

POWER ONE INC
Form 10-K
March 16, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

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 No. 0-29454

POWER-ONE, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of incorporation or
organization)
740 Calle Plano
Camarillo, California
(Address of principal executive offices)

77-0420182
(I.R.S. Employer Identification No.)
93012
(Zip code)

Registrant's telephone number, including area code (805) 987-8741

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$0.001 par value

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Aggregate market value of registrant's common stock held by non-affiliates of the registrant, based upon the closing price of a share of the registrant's common stock on July 2, 2006, as reported by the National Market System of the National Association of Securities Dealers Automated Quotation (NASDAQ) System on that date was approximately \$409,157,000

As of March 9, 2007, 86,809,911 shares of the registrant's \$0.001 par value common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A and relating to the registrant's Annual Meeting of Stockholders For Fiscal Year 2006, to be held on April 24, 2007, are incorporated by reference into Parts II and III of this Annual Report on Form 10-K.

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Unless the context indicates otherwise, all references herein to *Power-One*, *the Company*, *we*, *us*, and *our* refer collectively to *Power-One, Inc.* and its subsidiaries.

This Annual Report on Form 10-K, including *Management's Discussion and Analysis of Financial Condition and Results of Operations*, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that can be identified by the use of forward-looking terminology such as *may*, *will*, *can*, *believe*, *expect*, *anticipate*, *estimate*, *plan*, *intend* or *continue* or the negative or other variations of such terms or comparable terminology. We caution that the matters set forth under *Risk Factors*, constitute cautionary statements identifying important factors with respect to such forward-looking statements, including certain risks and uncertainties that could cause actual results to differ materially from those in such forward-looking statements.

PART I

ITEM 1 BUSINESS

Overview

We are a leading designer and manufacturer of power conversion and power management products, most of which are sold into the communications infrastructure and high technology markets. Our products are used to convert, process and manage electrical energy, in both alternating current (AC) and direct current (DC) form, to the high levels of quality, reliability and precision required by communications infrastructure and other equipment. With hundreds of different standard products and the ability to create custom products, we have one of the most comprehensive product lines in the power conversion and power management industry and are one of just a few companies that can power virtually every component and system of an infrastructure network.

Our power conversion and power management products include:

- AC/DC power supplies that convert AC from a primary power source, such as a wall outlet, into a precisely controlled DC voltage. Virtually every electronic device that plugs into an AC wall outlet requires some type of AC/DC power supply, and we provide a broad range of AC/DC power supplies that power a wide variety of equipment in the communications, networking, server/storage, computer, instrumentation, industrial, and electronic industries;
- DC power systems that are used by communications and Internet service providers to power large communications infrastructure equipment;
- DC/DC converters that modify an existing DC voltage level to a different DC voltage level to meet the power needs of various subsystems and components within electronic equipment. Our DC/DC converters include high-density and low-density brick converters that are generally used to control power on communications printed circuit boards and also include Point-of-Load (POL) converters that power devices within an Intermediate Bus Architecture as well as in other applications. Our Z-One® digital power management products fall into the DC/DC converter category.
- A range of other products that include alternative energy (AE) products that convert solar (photo-voltaic) or wind energy into useable AC/DC power, digital control products for motors, and a variety of application-specific specialty power products.

We design our power conversion and power management products primarily to meet the needs of higher-end markets, including manufacturers of communications and server/storage infrastructure equipment; industrial applications; and higher-end consumer and industrial appliances; rather than for use in personal computers, and mobile phones. For high-end manufacturers, a fluctuation of power may cause severe damage to sensitive systems, resulting in data loss, file corruption and significantly reduced productivity. We design our products to take lower-quality power from the electrical grid and convert, process, and purify it to meet the higher quality demanded by communications networks, providing significantly greater protection against power disturbances, fluctuations and outages. In addition, our products' compact designs are critical to our customers who need to minimize the space allocated to power conversion products within a system in order to maximize the space available for other components and subsystems. We continually strive to stay ahead of the technology curve to develop innovative products that meet and exceed our customers' needs.

While approximately 35.9% of our sales were to our top ten customers in 2006, we sell our products to hundreds of direct customers worldwide. Our largest customer in 2006 was Cisco Systems and its contract manufacturers, which accounted for 12.2% of our sales in 2006 and 15.1% of our sales in both 2005 and 2004. No other customer accounted for more than 10% of our sales during 2006, 2005, and 2004.

In October 2006, we completed the acquisition of Magnetek, Inc.'s Power Electronics Group for approximately \$69.0 million plus the assumption of approximately \$27.8 million in debt. The acquisition added a team of experienced engineers to our employee base, enhanced our custom AC/DC design capabilities, expanded our product portfolio, broadened our customer list, and provided us with a low-cost manufacturing operation in China.

We were originally incorporated in 1973 as a California corporation and re-incorporated in the State of Delaware in January 1, 1996.

Industry Background

The power conversion and power management industry is highly fragmented and diverse. Manufacturers of power conversion and power management products are generally divided into two broad categories: those who sell to third-party customers (merchant) and those who sell for use in-house to other divisions within the manufacturer's own company (captive). We are a merchant power supply manufacturer whose products are sold to third parties.

The communications industry experienced rapid change in the late 1990s through 2000 as deregulation and privatization fueled the entry of new competitors. In addition, advances in technology allowed communications service providers to offer a more varied range of services, and increases in Internet usage and demand for broadband and wireless services contributed to the growth of the communications industry. Because these technological advances required significantly greater and more reliable power, the demand for power conversion and power management products also grew. In 2001, however, the communications infrastructure industry entered into a severe, multi-year downturn that was characterized by delayed network deployments and upgrades by service providers due to lower-than-expected demand for their products and services and a resulting oversupply of capacity and inventory. Due to the downturn, we experienced decreasing sales, price erosion, cancellation of orders, write-offs of excess inventory, restructuring charges and asset impairment charges. In recent years, however, we have experienced revenue growth.

Long term, we believe the following key trends will continue to drive demand for power conversion and power management products:

Increasing Amounts of Power Required by the Communications Infrastructure Industry. With the development and proliferation of the Internet, wireless communications, broadband applications and other new technologies, recent years have witnessed unprecedented growth in the volume of information being transmitted around the world at any given moment. We believe that this increasing volume will drive demand for larger data processing capabilities among communications infrastructure companies and that increased data processing needs in turn will require increases in power and more demand for power conversion and power management products. Industry sources project that the amount of power required by communications infrastructure equipment manufacturers will grow significantly faster than the demand by other traditional users of power.

Increasing Demand for High Conversion Efficiencies. Recent developments in the European Union (EU), the United States and China to cut energy consumption will increase the demand for digital power. The use of digital control techniques can contribute to improved conversion efficiencies of AC/DC power supplies across a wide range of conditions.

Increasing Demand for High Reliability Power. The nature of power demanded by the digital economy is significantly different from the power provided by the electric utility grid. The electric utility grid supplies acceptable power quality, or power that is free from surges, spikes, or sags, 99.9% of the time, resulting in the equivalent of nine hours per year of interrupted, or unavailable, power. These nine hours of downtime often occur in many isolated interruptions of very short duration. In traditional industries, a

brief interruption of power only interrupts operations for the time that the power is actually unavailable. For a modern communications network, however, even a minor power disturbance or brief interruption could cause equipment to crash and significantly shorten the life-span of electrical components. A network crash could result in several hours of downtime, including the time necessary for complex microprocessor-based equipment to reboot and regain power. This downtime could lead to significant lost revenue and customer dissatisfaction. As a result, modern communications network operators are increasingly requiring significantly more reliable power than that provided by the electric utility grid. We believe this demand will increase as wireless communications, broadband applications and other new technologies became more pervasive in society and as society becomes more dependent on their reliability.

Proliferation of Distributed Power Architecture and Intermediate Bus Architecture, as well as the Trend Toward Power Management Rather than Simple Power Conversion. Traditional power supply architecture uses a single, centralized power supply, which distributes power through a cable of wires to the various individual components and subsystems dispersed throughout a system. Newer communications systems demand increasing amounts of power for semiconductors located throughout their communications equipment. At the same time, newer-generation communications technologies being developed are requiring semiconductors that use lower voltages than previous-generation technologies. In many sophisticated systems, the traditional architecture distributes power too inefficiently to accomplish these goals because as power increases and voltage decreases, the current level increases and therefore the cable thickness increases, often to an unacceptable size.

Distributed Power Architecture, or DPA, is a technology that has been developed to address this technical issue. DPA uses a front-end power supply that converts AC voltage into a high-level DC voltage, typically 48 volts, thus allowing a smaller cable to be used within a system to distribute power and then uses DC/DC brick converters that are placed throughout the system close to the devices that actually use power and reduce the voltage to the precise amount needed by the devices. Furthermore, DPA helps to diversify the risk within a large communications system. While the failure of a traditional centralized power supply could jeopardize the entire system, the failure of a single DC/DC brick converter in a DPA system may only affect those few individual components that it serves. Finally, because there are many DC/DC brick converters within a system, DPA allows for greater flexibility by permitting part of the system to be reconfigured or upgraded without requiring a major change to the overall system.

More recently, a modified version of DPA called Intermediate Bus Architecture, or IBA, has emerged, which addresses the number of different and lower voltages required by different systems. Instead of using multiple DC/DC brick converters that have a typical input of 48 volts and low output voltages of less than 3 volts, the IBA uses a single brick converter with an input of 48 volts and an intermediate output voltage (typically between 12 volts and 3 volts) that is then transmitted to multiple DC/DC Point-of-Load (POL) converters, each of which converts the intermediate voltage to the voltages required by the local devices (typically 3 volts or less). During 2003 we announced our new Silicon Power Systems (SPS) division to focus on the design of highly innovative and efficient silicon-based solutions for next generation DC/DC power management products in the IBA market. We developed our maXyz® product line specifically for the IBA market. In 2004 we introduced our Z-One® digital power management architecture and related products as part of the maXyz product line. We have spent and anticipate spending significant capital on research and development efforts to develop new power conversion technology.

Our Competitive Advantages

We believe that we have key advantages that have helped us to establish a leading brand for our products. Some of the factors that we believe have contributed to this leading position are as follows:

Broad Product Line. We offer hundreds of products, in power ranging from one watt to a half-megawatt. Our smaller products are no larger than a fingernail, while our larger DC power systems could fill an entire cabinet. With millions of potential current and voltage configurations, our broad product line offers our customers a one stop-shop opportunity, allowing them to purchase nearly all of their power conversion and power management products from a single supplier. As a result, we are one of the few companies that can power virtually every component and system of an infrastructure network.

Leading Design and Development Capabilities. There are a limited number of highly-skilled power engineers in the world, and we believe that we have assembled some of the most capable and innovative of such engineers through our hiring efforts and through strategic acquisitions, including our October 2006 acquisition of Magnetek, Inc.'s Power Electronics Group. Furthermore, we have been effective at maintaining a high retention rate among our technical staff. This team of engineering talent has allowed us to consistently upgrade to new generations of power conversion and power management products, each of which has outperformed prior products with higher power density and smaller size. It has also allowed us to become a leader in the implementation of DPA technology, and we expect to achieve a similar leading position in IBA technology. We believe that our Z-One digital power management architecture has created a first-to-market competitive advantage for us, although certain of our competitors are working to develop similar or competing products and to promote such products via a competing strategic alliance and open-standards consortium. We have been diligent in seeking to secure patent and other intellectual property rights for the technology that we have developed and implemented in our Z-One digital power management architecture and products, and we have also been diligent in protecting those rights. We are currently involved in patent infringement litigation against one company that has announced and introduced products that we believe infringe upon certain of our intellectual property rights as secured in certain U.S. patents issued to us.

Reputation for Quality and Reliability. We have been in the power conversion and power management product industry since 1973. By establishing rigorous internal quality control programs, we believe that we have been able to provide our customers with products that are highly reliable. This is particularly important for manufacturers of infrastructure equipment. As a result, we established a strong customer base that includes many of the largest manufacturers in the communications infrastructure industry. Although power conversion products typically represent only 2% to 5% of the cost of an entire network, their failure can cripple the entire system in which they are installed. Consequently, we believe most customers are not willing to risk buying from an unproven supplier in an effort to cut costs in this area.

Changing Customer Needs. Manufacturers and service providers are facing greater competition to accelerate the time-to-market for their new products and are increasingly expected to produce newer generations of products in a shorter period of time. As a result, they are more likely to purchase from suppliers who can offer a broad range of standardized power conversion products, rather than highly customized products that take more time to design and manufacture. Manufacturers of communications infrastructure equipment are also focusing more on their core competencies and therefore increasingly are outsourcing the manufacture of power conversion and power management products to more efficient suppliers. Consequently, these customers are moving towards sourcing from the limited number of suppliers who can meet all of these needs.

Our Strategy: Powering the High Technology and Communications Markets

Our primary objective is to become one of the worldwide leaders in power conversion and power management equipment for the global communications and high technology equipment markets. To achieve this objective, we plan to do the following:

Expand Product Lines, Including DPA and IBA Products. We provide one of the most comprehensive lines of power conversion and power management products, including DPA and IBA products. Our products are increasingly being designed into infrastructure equipment. We believe that we have good relationships with our customers, including leading infrastructure equipment manufacturers, and through these relationships we can work with our customers to understand their changing product needs in order to proactively develop leading technology products for them. We intend to continue our extensive research and development program to improve our products' performance and expand the breadth of our product offerings. Our Z-One digital power management products play a key role in this strategy.

Continue to Cross-Sell Products on a Global Basis. We expanded the geographic reach of our business into Europe and Asia through internal efforts and through a series of strategic acquisitions from 1998 through 2006. We believe we have substantial opportunities to market products developed in one region to customers located in other regions and to market products to customers who had previously purchased only a single line or family of products from us but who have increasing needs for other products that we develop.

Continue to Acquire and Invest in Strategic Businesses and Technologies. We plan to selectively acquire and invest in businesses and technologies that can extend our geographic reach, increase the breadth of our product line, enhance the performance of our products, lower our manufacturing costs or expand our customer base in the communications infrastructure equipment market. We believe the fragmentation of the power conversion and power management product industry presents opportunities for further consolidation. In addition, we are investing aggressively in research and development initiatives to create next-generation power conversion and power management products and continuing to invest in advanced technologies to enable significantly smaller DC/DC power converter products, higher efficiencies in these products, and better performance by them in controlling and managing power on communications-oriented printed circuit boards. We continue to earmark a significant portion of our overall research and development budget to develop this technology.

In 2004, we introduced our Z-One digital power management architecture and released products designed using this architecture. We believe that these products integrate conversion, communications, and control for a digital board-level solution in a significantly enhanced manner over traditional power supplies. Features of this architecture and the related Z-7000 product line include the ability to fully manage up to 32 POL DC/DC converters with a single-wire digital bus. It also provides a significant reduction in printed circuit board space, design time and number of components, which in turn can lead to cost savings.

In 2005, we introduced our Z-1000 product line, which includes power conversion and power management products that contain many, but not all, of the same features as the Z-7000 products, and we market the Z-1000 products for customers' mid-range applications.

In 2006, we redesigned our products in such a way that allowed the circuit board to be one-sixth the size of its predecessor, and we further increased the capability of the system by adding functionality that allows the control of devices manufactured by third parties. This provides the ability of the Z-One architecture to integrate with existing analog systems to provide customers with more flexibility and further enables adoption to a broader range of customers and applications.

Our Products

We design, develop, manufacture and market power conversion and power management products. All of our products are designed to convert, regulate, purify, store, manage or distribute electrical power for electronic equipment but power conversion products generally convert one voltage into another voltage, whether AC-to-DC or DC-to-DC, while power management products generally manage multiple voltages and provide other functionality.

Depending on our customer's needs, including the balancing of cost and time-to-market of new products, we offer standard, modified-standard and custom-designed products. Standard products refer to products that are standard to a particular manufacturer, while modified-standard products refer to standard products of a manufacturer that can be easily modified to meet a customer's particular application. Because they have already been designed and manufactured, standard and modified standard products allow our customers to reduce their time-to-market and minimize costs for new product introductions. Custom products are usually designed from scratch to meet the specifications of a unique customer application and may require significant tool and die costs and four-to twelve-month lead-times from conception through production.

We operate in an industry where quantity discounts, price erosion (and corresponding decreases in revenues and margins), and product obsolescence due to technological improvements are normal. While we see price erosion on most of the products we sell, we also have seen a smaller price erosion on many of the components we purchase for inclusion in our products, thereby decreasing our costs. Product obsolescence refers to the tendency of small and less expensive products to replace larger and more expensive products. For example, the functions of a full-size DC/DC brick converter were replaced by a half-brick, which was subsequently replaced by a quarter brick and then a 1/8th-brick, and this will eventually be replaced by a 1/16th-brick or even smaller product. Each successive product is smaller and somewhat less costly than its predecessor but has usually retained or expanded the functionality of its predecessor. Sales of each successor product typically replace sales of the predecessor product, making the predecessor product obsolete. These phenomena are normal in our industry, and we have experienced price erosion and product obsolescence in line with industry trends. Price erosion and product obsolescence may continue to negatively impact gross margins and result in inventory write-offs. Price erosion may also mask increases in unit sales (as opposed to revenues) of certain products.

Our products can be classified into the following main groups: AC/DC power supplies, DC/DC converters, DC power systems, alternative energy (AE), and a category of other products, including smart motor control. Our Z-One silicon board power management products fall into the DC/DC converter category. These categories can be distinguished based on their location within a system, size and function.

AC/DC power supplies:

- are typically embedded within the equipment that they are powering;
- range in size from a small paperback book to a desktop computer;
- may be standard, modified-standard or custom designed;
- convert AC voltage, from a primary power source such as a wall outlet, into DC voltage; and
- are used primarily in networking systems, large scale data processors and industrial equipment.

DC/DC converters (Bricks) and POL converters:

- are embedded within the equipment that they are powering and are generally mounted directly on a printed circuit board within the equipment;

- bricks range in size from an AA battery to a portable CD player, while POL converters may be silicon-based and range in size from a fingernail to a small matchbox;
- modify an existing DC voltage level to a different DC voltage level;
- are the cornerstone of DPA and IBA technology; and
- are used by our customers primarily to power communications infrastructure equipment, although their usage is expanding to other markets including server and storage.

DC power systems:

- can be either stand-alone units that are external to the equipment or sub-systems (commonly called racks) that are integrated into a system;
- range in size from a shelf of integrated modules to large-scale systems that can fill entire cabinets;
- convert AC voltage into DC voltage and, together with a generator or an array of batteries, provide several hours of additional power capacity in the event of an AC input disturbance or power outage; and
- are used primarily to power communications networks and cellular communications systems.

Smart motor control and other products:

- are used primarily in sophisticated appliances, such as high-end clothes washers and dryers, and air conditioners, where energy efficiency is very important; and
- are generally board-level products or modules that are incorporated by the manufacturer in their system.

Alternative energy (AE) products:

- are generally stand-alone units that are sometimes called inverters. These products are DC-to-AC converters that convert DC voltage from either solar, wind, or fuel cells into useable AC power.
- range in size from a briefcase to a small file cabinet.

We organize these products into two product lines, referred to as embedded products and power systems. Embedded products include AC/DC power supplies, DC/DC converters (including brick converters and POL converters), alternative energy, and smart motor control products. Power systems products include DC power systems.

Division Structure

Prior to 2005, we had four divisions: the Compact Advanced Power Systems (CAPS) division, the Energy Solutions (ES) division, the Silicon Power Systems (SPS) division and di/dt. In 2005, we restructured and integrated most of our operations into a single integrated business. The most significant components of the restructuring involved the elimination of most of the DC power systems operations in Norway through their integration into our other existing locations and the elimination of certain manufacturing operations in North America through their transfer to our other existing locations or to contract manufacturers. Our SPS group is focused on developing next-generation silicon-based digital power management products for our Z-One digital power management architecture. We intend to fully integrate the Power Electronics Group that we acquired from Magnetek, Inc. in October 2006 into our existing business and not operate it as a separate division.

Customers

We sell our power conversion and power management products to a diversified group of hundreds of equipment manufacturers, including contract manufacturers. Cisco Systems and its contract manufacturers accounted for 12.2% of our sales in 2006, 15.1% of our sales in 2005, and 15.1% of our sales in 2004. Cisco Systems and its contract manufacturers collectively were the only customers to account for more than 10% of our sales during these periods.

Our top 10 customers accounted for approximately 35.9% of net sales in 2006, 36.2% of net sales in 2005 and 38.4% of net sales in 2004. Although our sales are diversified across many markets, our strategy has been to focus our efforts on the communications infrastructure equipment and other high technology markets because the quality, reliability and precision of our products make them particularly suitable for these markets and because of the higher long-term growth we believe these markets will experience. The following table illustrates the percentage of our net sales in our primary markets:

	Year Ended December 31,	
	2006	2005
Communications	59 %	61 %
Instrumentation and Industrial	27 %	30 %
Server, Storage and Computer	7 %	3 %
Other	7 %	6 %
Total	100 %	100 %

Our customers are located throughout the world, and the following table summarizes our revenues in different geographic locations for our two product lines (in millions):

	Years Ended December 31,								
	2006			2005			2004		
	Embedded products	Power systems	Total	Embedded products	Power systems	Total	Embedded products	Power systems	Total
Revenues:(a)									
North America	\$ 109.0	\$ 12.7	\$ 121.7	\$ 91.8	\$ 14.9	\$ 106.7	\$ 112.5	\$ 20.3	\$ 132.8
European countries	74.5	54.2	128.7	50.1	43.5	93.6	55.3	41.8	97.1
Malaysia	30.3	0.9	31.2	25.5	1.0	26.5	19.5	1.3	20.8
Other Asian countries	32.7	18.4	51.1	18.9	11.0	29.9	12.8	11.6	24.4
Other	0.5	4.8	5.3	0.2	4.7	4.9	0.1	5.1	5.2
Total	\$ 247.0	\$ 91.0	\$ 338.0	\$ 186.5	\$ 75.1	\$ 261.6	\$ 200.2	\$ 80.1	\$ 280.3

(a) Revenues are attributable to countries based on location of customer.

Long-lived Assets

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The following is a summary of our long-lived assets by geographical locations, in millions:

	December 31,	
	2006	2005
Long-Lived Assets:		
United States	\$ 48.1	\$ 51.4
Italy	47.9	
Switzerland	14.5	14.2
Dominican Republic	14.0	15.8
China	9.4	1.0
Slovakia	7.2	5.0
Other foreign countries	5.8	2.8
Total	\$ 146.9	\$ 90.2

Sales and Marketing

We market our products through a global sales force. We have direct sales offices in Europe, North America, Asia, Middle East, South America, and Australia. These direct sales offices are augmented by an extensive network of manufacturers' representatives and distributors.

Our direct sales force is typically oriented towards customers that have the potential to purchase large volumes of our products, generally several million dollars or more annually. Our direct sales force works closely with existing and potential customers to determine their long-term technology requirements for power conversion products. This close collaboration allows us to design products that best fit our customers' expected applications. We expect that our direct sales to strategic accounts will increase in the future as we increasingly focus on sales to these customers.

Research, Development and Engineering

Worldwide we have 458 employees in our research and development departments of which 182 are engineers. We spent approximately \$21.7 million on research and development (R&D) in 2006, approximately \$22.0 million in 2005 and approximately \$29.4 million in 2004. During 2006, we shifted our R&D operations toward lower-cost locations, thereby significantly reducing R&D costs with only a modest decrease in R&D resources. We have established engineering and design centers in areas that are strategically located for servicing our customers and where we have strong access to technical talent. Our four engineering and design centers in the United States are located in Andover, Massachusetts and Camarillo, Carlsbad, and Morgan Hill, California. We also have engineering and design centers in Santo Domingo, Dominican Republic; Uster, Switzerland; Dubnica, Slovakia; Tuscany, Italy; Shenzhen, China and Limerick, Ireland. Additionally, we have engineering staff on site in each of our manufacturing facilities. Finally, we have engineering teams at each of our power plant system integration facilities to enable more efficient customization of our system configurations for our customers.

Manufacturing Process and Quality Control

Production of many of our products typically entails subassembly of sophisticated printed circuit boards that are in turn combined with hardware components to produce a final product. In response to demand for increased quality and reliability, design complexity, and sophisticated technology, we continue to invest in state-of-the-art processes. We have also standardized many of our manufacturing processes and much of our equipment worldwide to increase efficiency and optimize flexibility between facilities.

Our manufacturing processes are designed to rapidly produce a wide variety of quality products at a low cost. The use of surface mount technology, or SMT, permits us to reduce board size by eliminating the need for holes in the printed circuit boards and by allowing us to use smaller components. Our investment in SMT has significantly increased our product development processes and production capacity, and we believe it has also improved our product quality. In addition, we made an equity investment in and have manufacturing outsourcing arrangements with a contract manufacturer in Asia and we have outsourcing arrangements with other contract manufacturers.

Product quality and responsiveness to our customers' needs are of critical importance in our efforts to compete successfully. We emphasize quality and reliability in both the design and manufacturing of our products. In addition to testing throughout the design and manufacturing process, we test and /or burn-in our products using automated equipment and customer-approved processes. We also perform out-of-box test or pre-ship audit on randomly selected units before delivery. We insist on the same levels of quality from our contract manufacturers, and as a result have and may continue to incur additional costs to ensure quality products.

As our customers' operations expand internationally, they increasingly require that their power products meet or exceed established international safety and quality standards. We therefore design and manufacture our power conversion and power management products in accordance with the certification requirements of many international agencies, including the Underwriters Laboratories in the U.S., the CSA International in Canada, and TUV Product Service for the European market. In addition, various products may be tested to Network Equipment-Building System requirements for the U.S. telecommunications market and to European Telecom Standard Institute requirements for the European Union telecommunications market.

We have manufacturing operations in the United States, Dominican Republic, Slovakia, Italy, China, and Hungary; and we expect that for 2007 we will manufacture and assemble approximately 70% of our products at our facilities in the Dominican Republic, China, Italy, and Slovakia. Production of our silicon-based products is outsourced to contract manufacturers in North America and in Asia. All of our manufacturing facilities are ISO certified. In our global operations, we currently have an aggregate of approximately 630,000 square feet of manufacturing space. In addition to our own facilities, we utilize low-cost contract manufacturing in several locations around the world, although most of our subcontractors are located in Asia.

Suppliers

We maintain a network of suppliers for components and other materials used in the manufacture of our power conversion and power management products. We typically design products using components readily available from several sources and attempt to minimize our use of components that we can only obtain through a single source. We procure components based upon our enterprise resource planning system and use a combination of forecasts, customer purchase orders and formal purchase agreements to create our materials requirements plan.

We occasionally use components or other materials for which a single supplier is the only source of supply. We may seek to establish long-term relationships with such suppliers. We have volume purchase agreements with certain suppliers of key items. This practice enables us to maintain a more constant source for required supplies and produce cost savings through volume purchase discounts.

Backlog

We generally sell our products pursuant to purchase orders rather than long-term contracts. Backlog consists of purchase orders on-hand having delivery dates scheduled within the next six months. Customers may cancel or reschedule most deliveries without penalty. We do not maintain long-term contracts with our customers and they are free to cancel or modify their orders. We also derive a significant portion of our revenues from "turns" business (that is, revenues from orders that are booked and shipped within the same reporting period and that therefore do not appear as backlog at the end of a reporting period). In addition, customers on our Vendor Managed Inventory (VMI) programs exercise discretion as to the timing of inventory consumption. When customers adopt our VMI program, they no longer place orders with us and instead use an automated forecasting model. We then manufacture products for the customer based on its forecast, and the customer uses the inventory as needed. As a result, under a VMI program, the booking and billing occur simultaneously upon use of the product, and therefore there is always a book-to-bill ratio of 1.0 for these programs. We may bring additional VMI programs on-line in the future, which would result in higher "turns" business, lower book-to-bill ratio, and higher finished goods inventory. As such, we believe that backlog may not necessarily be a reliable indicator of future results.

Competition

The power conversion and power management industry is highly fragmented and characterized by intense competition. No single company dominates the overall market, and our competitors vary depending upon the specific type of products they produce. We believe that the principal bases of competition in our targeted markets are breadth of product line, stability and reputation of the provider, along with cost. Our main competition includes companies located throughout the world, including Emerson Electric, C&D Technologies, Delta Electronics, Eltek and a division of Tyco International.

Intellectual Property Matters

We consider our intellectual property to be very important and valuable, and we have made intellectual property protection a key element of our overall business strategy. We rely on a combination of patent, trade secret and other intellectual property laws, confidentiality agreements executed by most of our exempt employees and other measures to protect our proprietary rights. We currently maintain 116 active U.S. patents, many of which are protected by corresponding foreign patents in selected jurisdictions. Additional U.S. and foreign patent applications are pending. We hold 18 U.S. registered trademarks with additional trademark applications pending, and we claim common law trademark rights to additional marks. We consider our intellectual property in the area of digital power management and control, including trademarks and patents that we have secured and are continuing to seek in that area, to be of particular importance and strategic significance. These particular patents have all been issued since 2004 and have patent terms extending for approximately 20 years from date of grant.

Employees

At December 31, 2006, we employed 4,167 employees at our facilities in the following functions:

Function	Number of Employees
Manufacturing	3,037
Engineering	458
General and administrative	291
Sales and marketing	187
Quality assurance	194
Total	4,167

We believe that our continued success depends, in part, on our ability to attract and retain qualified personnel. We consider our relations with our employees to be good.

Company Website, Corporate Governance Website and Access to Company Filings

We post all of our periodic reports on Form 10-K and 10-Q, current reports on Form 8-K, and amendments to these reports filed or furnished pursuant to the Securities Exchange Act of 1934 on our website at www.power-one.com as soon as reasonably practicable after we file or furnish the reports with the Securities and Exchange Commission. Access to these reports is free of charge. In addition, we maintain a Corporate Governance section on our Website to provide the investor community with easy access to relevant information about our corporate governance. The public may read and copy any materials that we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, and the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, 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>.

EXECUTIVE OFFICERS OF THE REGISTRANT

Set forth below is certain information concerning our executive officers.

Name	Age(1)	Position
Steven J. Goldman	49	Chairman of the Board
William T. Yeates	46	Chief Executive Officer
Brad W. Godfrey		