactive textual references only.

As discussed in Note 10 to the condensed consolidated financial statements, the Company's financial statements for the three and nine months ended September 27, 2003 have been restated. The accompanying management's discussions and analysis gives effect to that restatement.

Overview

We design, manufacture and market high performance, value-added analog integrated circuits, or ICs, serving the broad analog signal processing market. We produce interface, power management and optical storage ICs for use in the automotive, portable products, computing, communications and networking infrastructure markets. End product applications that contain our ICs include cellular phones, base stations, computers, DVD players, and digital cameras. We categorize our products into three major product families: interface; power management; and optical storage.

Net Sales and Product Mix

Net sales for the third quarter of 2004 increased by 23.6% to \$18.8 million, as compared to net sales of \$15.2 million in the corresponding period of 2003. We experienced an increase in net sales of 19.4% from \$15.7 million in the second quarter of 2004. The increase in net sales in the third quarter of 2004 as compared to the corresponding quarter of the previous year was driven by increases in net sales of optical storage and power management products, partially offset by lower sales of interface products. The increase in net sales in the third quarter of 2004 as compared to the second quarter of 2004 followed this trend with increases in optical storage and power management products, partially offset by lower sales on interface products.

We continually face both aggressive pricing practices as well as the emergence of new competitors in these markets. In an effort to remain competitive, we intend to continue focusing on the key areas that we believe are critical to driving enhanced operating and financial performance, including product mix, new product introductions, capacity utilization, cost reductions and productivity. All of these key areas are related and impact our gross margin. Cost reductions and productivity improvements are also required in order to remain competitive in our marketplace. Cost reductions are achieved in several ways, such as re-designing the products to shrink the size of the die, providing more

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individual products per wafer produced. This would generate increased output without adding significant incremental cost. Other cost reductions and productivity improvements could come through product back end yield improvement and test time reduction.

Capacity utilization of our wafer fab in Milpitas, California is also an important factor impacting our gross margin. A large portion of our fab cost structure is fixed, such as depreciation and payroll expenses for process engineering and manufacturing support, which can be leveraged over an increasing volume of completed wafers. We build wafers for certain power management and all interface products in our fab. We outsource the production of optical storage products and some of our power management products. Our wafer fab operation in Milpitas, California produced approximately 80% of our wafer requirements in the third quarter of 2004.

Our gross profit improved from a \$2.3 million profit in the third quarter of 2003 to a \$4.8 million profit in the third quarter of 2004. Gross profit as a percentage of net sales, or gross margin, was 25.4% in the third quarter of fiscal 2004 compared to 14.9% in the corresponding quarter of 2003. The increase was attributable to the shift in our product mix to higher margin products in our optical storage and power management product lines. The increase was also attributable to improvements in average selling prices for these product lines and improvements in manufacturing yields and processes as a result of our continued efforts to standardize our manufacturing processes and improve our product design for manufacturability. Our gross profit of \$4.8 million improved from \$4.1 million in the second quarter of 2004. However, as a percentage of net sales, gross profit declined from 26.2% in the second quarter to 25.4% in the third quarter. This decline was driven by a decline in average selling prices along with additional costs of sales charges for inventory write-down and higher manufacturing costs per unit on lower wafer fab production volumes as we acted to minimize inventory growth.

Restructuring

In October 2003, we established a \$1.1 million restructuring reserve for our facility in Billerica, Massachusetts. This followed our 2002 restructuring initiative in which we transferred our back end test operations to Asia in the first quarter of 2003 and began to integrate other support activities to Milpitas, California. By the fourth quarter of 2003 we had vacated and segregated approximately 75% of the Billerica, Massachusetts facility and were seeking a lessee for this unoccupied space. During the third quarter of 2004, we entered into a sublease arrangement for a portion of the facility and decided to relocate the remaining personnel to Milpitas, California. This resulted in additional restructuring costs of \$1.9 million for severance payments, remaining facility exit costs and the write-off of leasehold improvements in Billerica.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those significant estimates that are particularly susceptible to change, which include revenue recognition, sales returns, inventory valuation, restructuring and impairment, and income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. There is no assurance that actual results will not differ from those estimates.

We have identified the accounting policies below as the policies most critical to our business operations and the understanding of our results of operations. The impact and any associated risks related to these policies on our

business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results.

Revenue recognition. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collectibility is reasonably assured. From time to time, the Company develops custom products for various customers under engineering service contracts culminating in delivery of development sample products. The Company recognizes revenue under these agreements upon delivery of known functional development samples as delivery of such represents the culmination of utility of the contract to the customer. The Company recognizes the costs associated with these contracts as research and development expenses due to the uncertain nature of the development efforts until delivery of the known functional development samples.

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Future, a related party, is our exclusive distributor for North America and Europe. Sales to this distributor are made under an agreement that provides protection against price reduction for Future's inventory of our products. In addition, Future has stock rotation rights. Pursuant to these stock rotation rights, Future is permitted on a quarterly basis to return for credit up to 10% of its total purchases during the most recent three-month period. As the price of products sold to Future is not fixed or determinable until resold by Future to the end customer, we recognize revenue on sales to Future when Future sells the products through to the end customer. Accounts receivable are recognized and inventory is released upon shipment as title to inventories generally transfers upon shipment at which point the Company has a legally enforceable right to collection under normal terms.

For all other sales, revenue is recognized upon title transfer and shipment because these distributors/customers have no price protection and have limited return rights. Distributors are permitted to return products limited to a percentage of their purchases over a specified period of time. We believe that we are able to estimate and establish appropriate reserves for future returns from these distributors. For product sales recognized at the time of shipment, we accrue for estimated sales returns upon shipment based upon historical trends as well as any known pending sales returns.

Sales returns. To estimate reserves for future sales returns, we regularly review our history of actual returns for each major product line. We also communicate monthly with our channel partners to gather information about sell-through activity, end user satisfaction and to determine the volume of inventory in the channel. We use the results of this analysis to estimate the reserves for sales returns. We adjust our reserves for future returns as necessary, based on returns experience, returns expectations and our communications with our channel partners.

In estimating reserves, we also consider unusual events and market conditions. It is possible that future events such as the introduction of a competitive product, product obsolescence, price competition, weakness in the semiconductor industry and distributors' desire to decrease levels of inventory in the distribution channel could result in significant changes in customer demand and cause future returns to increase beyond historical levels. Management believes that it is able to estimate returns and establish appropriate reserves for returns from customers for which Sipex recognizes revenue as of shipment, using the process described above. However, since reserves for estimated sales returns are recorded as a reduction in revenues, any significant difference between our estimated and actual returns experience, or changes in our estimate of reserves for future returns, would be reflected in our reported net sales in the period we determine that difference, and could have a material impact on our future results of operations.

Inventory valuation. We write down inventory for estimated excess quantities, obsolescence or marketability. In addition, we write down inventory costs to the lower of cost or market. Excess and obsolete inventory is determined by comparing current inventory to current backlog, anticipated future demand and shipment history. Lower of cost or market adjustments are determined by reviewing shipments during the quarter as well as quarter ending backlog and comparing standard cost to anticipated market pricing. Inventories are written down to the lower of cost or market which becomes the new cost basis. In estimating anticipated market pricing, we also consider current market conditions, industry performance, distributor inventory levels and sales to end-users and other relevant factors. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Reviews of the valuation of inventory reserves are performed on a quarterly basis.

Restructuring and impairment. The determination of the estimated restructuring accrual and impairment requires significant management judgment. To estimate the restructuring accrual, we prepare a plan that includes the number of employees to be terminated and the related severance cost, the amount of impairment for certain fixed assets and inventory, the termination costs of certain leases and the related actions required to execute the plan. It is possible that future events such as voluntary employee terminations, sublease agreements or a shift in the timing of the execution of the plan could result in significant changes to the original estimate.

We account for restructuring charges beginning January 1, 2003 in accordance with Statement of Financial Accounting Standards (SFAS) No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*." SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of commitment to an exit or disposal plan. Prior to January 1, 2003, we accounted for restructuring in accordance with Emerging Issues Task Force Issue No. 94-3 (EITF 94-3), "*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in*

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a *Restructuring*) and SEC Staff Accounting Bulletin No. 100 (SAB 100), "*Restructuring and Impairment Charges*."

We review long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If an impairment is indicated, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell. In estimating future net cash flows, management makes certain assumptions including future sales levels, gross profit margins and expense levels and proceeds from disposition. The future net cash flows can vary from management estimates due to unforeseen circumstances that may result in additional impairment charges required to be recognized in the income statement.

Income taxes. In assessing the net realizable value of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become taxable. Management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management assessed that it is not more likely than not that the deferred tax assets will be realized in the future. Our deferred tax assets at October 2, 2004 continue to have a full valuation allowance.

Results of Operations

The table below presents the statements of operations for the three months and nine months ended October 2, 2004 and September 27, 2003, as a percentage of net sales:

	For the Three Months Ended		For the Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	74.6	85.1	74.4	92.4
Gross profit	25.4	14.9	25.6	7.6
Operating expenses:				
Research and development	21.6	22.2	22.2	21.5
Marketing and selling	10.5	11.6	11.6	11.3
General and administrative	11.9	10.0	12.7	12.4
Restructuring	10.0	(0.2)	3.7	(0.7)
Total operating expenses	54.0	43.6	50.2	44.5

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Loss from operations	(28.6)	(28.7)	(24.6)	(36.9)
Other income (expense), net	<u>0.4</u>	<u>(1.7)</u>	<u>0.3</u>	<u>(1.3)</u>
Loss before income taxes	(28.2)	(30.4)	(24.3)	(38.2)
Income tax expense (benefit)	<u>0.0</u>	<u>0.2</u>	<u>(0.1)</u>	<u>0.6</u>
Net loss	<u>(28.2)%</u>	<u>(30.6)%</u>	<u>(24.2)%</u>	<u>(38.8)%</u>

Net Sales

Net sales were \$18.8 million and \$15.2 million for the third quarter of 2004 and 2003, respectively, representing an increase of 23.6%, or \$3.6 million, in the third quarter of 2004. For the nine months ended October 2, 2004, net sales increased 16.4% to \$52.6 million compared to \$45.2 million for the nine months ended September 27, 2003. The increases were driven by several factors, including the introduction of several new optical storage and power management products, cost reductions in interface and power management products, and increased focus on managing the sales channel of representatives and distributors to increase design wins for interface and power management products.

Our international net sales were 81% and 84% of the total net sales for the third quarter of 2004 and 2003, respectively, and 78% and 82% for the nine months ended October 2, 2004 and September 27, 2003, respectively. In

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dollar terms, international net sales were \$15.2 million and \$12.7 million for the third quarter of 2004 and 2003, respectively. For the nine months ended October 2, 2004 and September 27, 2003, international sales were \$41.1 million and \$36.9 million, respectively. Geographically, we experienced sales growth of 46% in the United States and 47% in Europe for the third quarter of 2004 as compared to the same period in 2003. For the nine months ended October 2, 2004, sales growth was 39% in the United States and 48% in Europe as compared to the nine months ended September 27, 2003. Net sales in Asia other than Japan decreased by 2% in the third quarter of 2004 as compared to the same period in 2003, but showed 6% growth for the nine months ended October 2, 2004 as compared to the nine months ended September 27, 2003. The increases were primarily attributable to increases in shipment of optical storage and power management products in 2004 compared to 2003. Net sales increased by 37% and 7% in Japan for the three and nine months ended October 2, 2004 as compared to the corresponding periods in 2003. This increase was driven by higher shipment of optical storage products.

Gross Profit

Gross profit improved to \$4.8 million, or 25.4% of net sales, in the third quarter of 2004 from \$2.3 million, or 14.9% of net sales, in the corresponding period of 2003. For the nine months ended October 2, 2004, gross profit increased to \$13.4 million, or 25.6% of net sales, compared to \$3.5 million, or 7.6% of net sales, for the nine months ended September 27, 2003. The increases were primarily attributable to the improvements in manufacturing yields and processes as a result of our continued efforts to standardize our manufacturing processes and improve our product designs for manufacturability. These manufacturing process improvements reflected the conversion of our manufacturing capacity to two-micron geometry from five-micron geometry. This conversion increases the number of circuits per wafer, as well as improves the end product sales value per wafer significantly with relatively minor increases in wafer cost. The conversion has improved our cost and yield performance. In addition, we decided in the second quarter of 2004 to run our business through our Asian distribution network in a more disciplined manner by rejecting some customer orders that did not meet our pricing or product profitability criteria. While we may have sacrificed revenue in the second quarter, this discipline contributed to the improvement in our gross profits and an increase in our average selling prices in the third quarter of 2004.

Future Electronics has historically accounted for a significant portion of our revenues and gross profits. As our largest distributor, Future accounted for 38% and 43% of total net sales for the three and nine months ended October 2, 2004, respectively. For both the three and nine month corresponding periods of 2003, Future accounted for 31% of total net sales. Future also accounted for 42% and 57% of our gross profits for the three months and nine months ended October 2, 2004, respectively. The gross profit on net sales to Future was 28% for the three months ended October 2, 2004 as compared to 7% for the corresponding period of 2003. The gross profit on net sales to Future for the nine months ended October 2, 2004 was 34% as compared to 6% for the corresponding period of 2003. The increases in the gross profit percentages for these periods were driven by increased net sales through Future as well as lower product costs achieved by the manufacturing process and cost improvements noted above.

Research and Development

Research and development expenses were \$4.1 million and \$3.4 million for the third quarters of 2004 and 2003, respectively. The \$0.7 million increase resulted primarily from a \$0.5 million increase in purchases of mask sets and prototype wafers, a \$0.2 million increase in engineering consulting and a \$0.2 million increase in write-off of engineering assets. These increases resulted from increased new product development and process improvement activities. These increases were offset by lower depreciation and amortization expenses as fixed asset additions were reduced and as the equipment reached the end of its economic useful life. As a percentage of net sales, research and development expenses decreased to 21.6% for the third quarter of 2004 as compared to 22.2% for the same quarter in 2003. For the nine months ended October 2, 2004, research and development expenses increased to 22.2% of net sales, or \$11.7 million compared to 21.5% of net sales, or \$9.7 million for the nine months ended September 27, 2003.

The percentage increase for the nine months ended October 2, 2004 was primarily attributable to higher spending on additional headcount and new product and manufacturing technologies including mask sets and prototype wafers.

Marketing and Selling

Marketing and selling expenses were \$2.0 million and \$1.8 million for the third quarters of 2004 and 2003, respectively. The net increase of \$0.2 million was primarily attributable to an increase in salaries, benefits and travel related expenses driven by additional sales and marketing headcount compared to the corresponding period of 2003.

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As a percentage of net sales, marketing and sales were 10.5% of net sales in the third quarter of 2004 compared to 11.6% of net sales in the corresponding period of 2003. For the nine months ended October 2, 2004, marketing and selling expenses increased to 11.6% of net sales, or \$6.1 million, compared to 11.3% of net sales, or \$5.1 million, for the nine months ended September 27, 2003. These percentage and absolute dollar increases for the nine months ended October 2, 2004 were primarily driven by higher spending on headcount in marketing and sales as well as additional commission expenses incurred during the third quarter of 2004.

General and Administrative

General and administrative expenses were \$2.2 million and \$1.5 million for the third quarters of 2004 and 2003, respectively. The increase of \$0.7 million was primarily driven by additional consulting fees incurred in the Company's efforts to comply with Sarbanes-Oxley Act requirements as well as additional bad debt expenses. As a percentage of sales, general and administrative expense increased from 10.0% in the third quarter of 2003 to 11.9% in the third quarter of 2004, due primarily to the changes in expenses described above. For the nine months ended October 2, 2004, general and administration expenses were 12.7% of net sales, or \$6.7 million, compared to 12.4% of net sales, or \$5.6 million, for the nine months ended September 27, 2003. The increase in absolute dollars in 2004 was primarily driven by additional financial and consulting resources engaged to prepare for compliance with the attestation of the effectiveness of our internal controls as mandated by Section 404 of the Sarbanes-Oxley Act of 2002.

Restructuring

Restructuring consisted principally of accrued facility lease costs. In October 2003, we established a restructuring reserve of \$1.1 million for the unused portion of its Billerica, Massachusetts. During the third quarter of 2004, we entered into a sublease agreement and decided to move the remaining operations to Milpitas, California, resulting in adjustments and new additions to the restructuring charges.

For the three and nine months ended October 2, 2004, the restructuring expenses of \$1.9 million primarily included adjustments to the accrued facility lease costs of \$1.4 million associated with the unused portion of our Billerica facility since October 2003, \$447,000 for the write-off of leasehold improvements and \$32,000 for severance costs related to relocation of operations to Milpitas, California.

For the three and nine months ended September 27, 2003, restructuring credits of \$(29,000) and \$(329,000), respectively, represented adjustments to facility exit costs for closing of our San Jose fabrication facility in the third quarter of 2002, the anticipated severance costs being less than originally expected.

Other Income (Expense), Net

Other income (expense), net, was \$80,000 and \$(255,000) in the third quarter of 2004 and 2003, respectively. For the nine months ended October 2, 2004, other income (expense), net, was \$164,000 compared to \$(571,000) for the same period in the prior year. These increases were primarily attributable to a decrease in interest expense related to the convertible debt issued to the affiliates of Future which was converted to the Company's common stock in February of 2004.

Income Tax Expense (Benefit)

Income tax expense consisted principally of accruals for income taxes relating to our international locations. For the nine months ended October 2, 2004, income tax benefit resulted from the resolution of certain prior year foreign taxes at less than estimated amounts.

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Financial Condition, Liquidity and Capital Resources

Financial Condition

As of October 2, 2004, we had available funds of \$12.9 million consisting of cash and cash equivalents of \$9.9 million and short-term investments of \$3.0 million, as compared to \$21.2 million at December 31, 2003. The decrease of \$8.3 million was used principally to fund our ongoing operations and to provide restricted cash under a contractual arrangement.

Net cash used in operations was \$8.6 million for the nine months ended October 2, 2004, resulting primarily from a \$12.7 million net loss, of which \$8.6 million was non-cash related primarily related to depreciation and restructuring charges, offset by a \$4.1 million decrease in working capital, primarily related to an increase in inventories, and \$0.3 million payment of restructuring costs. Net cash used in operating activities for the nine months ended September 27, 2003 was \$9.5 million, resulting primarily from a \$17.5 million net loss, of which \$7.2 million was non-cash related primarily related to depreciation and fair value of debt conversion rights, partially offset by a \$1.3 million decrease in working capital, primarily related to an increase in accounts receivable, a \$0.4 million adjustment to restructuring, and offset by a \$2.6 million increase in deferred income.

Net cash used in investing activities was \$2.8 million for the nine months ended October 2, 2004, resulting primarily from \$1.8 million for restricted cash and \$0.9 million from purchases of property and equipment. Net cash provided by investing activities was \$2.1 million for the nine months ended September 27, 2003, resulting primarily from \$11.0 million of proceeds from maturity of short-term investments, offset by \$7.5 million from purchases of short-term investments and \$1.4 million purchases of property and equipment.

Net cash provided by financing activities was \$3.1 million for the nine months ended October 2, 2004, resulting from \$2.7 million of net proceeds from issuance of warrants and \$0.5 million of net proceeds from issuance of common stock under employee stock plans. Net cash provided by financing activities was \$11.1 million for the nine months ended September 27, 2003, resulting primarily from \$10.4 million of net proceeds from issuance of convertible secured note referred as the Second Note offset by \$0.7 million of net proceeds from issuance of common stock under employee stock plans.

In February 2004, the affiliates of Future exercised the conversion rights to convert the First Note and the Second Note into an aggregate of 4.6 million shares of our common stock. A total of \$22.6 million of principal portion of long-term debt, net of \$1.2 million in unamortized discount and \$0.2 million in unamortized issuance cost, was extinguished. As of October 2, 2004, the Company had no long-term debt.

Liquidity and Capital Resources

Management believes that our existing cash and cash equivalents are adequate to fund operations, capital expenditures and research and development efforts for the next twelve months. However in the event that we need to secure additional funds for operations, there is no guarantee that financing will be available or that it will be on terms that we will accept. In the long-term, management believes that the results of its recent years restructuring activities, cost control actions and revised product line focus will eventually result in a return to positive cash flow from operations at which time it anticipates that additional equity or debt financing would become available for financing working capital requirements and capital expenditure plans. However, there is no guarantee that the Company will return to positive cash flow from operations or that financing, if required, will be available or that it will be on terms that we will accept.

Table of Contents***Contractual Obligations***

As of October 2, 2004, Sipex's contractual obligations were as follows (in thousands):

Contractual Obligations	Total	Less Than 1 Year	1 - 3 Years	3 - 5 Years	More Than 5 Years
Restructuring liability (1)	\$ 2,315	\$ 671	\$1,409	\$235	\$
Operating leases (2)	1,829	727	571	505	26
Purchase commitment (3)	3,840	3,840			
Purchase commitment (4)	2,275	700	1,400	175	
Other commitments (5)	231	231			
Total contractual obligations	\$10,490	\$6,169	\$3,380	\$915	\$ 26

- (1) Represents the estimated future lease payments and related costs for the unused portion of our Billerica, Massachusetts facility.
- (2) Excludes the lease payments related to Billerica, Massachusetts that are included in (1) above.
- (3) Minimum purchase commitments to PolarFab based on quarterly rolling forecasts extending out for one year.
- (4) Fixed payment obligation for license to use software tool for circuit design.
- (5) Commitments for other obligations.

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Factors Affecting Results of Operations and Financial Position

Our quarterly and annual operating results are volatile and difficult to predict and may cause our stock price to fluctuate.

Our quarterly and annual operating results are affected by a wide variety of factors that could materially and adversely affect net sales and profitability from period-to-period, including:

the cyclical nature of the semiconductor industry;

competitive pressures on selling prices;

the timing and cancellation of customer orders;

our ability to maintain and expand our distributor relationships;

our ability to design and manufacture products to meet customers and distributors specifications and expectations;

our ability to introduce new products and technologies on a timely basis;

market acceptance of our products and our customers products;

the introduction of products and technologies by our competitors;

the level of orders received that can be shipped in a quarter;

delays in shipments from our fabrication plant to assembly houses;

the availability of foundry capacity, raw materials and assembly and test capacity;

our ability to manufacture the correct product mix to respond to orders on hand and new orders received in the future;

fluctuations in yields;

changes in product mix;

the level of future product returns;

the timing of investments in research and development, including tooling expenses associated with product development, process improvements and production;

costs associated with increased regulation of corporate governance and disclosure and risks of non-compliance with such regulation; and

the overall economic conditions in the United States and abroad.

Due to the absence of substantial non-cancelable backlog, we typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially.

Our expense levels are based, in part, on expectations of future revenues and are, to a large extent, fixed in the short term. For example, we have a minimum purchase arrangement with one of our suppliers based on requirements forecasted one year in advance. Our future revenues are difficult to predict and at times in the past we have failed to achieve revenue expectations. We may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. If revenue levels are below expectations for any reason, operating results are likely to be unfavorably affected. We may also take steps to adjust our strategic product families and change our cost structure, which may result in our incurring additional restructuring, reorganization and other charges. Based on forecasts, we may increase our operating expenses for personnel and new product development and for inventory in anticipation of increasing sales levels; therefore, operating results would be worsened if increased sales are not achieved. In addition, we are limited in our ability to reduce costs quickly in response to any revenue shortfalls.

From 2001 through 2003, the semiconductor industry experienced a prolonged and severe downturn that adversely affected our results of operations. In 2004, the industry has experienced strong growth, anticipated to be in the 28% range. Our business depends on market demand for products using analog semiconductors. While some industry forecasts project only flat growth in 2005 over 2004, primarily in relation to memory products, which we do not sell, a less robust semiconductor market could negatively impact our net sales, results of operations and cash flows.

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As a result of the foregoing and other factors, we may experience material fluctuations in future operating results on a quarterly or annual basis, which could substantially negatively affect our business, financial condition and operating results.

Our auditors have identified certain reportable conditions and material weaknesses in the design and operation of our internal controls, which, if not adequately addressed, could result in accounting errors, call into question the accuracy of our financial results and prevent us from achieving Section 404 certification as mandated by the Sarbanes-Oxley Act.

In communications by our registered independent public accounting firm, Deloitte & Touche LLP, or D&T, to our Audit Committee with respect to D&T's audit for the year ended December 31, 2003, D&T informed the Audit Committee that they identified the following reportable conditions in the design and operation of our internal controls:

Deficiencies in our process for determining costs related to deferred profit on shipments to our largest distributor, Future; and

Deficiencies in the staffing of our accounting department and related reliance on manual reconciliations and analysis.

In addition, in connection with the audit for the year ended December 31, 2002, our former auditors identified certain material weaknesses in our internal controls, under standards established by the American Institute of Certified Public Accountants, primarily resulting from deficiencies in the systems and processes used in the preparation of our financial statements and the lack of proper management review and account analysis in certain areas. Although other areas were impacted by the material weaknesses, the most significant issues arising from the material weaknesses included inappropriate process and systems tracking of inventory, including significant manual reconciliations, as well as inappropriate and insufficient analysis performed in evaluating inventory costs capitalized and inventory excess and obsolete reserves established.

The reportable conditions and material weaknesses noted above, if not adequately addressed, could result in accounting errors such as those underlying the restatements of our consolidated financial statements more fully discussed in Note 14 to our consolidated financial statements for the year ended December 31, 2003. Our failure to fully address these reportable conditions and material weaknesses in the design and operation of our internal controls could have a material adverse effect on our business, results of operations and financial condition.

Our ability to implement our business plan successfully in a volatile market requires effective management systems and a system of financial processes and controls. We have identified a need to further evaluate and improve our inventory costing system and procedures. In addition, we have begun the process to implement a new enterprise requirements planning system, which is expected to be completed in 2005. During the process of preparing our financial statements for the past three quarters, we continued to experience some delays and difficulties due to reliance on manual reconciliations and analyses. If we are unable to maintain an adequate level of processes and controls and improve our systems and procedures, we may not be able to accurately report our financial performance on a timely basis and our business and stock price would be adversely affected.

We are spending an increased amount of management time and external resources to understand and comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules and listing requirements. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management's annual review and evaluation of our internal control systems, and attestations of the effectiveness of these systems by our management and our independent registered public accounting firm. We are currently documenting and testing our internal control systems and procedures and implementing improvements that may be necessary in order for us to comply with the

requirements of Section 404 by the end of 2004. This process has required us to hire additional personnel and outside advisory services and has resulted in significant additional accounting and legal expenses. In addition, the evaluation and attestation processes required by Section 404 are new

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and neither companies nor auditing firms have significant experience in testing or complying with these requirements. Accordingly, to date we have encountered delays in completing the review and evaluation and the implementation of improvements in our internal control systems and procedures. There is a significant risk that we may experience further delays in our process and may not be able to complete our documentation, testing and improvements in a timely manner, that there may be insufficient time to demonstrate the effectiveness of our improvements, or that for any other reason a material weakness may exist at year end. As a result, our management may be unable to report favorably as to the effectiveness of our controls over financial reporting, and we may not receive a positive attestation by our independent registered public accounting firm. In the event that our chief executive officer, chief financial officer or independent registered public accounting firm determines that our controls over financial reporting are not effective as defined under Section 404 investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock. Please see Item 4 Controls and Procedures below.

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We may experience some delays and difficulties in developing and introducing new or enhanced products necessitated by technological advances.

Our future success will depend, in part, upon our ability to anticipate changes in market demand and evolving technologies. To remain competitive, we must enhance our current products and develop and introduce new products that keep pace with technological advancements and address the increasingly sophisticated needs of our customers. Our products may be rendered obsolete if we fail to anticipate or react to change, and, as a result, our revenues and cash flow may be negatively impacted. Our success depends on our ability to develop new semiconductor devices for existing and new markets, to introduce these products in a timely manner and to have these products selected for design into new products of our customers. The development of these new devices is highly complex and from time to time we have experienced delays in completing the development of new products. Successful product development and introduction depends on a number of factors, including:

accurate new product definition;

timely completion and introduction of new product designs;

availability of foundry capacity;

achievement of manufacturing yields; and

market acceptance of our products and our customers' products.

Our success also depends upon our ability to accurately specify and certify the conformance of our products to applicable standards and to develop our products in accordance with customer requirements. There can be no assurance that we will be able to adjust to changing market conditions as quickly and cost effectively as necessary to compete successfully. There can be no assurance that we will be able to introduce new products in a timely and cost-effective manner or in sufficient quantities to meet customer demand or that these products will achieve market acceptance. Furthermore, there can be no assurance that our customers' products will achieve market acceptance.

We depend on distributors who sell directly to OEMs and the loss of one or more of our significant distributors could have a material adverse effect on our business.

Approximately 84% of our net sales for both the three and nine months ended October 2, 2004 are from shipments of our product to distributors who sell directly to OEMs. Our agreements with distributors contain limited provisions for return of our product, including stock rotations whereby distributors may return a percentage of their product based upon a percentage of their most recent three months of shipments effective in the first quarter of 2004. In addition, in certain circumstances upon termination of the distributor relationship, distributors may return a percentage of purchases. The loss of business from any of our significant distributors or the delay of significant orders from any of them, even if only temporary, could significantly reduce our income, delay recognition of revenue and impact our ability to accurately predict cash flow. We estimate the amount of future returns and have established reserves for estimated returns based upon available information, including sales during the period into the distribution channel, reported sell-through by distributors to OEMs, distributor inventory levels and the specific terms of the distributor agreements, as well as historical returns. We defer revenue on shipments to Future until the product is resold by the distributor to the end user. These provisions, as well as the significant share ownership by Future, cause management to conclude that reasonable estimates of price concessions and returns cannot be made at the time of shipment to Future.

In October 2004, we received a notice of intent from one of our Japanese distributors, Microtek, to terminate the distribution agreement with Sipex at the end of March 2005. This distributor markets our optical storage products

along with other standard products of Sipex. Microtek accounted for 25% and 14% of our total net sales for the three and nine months ended October 2, 2004, respectively, and 23% and 19% of our total net sales for the three and nine months ended September 27, 2003, respectively. In certain circumstances upon termination of the distributor relationship, our distributors may return some portion of their prior purchases. We do not believe it is probable that we will be obligated to repurchase a material portion of this distributor's prior product purchases.

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We derive a substantial portion of our revenues and gross profits from Future, a related party, and our revenues and gross profits would likely decline significantly if Future elects not to make, cancels, reduces or defers purchases of our products.

Future has historically accounted for a significant portion of our revenues and gross profits. It is our largest distributor worldwide and accounted for 38% and 43% of total net sales for the three and nine months ended October 2, 2004, respectively; and 16%, 24% and 21% of total net sales for the years ended December 31, 2003, 2002 and 2001, respectively. Future also accounted for 42% and 57% of our gross profits for the three months and nine months ended October 2, 2004, respectively, as compared to 15% and 23% for the corresponding periods of 2003. We anticipate that sales of our products to Future will continue to account for a significant portion of our revenues and gross profits. The loss of Future as a distributor, a significant reduction in orders from Future, or a reduction in average selling prices to Future would materially and adversely affect our operating results, our business, our financial condition and our stock price.

We have a distributor agreement with Future that provides for Future to act as our sole distributor within North America and Europe. Sales to Future are made under an agreement that provides protection against price reduction for their inventory of Sipex products. Sipex maintains a separate price list for products sold to Future, which may be different from the prices charged to customers in direct sales transactions. Our distributor agreement with Future does not contain minimum purchase commitments. As a result, Future could cease purchasing our products with short notice to us. In addition, Future may defer or cancel orders without penalty, which would likely cause our revenues, our business, our financial condition and our stock price to decline.

We may not successfully expand our sales and distribution channels.

An integral part of our strategy is to expand our sales and distribution channels. We are increasing resources dedicated to developing and expanding these channels but we may not be successful doing so. If we are successful in increasing our sales through indirect sales channels, we expect that those sales will be at lower per unit prices than sales through direct channels, and revenues we receive for each sale will be less than if we had sold the same product to the customer directly. Selling through indirect channels may also limit our contact with our customers. As a result, our ability to accurately forecast sales, evaluate customer satisfaction and recognize emerging customer requirements may be hindered. Even if we successfully expand our distribution channels, any new distributors may not have the technical expertise required to market and support our products successfully. If parties do not provide adequate levels of services and technical support, our customers could become dissatisfied, we could be required to devote additional resources for customer support and our brand name, reputation and business could be negatively impacted. Our strategy of marketing products directly to our customers and indirectly through distributors may result in distribution channel conflicts.

Affiliates of Future, our largest distributor, beneficially own a significant percentage of our common stock, which will allow them to significantly control matters requiring stockholder approval and could discourage potential acquisitions of our Company.

As of December 31, 2003, affiliates of Future, our largest distributor, held approximately 8.5 million shares of our common stock, or approximately 30%, of our outstanding common stock. During February 2004, the affiliates of Future exercised the conversion rights to convert their notes into our common stock for an additional 4.6 million shares, bringing their ownership up to 13.1 million shares, or approximately 40% of our outstanding common stock. On August 5, 2004, the affiliates of Future exercised a warrant to purchase 900,000 shares of our common stock. The warrant was issued to the affiliates of Future in conjunction with the \$12 million convertible note issued in 2002, which was converted into our common stock in February 2004. In connection with the warrant exercise, Sipex agreed to modify the standstill restrictions on the affiliates of Future to enable them to hold the lesser of (i) 49% of the

Company's issued and outstanding voting capital stock and (ii) 42.5% of the Company's issued and outstanding voting capital stock, measured on a Fully Diluted Basis, as defined using the following equation: The numerator includes all voting capital stock and securities convertible into or exercisable for voting capital stock held by the affiliates of Future and the denominator is the greater of (i) all shares of the Company's voting capital stock outstanding or issuable upon the exercise or conversion of vested securities convertible into or exercisable for voting capital stock and (ii) 40,000,000 (as adjusted for stock dividends, splits or like transactions).

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On August 9, 2004, they purchased 2.5 million shares of our common stock on the open market bringing their aggregate ownership to approximately 48% of our issued and outstanding voting capital stock.

Affiliates of Future are not currently represented on our board of directors and do not have contractual rights to such representation or to any participation in the corporate governance of Sipex management. Due to their ownership of a significant percentage of our common stock, these security holders will be able to significantly control actions requiring the approval of our stockholders, including the election of directors, many types of change of control transactions and amendments to our charter documents. The significant ownership percentage of these security holders could have the effect of delaying or preventing a change of control of Sipex or otherwise discouraging a potential acquirer from obtaining control of Sipex.

We face significant risks related to our international operations.

We derive a significant portion of our net sales from international sales, including Asia, which are subject to certain risks, including:

unexpected changes in legal and regulatory requirements;

changes in tariffs;

exchange rates and other barriers;

political and economic instability;

difficulties in accounts receivable collection;

difficulties in managing distributors or representatives;

difficulties in staffing and managing international operations;

difficulties in protecting our intellectual property overseas;

the seasonality of sales; and

potentially adverse tax consequences.

Our international sales for the nine months ended October 2, 2004 were \$41.1 million or 78% of total net sales, and \$43.0 million, or 87% of total net sales for the year ended December 31, 2003 and \$51.2 million and \$42.0 million for the years ended 2002 and 2001, respectively, or 77% and 58% of total net sales for those years, respectively. There can be no assurance that economic and geopolitical troubles in any area of the world will not have a material adverse effect on our business, results of operations and financial condition.

Our inability to meet any increase in demand could reduce our market share.

Demand shifts in the semiconductor industry are rapid and difficult to predict, and we may not be able to respond quickly enough to an increase in demand, if it occurs. Our ability to increase sales of our products depends, in part, upon our ability to optimize the use of our manufacturing capacity in a timely manner and, if necessary, expand our manufacturing capacity. If we are unable to respond to rapid increases in demand, if it occurs, for our products on a timely basis or to manage any corresponding expansion of our manufacturing capacity effectively, our customers could increase their purchases from our competitors, which would reduce our market share.

Our financial results may be adversely affected due to the highly volatile optical storage market.

A significant component of our growth strategy depends on increasing shipments in the optical storage market. During 2003, we derived all of our optical storage sales from a limited number of customers in Japan. Local

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suppliers in Japan may have a competitive advantage over Sipex, which could adversely affect our ability to grow sales or continue to compete in Japan or other regions of the world. Any failure to increase our shipments in the optical storage market could limit our ability to grow our business and could adversely affect our operating results.

If we are unable to compete effectively with existing or new competitors, we will experience fewer customer orders, reduced revenues, reduced gross margins and lost market share.

We compete in markets that are intensely competitive, and which are subject to both rapid technological change and continued price erosion. Our competitors include many large domestic and foreign companies that have substantially greater financial, technical and management resources than we have. Loss of competitive position could result in price reductions, fewer customer orders, reduced revenues, reduced gross margins and loss of market share, any of which would affect our operating results and financial condition. To remain competitive, we continue to evaluate our manufacturing operations, looking for additional cost savings and technological improvements. If we are not able to successfully implement new process technologies and to achieve volume production of new products at acceptable yields, our operating results and financial condition may be affected. In addition, if competitors in Asia reduce prices on commodity products, it would adversely affect our ability to compete effectively in that region. Our future competitive performance depends on a number of factors, including our ability to:

accurately identify emerging technological trends and demand for product features and performance characteristics;

develop and maintain competitive products;

enhance our products by adding innovative features that differentiate our products from those of our competitors;

bring products to market on a timely basis at competitive prices;

respond effectively to new technological changes or new product announcements by others;

increase device performance and improve manufacturing yields;

adapt products and processes to technological changes; and

adopt and/or set emerging industry standards.

There is no assurance that our design, development and introduction schedules for new products or enhancements to our existing and future products will be met. In addition, there is no assurance that these products or enhancements will achieve market acceptance, or that we will be able to sell these products at prices that are favorable.

The implementation of a new management information system may disrupt our business.

We have begun the process to implement a new enterprise resource planning and financial accounting and planning system, and integrate this new system with our customer relationship management system and our product management system. Implementation of the new management information system, including the integration with other systems, is a very complex process that requires significant financial resources and personnel time, as well as unifying operating policies and procedures to ensure that the total system operates efficiently and effectively. Delays and/or errors in the implementation could result in additional costs and cause disruptions to our business, which could adversely affect our ability to accurately report our financial results on a timely basis and could have a material adverse effect on our business, financial condition and operating results.

We have only limited protection for our proprietary technology.

The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. Although we are not aware of any pending or threatened patent litigation that we consider material, there is no assurance that third parties will not assert claims against us with respect to existing or future products or

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technologies and we have been subject to such claims in the past. To determine the validity of any third party claims, such litigation, whether or not determined in our favor could result in significant expense to us and divert the efforts of our management personnel from productive tasks. In the event of an adverse ruling in such litigation, we may be required to discontinue the use of certain processes, cease the manufacture, use and sale of infringing products, and expend significant resources to develop non-infringing technology or obtain licenses to the infringing technology. There is no assurance that licenses will be available on acceptable terms, or at all, with respect to disputed third party technology. In the event of a successful claim against us and our failure to develop or license a substitute technology at a reasonable cost, our business, financial condition and results of operations would be materially and adversely affected.

There is no assurance that foreign intellectual property laws will protect our intellectual property rights. Furthermore, there can be no assurance that others will not independently develop similar products, duplicate our products or design around any of our patents. We may be subject to, or may initiate, interference proceedings in the U.S. Patent and Trademark Office, which can demand significant financial and management resources.

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Our future success depends on retaining our key personnel and attracting and retaining additional highly qualified employees.

Our success depends upon the continued service of our executive officers and other key management and technical personnel, and on our ability to continue to attract, retain and motivate qualified personnel, such as experienced analog circuit designers. The competition for these employees is intense. Our employees are employed at-will, which means that they can terminate their employment at any time. There is no assurance that we will be able to retain our design engineers, executive officers and other key personnel. The loss of the services of one or more of our design engineers, executive officers or other key personnel or our inability to recruit replacements for these personnel or to otherwise attract, retain and motivate qualified personnel could seriously impede our success.

We have recently experienced significant changes in senior management and our corporate organization.

Our Senior Vice President of Finance and Chief Financial Officer, Clyde R. Wallin, joined Sipex in April 2004 and Rick Hawron, our Senior Vice President of Sales, joined Sipex in February 2004. Changes in management may be disruptive to our business and may result in the departure of existing employees and/or customers.

Our manufacturing processes are very complex, which may result in manufacturing difficulties.

Our manufacturing processes are highly complex and are continuously being modified in an effort to improve yields and product performance. Process changes can result in interruptions in production or significantly reduced yields causing product introduction or delivery delays. In addition, yields can be adversely affected by minute impurities in the environment or other problems that occur in the complex manufacturing process. Many of these problems are difficult to diagnose and are time-consuming or expensive to remedy. From time to time we have experienced unfavorable yield variances. In particular, new process technologies or new products can be subject to especially wide variations in manufacturing yields and efficiencies. There is no assurance that our foundries will not experience unfavorable yield variances or other manufacturing problems that result in delayed product introduction or delivery delays.

Product defects or compatibility problems with our products could damage our reputation, decrease market acceptance of our technology, cause us to replace defective or incompatible products at a substantial cost and result in potentially costly litigation.

A number of factors, including design flaws, materials failures, manufacturing problems, and misapplication of our products may cause our products to contain undetected errors, defects or compatibility problems. Defects or compatibility problems with our products may:

cause delays in product introductions and shipments;

result in increased costs and diversion of development resources;

result in increased product returns and cause us to incur costs due to unusable inventory or replacement of defective or incompatible products; or

require design modifications.

If any of our products contain defects, or have reliability, quality or compatibility problems, our reputation might be damaged significantly and customers might be reluctant to buy our products. This could result in the loss of existing customers and impair our ability to attract new customers in the future. In addition, we may discover defects or failures in our products after they are installed by customers. In such cases, we may incur significant costs and

devote substantial management resources to correcting these problems. Our customers may also sue us for, or otherwise seek to recover from us, any losses resulting from alleged defects or errors in our products.

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We rely on outside foundries to supply certain of our wafers and those foundries may not produce at acceptable levels.

We rely on outside foundries to supply certain of our fully-processed semiconductor wafers. This reliance on outside foundries presents the following potential risks:

lack of adequate wafer supply;

limited control over delivery schedules;

unavailability of, or delays in obtaining access to, key process technologies; and

limited control over quality assurance, manufacturing yields and production costs.

Additionally, the manufacture of integrated circuits is a highly complex and technologically demanding process. Our third-party foundries have, from time to time, experienced lower than anticipated manufacturing yields, particularly in connection with the introduction of new products and the installation and start-up of new process technologies. There is no assurance that our outside foundries will not experience lower than expected manufacturing yields in the future.

Additionally, we do not have a guaranteed level of production capacity at any of these foundries with the exception of one of our foundries for whom we provide minimum purchase commitments in accordance with our supply agreement announced on August 11, 2003 (see Note 9 for Commitments and Contingencies). The ability of each foundry to provide wafers to us is limited by the foundry's available capacity, and the foundry's allocation of its available capacity among multiple customers. There can be no assurance that our third party foundries will allocate sufficient capacity to satisfy our requirements. We have experienced decreased allocations of wafer supplies from our suppliers in the past, which reduced our capacity to ship products, and, thus, recognize revenues. Additionally, any sudden reduction or elimination of any primary source or sources of fully processed wafers could result in a material delay in the shipment of our products. If any other delays or shortages occur in the future, our business and operating results will be negatively impacted.

Our wafer fabrication facility and the facilities of certain of our significant customers and third-party wafer suppliers are located in areas susceptible to earthquakes and other natural disasters.

Our in-house fabrication facility and the facilities of certain of our significant customers and third-party wafer suppliers are located in areas that are susceptible to earthquakes and other natural disasters. Damage caused by earthquakes may result in shortages in water or electricity or transportation, which could limit the production capacity of our wafer facility and/or the ability of certain of our subcontractors to provide needed products. Any reduction in production capacity or the ability to obtain fully processed semiconductor wafers could cause delays or shortages in our product supply, which would negatively impact our business. If our facilities or the facilities of our customers or suppliers are damaged by future earthquakes or other natural disasters, it could have a materially adverse effect on our business.

We rely on outside suppliers to assemble, test and ship products to our customers.

We rely on outside assembly houses to assemble, test and ship our products to end customers. There can be no assurance that our third-party suppliers will allocate sufficient capacity to us to meet our requirements. Any sudden reduction or elimination of a primary source could result in material delay in the shipment of our products and could have a material adverse affect on our business and operating results.

Because we rely on outside assembly house to assemble, test and ship our products, we have limited control over quality assurance, manufacturing yields and production costs, and we have in the past experienced yield problems and delays. We could experience delays or yield issues in the future due to the transfer of products from development to production, which could negatively impact our business and operating results. In addition, if defects in our products are undetected, we may experience higher warranty expenses than anticipated, which could negatively impact our reputation, business and operating results.

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We must comply with significant environmental regulations, which is difficult and expensive.

We are subject to a variety of federal, state and local governmental regulations related to the use, storage, discharge and disposal of toxic, volatile or otherwise hazardous chemicals used in our manufacturing processes. Although we believe that our activities conform to presently applicable environmental regulations, the failure to comply with present or future regulations could result in fines being imposed on us, suspension of production or a cessation of operations. Any failure by us to control the use of, or adequately restrict the discharge of, hazardous substances, or otherwise comply with environmental regulations, could subject us to significant future liabilities. In addition, there is no assurance that we have not violated laws or regulations in the past, which violations could result in remediation or other significant liabilities, or that past use or disposal of environmentally sensitive materials in conformity with then existing environmental laws and regulations will not result in remediation or other significant liabilities under current or future environmental laws or regulations.

It would be difficult for us to adjust our spending significantly if we experience any revenue shortfalls.

Our future revenues are difficult to predict and at times in the past we have failed to achieve our revenue expectations. Our expense levels are based in part, on our expectations of future revenues, and expense levels are, to a large extent, fixed in the short term. Since the fourth quarter of 2000, we have adjusted our spending levels as a result of decreased revenues and continue to focus on controlling costs. We may, however, be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. If revenue levels are below expectations for any reason, our operating results will be negatively impacted. Due to the absence of substantial non-cancelable backlog, we typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and often fluctuates substantially. In the future, if we believe that demand is increasing, our operating expenses for personnel, new product development and for inventory would correspondingly increase as needed in anticipation of increasing sales levels. Our operating results would be negatively impacted if increased sales were not achieved. In addition, we are limited in our ability to reduce costs quickly in response to any revenue shortfalls.

We may not have sufficient capital to maintain and grow our business and we may not be able to secure adequate capital on acceptable terms.

In order to remain competitive, we must continue to make investments in our facilities and capital equipment. We obtained additional funding through the private placement of 3.0 million shares of Sipex common stock on April 16, 2002, which provided \$23.5 million, net of placement agent fees and other costs of issuance, and through the private placement of a convertible secured note and related warrant on September 27, 2002, which provided approximately \$12.0 million, net of costs of issuance. We obtained funding from the private placement of a convertible secured note on June 20, 2003 which provided approximately \$10.4 million, net of costs of issuance. In December 2003, we entered into an agreement to amend both outstanding convertible notes and accelerated the associated conversion rights. In connection with this agreement, we received \$3.0 million in cash. During February 2004, the note holders converted their notes into our common stock, resulting in dilution to our stockholders. On August 5, 2004, we received \$2.7 million in cash for our common stock issued to the warrant holders in conjunction with the \$12.0 million convertible note on September 27, 2002. This resulted in further dilution to our stockholders. If we require additional financing, it may not be available or available on terms acceptable to us, and could result in additional dilution to existing stockholders.

Our stock price has been volatile and could continue to remain volatile.

The trading price of our common stock is subject to wide fluctuations in response to quarter-to-quarter variations in operating results, announcements of technological innovations or new products by us or our competitors, general conditions in the semiconductor manufacturing and electronics markets, changes in earnings estimates by analysts, or

other events or factors. In addition, the public stock markets have experienced extreme price and trading volume volatility in recent months. In the third quarter of 2004, our stock closing price ranged from a high of \$5.75 to a low of \$3.80. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to the operating performance of the specific companies. These broad market fluctuations may adversely affect the market price of our common stock.

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We could become involved in litigation or have claims made against us which could result in substantial costs, potential damages, and the diversion of management's attention and resources, all of which could have a negative impact on our business and our financial results.

We have in the past, and may in the future, become involved in litigation or have claims made against us by customers, distributors, former employees, shareholders or other third-parties related to a variety of matters concerning the operations of our business. The litigation process is uncertain and unpredictable and there is no guarantee that we will not become subject to lawsuits or claims in the future. If we do become subject to lawsuits or claims, it could result in substantial costs, potential damages, and the diversion of management's attention and resources, all of which could have a negative impact on our business and our financial results.

Changes in laws, regulations and financial accounting standards may affect our reported results of operations.

The Sarbanes-Oxley Act of 2002 and related regulations may result in changes in accounting standards or accepted practices within our industry. New pronouncements and varying interpretations of pronouncements have occurred in the past and are likely to occur in the future, as a result of recent Congressional and regulatory actions. New laws, regulations, and accounting standards, as well as the questioning of, or changes to, currently accepted accounting practices in the technology industry may adversely affect our reported financial results, which could have an adverse effect on our stock price. Proposals have been made concerning the expensing of stock options which could result in rules or laws that may adversely affect our reported financial results and have an adverse effect on our stock price.

We are incurring additional costs and devoting more management resources to comply with increasing regulation of corporate governance and disclosure and we face the risk of an unfavorable report under Section 404 of the Sarbanes-Oxley Act.

We are spending an increased amount of management time and external resources to understand and comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules and listing requirements. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management's annual review and evaluation of our internal control systems, and attestations of the effectiveness of these systems by our management and our independent registered public accounting firm. We are currently documenting and testing our internal control systems and procedures and implementing improvements that may be necessary in order for us to comply with the requirements of Section 404 by the end of 2004. This process has required us to hire additional personnel and outside advisory services and has resulted in significant additional accounting and legal expenses. In addition, the evaluation and attestation processes required by Section 404 are new and neither companies nor auditing firms have significant experience in testing or complying with these requirements. Accordingly, to date we have encountered delays in completing the review and evaluation and the implementation of improvements in our internal control systems and procedures. There is a significant risk that we may experience further delays in our process and may not be able to complete our documentation, testing and improvements in a timely manner, that there may be insufficient time to demonstrate the effectiveness of our improvements, or that for any other reason a material weakness may exist at year end. As a result, our management may be unable to report favorably as to the effectiveness of our controls over financial reporting, and we may not receive a positive attestation by our independent registered public accounting firm. In the event that our chief executive officer, chief financial officer or independent registered public accounting firm determines that our controls over financial reporting are not effective as defined under Section 404 investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk:

Market Risk

We invest excess cash in financial instruments that are sensitive to market risks as part of our investment strategy. None of these market-sensitive instruments are held for trading purposes. We do not own derivative financial instruments in our portfolio. The investment portfolio contains instruments that are subject to the risk of a decline in interest rates. As required by our investment policy, available funds are invested in a manner that assures maximum safety and liquidity and, secondarily, maximizes yield within such constraints

Interest Rate Risk

Our financial instruments consist primarily of high quality commercial paper and money market funds. We do not believe that we have a material exposure to interest rate risk.

Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio. The two debt instruments that we entered into had fixed interest rates. We do not use derivative financial instruments or engage in hedging activities in our investment portfolio. We ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities.

At October 2, 2004, we had short-term investments of \$3.0 million. Our short-term investments consist of highly liquid investments with original maturities at the date of purchase between 91 and 180 days. These investments are subject to interest rate risk and will fall in value if market interest rates increase. The Company believes a hypothetical increase in market interest rates by 10% from levels at October 2, 2004, would cause the fair value of these short-term investments to fall by an immaterial amount. Since we are not required to sell these investments before maturity, we have the ability to avoid realizing losses on these investments due to a sudden change in market interest rates. On the other hand, declines in the interest rates over time will reduce our interest income.

Foreign Currency Exchange Risk

The majority of our sales, expense, and capital purchasing activities are transacted in U.S. dollars. However, since a portion of our operations consists of sales activities outside of the U.S., we enter into transactions in other currencies. We are primarily exposed to changes in exchange rates for the Euro, Japanese yen, and British pound. Currently, we have no plan to enter into any foreign currency hedging program since the amounts involved have not been material. Foreign currency fluctuations did not have a material impact on our consolidated financial position, results of operations or cash flows for the quarters ended October 2, 2004 and September 27, 2003.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

We carried out an evaluation under the supervision and with the participation of our senior management, including Walid Maghribi, our Chief Executive Officer, and Clyde R. Wallin, our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of October 2, 2004.

Senior management and our Audit Committee were informed by our previous independent auditors as part of the December 31, 2002 audit that they had identified material weaknesses (as defined under standards established by the

American Institute of Certified Public Accountants) relating to the deficiencies in the systems and processes used in the preparation of the consolidated financial statements and the lack of proper management review and account analysis. Mr. Maghribi and our former Chief Financial Officer, Phillip A. Kagel, determined that these material weaknesses, together with certain other deficiencies, if unaddressed, could result in accounting errors and impair our ability to accurately report our financial results in a timely manner. At the end of the third quarter of 2003, certain key accounting personnel resigned. While we hired temporary replacements and sought permanent replacements, the 2003 year end closing process took longer than anticipated and continued to require a significant level of manual reconciliations and adjustments. In connection therewith, errors were identified by the Company that required restatement of our second and third quarter of 2003 results of operations.

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On March 12, 2004, Deloitte & Touche LLP advised management and the Audit Committee of two reportable conditions in our internal controls. According to the American Institute of Certified Public Accountants, a reportable condition is a matter that comes to an auditor's attention that represents a significant deficiency in the design or operation of internal control that could adversely affect an entity's ability to initiate, record, process and report financial data consistent with the assertions of management in financial statements. The first reportable condition related to our process for determining the deferral of costs associated with the deferred sales to our major distributor, Future. Errors impacting cost of sales were detected in the process to determine the deferral of such costs. The second reportable condition related to staffing of the accounting department and our reliance on manual reconciliations and analysis.

Based on the above, and under the direction of the Audit Committee and the Board of Directors, senior management is dedicating resources and taking steps to strengthen control processes in order to both identify and rectify the deficiencies and prevent the situations from recurring. To this end, the following steps were and will be taken:

we established a Disclosure Committee with a mandate to assist our Chief Executive Officer and Chief Financial Officer in overseeing the accuracy and timeliness of our public disclosures and in regularly evaluating our disclosure controls and procedures;

we intend to implement improved processes and procedures related to revenue recognition;

we continue to implement improved inventory control systems and procedures throughout our manufacturing lines;

we intend to implement improved inventory costing systems and procedures;

we continue to implement procedures to ensure accurate and timely account analysis and reconciliations; and

updated written policies and procedures are being prepared to standardize and improve processes, including procedures relating to systems, finance policies and internal controls.

We continue to evaluate further improvements, including formalizing our processes, procedures and policies, to our internal controls and disclosure controls and procedures. In this regard, we are expanding the finance staff resources to focus on account reconciliations and process improvements. We are also replacing our existing management information system, of which we expect to implement in 2005.

As a result of the steps taken to improve controls and following the conclusion of our recently completed review of our financial accounts, Mr. Maghribi and Mr. Wallin, concluded that the information required to be disclosed in this quarterly report has been recorded, processed, summarized and reported as required. Based upon their evaluation, and as of the end of the period covered by this quarterly report, the Chief Executive Officer and Chief Financial Officer further concluded that our disclosure controls and procedures, taking into account the steps listed above to improve the controls and procedures, are effective in all material respects.

Changes in Internal Control Over Financial Reporting

Other than as described above, there have been no significant changes in our internal control over financial reporting that occurred during our third quarter of fiscal year 2004 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II: OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Title</u>
31.1	Certification of CEO pursuant to Section 302 the Sarbanes-Oxley Act of 2002.
31.2	Certification of CFO pursuant to Section 302 the Sarbanes-Oxley Act of 2002.
32.1	Certification of CEO pursuant to Section 906 the Sarbanes-Oxley Act of 2002.
32.2	Certification of CFO pursuant to Section 906 the Sarbanes-Oxley Act of 2002.

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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.

SIPEX CORPORATION

DATE: November 12, 2004

By: /s/ Clyde R. Wallin
Clyde R. Wallin
Senior Vice President, Finance
Chief Financial Officer & Treasurer
(Duly Authorized Officer &
Principal Financial Officer)

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Exhibit Index

<u>Exhibit Number</u>	<u>Title</u>
31.1	Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of CEO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of CFO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.