NEW RISK ALERT: (CREE)

Cree Misleads Investors on Inventory, Masks Exposure to Declining Industry

Company understates inventory by 7.6% in latest 10-K, revealing it's not the semiconductor pureplay it wants investors to believe.

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This alert compares the language used in the company's latest filing with the period before. Research suggests changes in language, particularly in the risk factor section, is a powerful indicator of future performance. Companies that change filing language, according to research, underperform those that don't by 30-50 basis points per month for the following year.

Cree Intentionally Misleads Investors, Understates Year End Inventories by 7.6%

Cree, which recently sold its lighting and LED businesses, wants investors to perceive it as a "semiconductor powerhouse". In building a new device fabrication facility, Cree is banking on a transition from silicon to silicon carbide. Silicon carbide, compared to silicon, promises to extend the range of electric vehicles (EV) and improve the efficiency of 5G and solar power applications.

The company's transformation, however, does not make it the semiconductor pureplay it would like investors to believe it is. In February 2021, we published a New Risk Alert revealing how Cree is masking its deteriorating working capital position:

- Cree Understates Inventory and Payables, Corrects Tax Calculation Error

The situation has worsened. In its latest 10-K, Cree understates its inventories and payables to mask further deterioration in its business fundamentals and its continued exposure to a declining industry it wants investors to believe it has exited.

In the fiscal year ending June 27, 2021, Cree reported its days of supply in inventory (DSI) increased from 117 to 147 days, or 25.6%. Sales grew just 11.66% in the fiscal year. However, the footnotes in Cree's latest 10-K reveal the company is not counting certain inventory in its DSI calculation:

> *"...(**excluding inventory related to the Wafer Supply Agreement** entered into in connection with the LED Business Divestiture)..."*

It's not appropriate to exclude inventory related to the Wafer Supply Agreement as Cree plans to supply the acquirer of the LED segment with silicon carbide materials— the foundation of Cree's transformed business— for the next four years. It's even more inappropriate to exclude these assets from balance sheet inventories, especially when you consider the following footnote:

> *""In addition to inventory held by the Company associated with the Wolfspeed business, **the Company holds inventory related to the Wafer Supply Agreement** entered into in connection with the LED Business Divestiture…"*

Instead, Cree includes inventory from the Wafer Supply Agreement in "Other Current Assets". In the prior year, Cree reported $19 million in Wafer Supply Agreement inventories. Since the LED segment sale closed March 1, 2021 and the fiscal year ended June 27, 2021, we estimate Cree shipped approximately $6.3 million of Wafer Supply Agreement inventory in that period, leaving approximately $12.7 million in Wafer Supply Agreement inventory.

If we add this to Cree's to the $166.6 million in inventory Cree reports on its balance sheet at year's end, the company actually has $179.3 million in inventory, or 7.6% more than it states in its annual report.

Cree Understates DSI by 12.8 Days as Annual Inventory Growth Quadruples Sales Growth

If we add back the inventory Cree excludes— and hides from investors on the balance sheet— the company ended the year with a fourth quarter DSI of 158.2, or 11.2 additional days of inventory than the company's adjusted number. On an annual basis, Cree's DSI increased to 181.2, or 12.8 additional days than the company might calculate.

The situation is even more concerning when you consider that inventories— when we add back the Wafer Supply Agreement the company excludes— grew 47.08% year-over-year rather than 36.6% as the company would have investors believe. This is quadruple, not triple as the company's figures imply, the company's 11.66% annual sales growth.

We suspect Cree's adjusted DSI is an attempt to distance itself from the LED business, which it sold for a loss of $29.1 million. The supply agreement Cree has with the acquirer ensures Cree will maintain exposure to the LED segment for four more years despite its poor economics. Net income for the LED business declined from $60.6 million in 2019 to $5.9 million in 2020. In FY21, even if you add back the $112 million non-cash goodwill impairment, the segment lost $70 million.

Hiding nearly 8% of the company's inventory in Other Current Assets— and excluding it from key metric calculations— matters to investors due to the rapid decline in the LED business. Not only is it no longer profitable, but sales have been cut in half over the past three years. The sales decline— and Cree's lack of transparency— suggest the Wafer Supply Agreement inventory may be obsolete or at minimum slower to sell.

Hiding this possibility from investors does nothing to help Cree become the semiconductor pureplay it wants to be perceived as. Later this year, Cree will change its name to Wolfspeed. Investors would be better served if the company changes how it calculates key metrics and accounts for suspect inventory.