

APA Enterprises, Inc.
Form 10-K
June 22, 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 Exchange Act of 1934
For the fiscal year ended March 31, 2007.

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 0-16106

APA ENTERPRISES, INC.

(Exact Name of Registrant as Specified in its Charter)

Minnesota

*(State or other jurisdiction of incorporation or
organization)*

41-1347235

(I.R.S. Employer Identification No.)

2950 N.E. 84th Lane

Blaine, Minnesota 55449

(763) 784-4995

(Address, including ZIP code and telephone number, including area code, of registrant's principal executive office)

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

Common Stock, par value \$.01 per share

(Title of class)

Series B Preferred Share Purchase Rights

(Title of class)

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

NONE

Indicate by check mark if the registrant is a well-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 section 15(d) of the Exchange 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 Exchange Act during the preceding 12 months and (2) has been subject to the 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.

YES NO

Indicate by check mark whether the registrant is a large accelerated filer, and accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

The aggregate market value of the voting and non-voting equity held by non-affiliates of the registrant, as of the last business day of the registrant's most recently completed second fiscal quarter computed by reference to the price at which the common equity was last sold was approximately \$14,959,137.

The number of shares of common stock outstanding as of June 17, 2007 was 11,872,331.

Documents Incorporated by Reference:

Portions of our proxy statement for the annual shareholders meeting to be held in August 2007 are incorporated by reference into Part III.

**APA ENTERPRISES, INC.
ANNUAL REPORT ON FORM 10-K
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PART I

ITEM 1. BUSINESS.

General Development of Business.

APA Enterprises, Inc. (“APA” or the “Company”), formerly APA Optics, Inc., is a Minnesota corporation which was founded in 1979. Our corporate headquarters is located at 2950 84th Lane N.E., Blaine, MN and our corporate website is www.apaenterprises.com. The information available on our website is not part of this Report.

The Company reports its operations activities in two segments, Optronics (comprising the activities in Blaine, Minnesota, Aberdeen, South Dakota, and India) and APA Cables and Networks, Inc. (“APACN”)

Description of Business - Optronics Segment.

Optronics focuses on leading edge research in gallium nitride (GaN), sophisticated optoelectronics, and optical systems, with the primary goal of developing advanced products for subsequent fabrication and marketing. Based on this research we have developed multiple products including fiber optic components for metro and access communications networks, a range of GaN based devices, and precision optical products.

In fiscal year 2005 we formed a wholly-owned subsidiary in India, APA Optronics (India) Private Limited (“APA India”), to take advantage of lower manufacturing costs thereby reducing the Company’s overall manufacturing and software development costs. In fiscal year 2006, the Company began construction of a larger facility in India to significantly increase its manufacturing activities. The building remains under construction currently. The subsidiary has been providing low cost support for both software needs related to GaN products and certain APACN components. However due to lower than expected demand for GaN products and logistics and time constraints for APACN’s fiber patch cords, the benefit has been less than expected. The Company is currently pursuing alternative options for the operation, including possible sale.

In fiscal year 2006 we sold certain equipment and intellectual property related to our research and development work surrounding gallium nitride based heterojunction field effect transistors. The sale to an unrelated third party for consideration including \$1.9 million in cash was intended to enable us to focus our R&D efforts on power amplifiers built using GaN technology by using commercially available parts, rather than building our own transistors. This was expected to decrease our operating costs and shorten our time to market for power amplifiers.

In fiscal year 2006, the Company also terminated its manufacturing operations, mostly related to fiber optic communication components, in Aberdeen, South Dakota. The associated assets were designated as not being utilized in manufacturing. Most of the assets, if not utilized within the Company, will be sold in the future. The Company is pursuing options to lease or sell this facility.

In fiscal year 2007, the Company decided to reduce its marketing cost for its Sun UV related products, namely the Personal UV Monitor (PUVM) and Sun UV Station by limiting its marketing to internet sales only. The Company also reduced its operating expenses in the development of its UV transistor related power amplifier and UV Profiler product line by eliminating the research personnel in transistor development and limiting the Profiler development to mainly one full time and one part time engineer. Two other persons related to Profiler development are available as consultants on an as needed basis. The Company is currently evaluating long-term options for this operation. These options include the possible sale of its GaN related operations, sale or lease of its Aberdeen facility and sale of its APA India business, including the facility under construction.

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Products

Our current products are described below.

- Ultraviolet (UV) Detector-Based Products We currently manufacture value-added products built around UV detectors fabricated by Optronics and procured externally. These products are:
 - SunUV® Personal UV Monitor The SunUV® Personal UV Monitor (formerly, SunUVWatch®) is a personal ultraviolet (UV) radiation monitor that also incorporates a time/day/date function. It detects UV radiation that is hazardous to human health. In fiscal year 2006, we developed and introduced an attractive new PUVM plastic/metal model that offers two key advantages for the product line. The SunUVStation consumer product complements the Personal UV Monitor, and together they were intended to provide Optronics a product line in the sun protection area. The SunUVStation offers a larger display that indicates the UV Index on a colorful 7" diameter analog face for backyard, pool, patio, campground, or other locations where groups of people are exposed to the sun.
 - Industrial Products: Profiler M UV Meter Optronics' *Profiler M* radiometer was created for the printing and coating industries that use UV curing. The instrument measures the intensity and distribution of four UV bands inside curing chambers. Data from the instrument can be transferred to a computer for analysis using proprietary *CureControl* software supplied as part of the purchase.

The Company introduced another Profiler product to the market in 2007, the Profiler MT, a radiometer capable of measuring surface temperature, in addition to all the spectral profile capabilities of the original Profiler M. Temperature of the surface under UV cure plays an important role in the ultimate quality of the cure, particularly in machines which operate at lower surface temperature. Whereas at present other products are capable of either surface temperature measurement without profile, or measuring the temperature profile at a location other than the curing plane, our Profiler MT accurately measures the surface temperature profile at the curing surface, and therefore, we believe, is a competitive advantage in the market.

• Power Amplifiers

- In the 4th quarter of fiscal year 2006 we completed the sale of our epitaxial foundry to an unrelated, third party for total consideration of \$1.9 million in cash and a license back of the technology within a specified field of use. The transaction included sale of APA's multi-wafer metal organic chemical vapor deposition system, the technical know-how associated with the growth of state-of-the-art epitaxial layers, two heterojunction field effect transistor patents (United States patent 5,192,987 and United States patent 5,296,395), an additional pending patent (now allowed, United States patent application claiming priority of United States provisional application No. 60/428,856), and associated intellectual property. Terms of the transaction allowed APA to market and sell products for applications greater than 1 GHz and provide revenue sharing based on future licensing agreements regarding these patents. The transaction allowed APA to terminate the lease of an off-site facility utilized by the epitaxial foundry and resulted in termination of three employees associated with the development and growth of epi-layers. The sale was intended to decrease operating costs while enabling early entry into power amplifier markets utilizing GaN power transistors procured from outside sources. Such transistors have demonstrated impressive performance while maintaining excellent reliability. During the later part of fiscal 2007, the Company elected to suspend the development of the power amplifier due mainly to market uncertainties, and the reliability and stability of the Gallium Nitride (GaN) transistors available in the market.

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Marketing and Distribution

We do not maintain a large internal sales force. We have no sales person dedicated to the SunUV[®] Personal UV Monitor or SunUV Station and we market these products via internet only. We currently have one employee dedicated part time to the sale of our Profiler products.

Description of Business - APACN Segment

APA Cables and Networks, Inc. (“APACN”) is a manufacturer and seller of telecommunications equipment. APACN focuses on custom-engineered products for telecommunications customers, primarily related to cabling management requirements of the Fiber-to-the-Home (“FTTH”) marketplace and in designing and terminating custom cable assemblies for commercial and industrial original equipment manufacturers (“OEMs”). To date, APACN has been able to successfully establish itself as a value-added supplier to its target market of independent telephone companies and cable television operators as well as OEMs who value a high level of engineering services as part of their procurement process. APACN has expanded its product offerings and broadened its customer base since its inception four years ago.

APACN continued to invest in the expansion of its sales and engineering programs in the broadband service provider market during fiscal year 2007 for the development of increased revenue in fiscal year 2008 and beyond.

APACN offers a broad range of telecommunications equipment and products developed from over 20 years of product expertise acquired in each of the CSP and Americable acquisitions. Its broad range of product offerings include the design and manufacture of standard and custom connectivity products such as fiber distribution systems, optical components, Outside Plant (OSP) cabinets, and fiber and copper cable assemblies that serve the communication service provider including FTTH, large enterprise, and OEM markets. APACN maintains a range of engineering and technical knowledge in-house that works closely with customers to develop, customize and enhance products from design through production. Most products are produced at APACN’s plant in Plymouth, Minnesota with support from a corporate network of global manufacturing partners. APACN produces these products on both a quick-turn and scheduled delivery basis.

Products

- **Fiber Distribution Central Office Frame Systems** APACN Fiber Distribution Systems (“FDS”) are high density, easy access fiber distribution panels and cable management systems that are designed to reduce installation time, guarantee bend radius protection and improve traceability. In the 144-port count configuration, APACN is the industry leader for density, saving the customer expensive real estate in the central office. The product line fully supports a wide range of panel configurations, densities, connectors, and adapters that can be utilized on a stand-alone basis or integrated into the panel system. The unique interchangeable building block design delivers feature rich solutions which are able to meet the needs of a broad range of network deployments.

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- **Fiber Distribution Outside Plant Cabinets** APACN's Fiber Scalability Center ("FSC") is a modular and scalable fiber distribution platform designed for "grow-as-you-go cost containment" as fiber goes beyond the control of a central office and closer to the user. This allows rollout of FTTH services by communication service providers without a large initial expense. Each outside plant cabinet stores feeder and distribution splices, splitters, connectors and slack cable neatly and compactly, utilizing field-tested designs to maximize bend radius protection, connector access, ease of cable routing and physical protection, thereby minimizing the risk of fiber damage. The FSC product has been designed to scale with the application environment as demand requires and to reduce service turn-up time for the end-user.
- **Optical Components** APACN packages optical components for signal coupling, splitting, termination, multiplexing, demultiplexing and attenuation to seamlessly integrate with the APACN FDS. This value-added packaging allows the customer to source from a single supplier and reduce space requirements. The products are built and tested to meet the strictest industry standards ensuring customers trouble-free performance in extreme outside plant environments.
- **Cable Assemblies** APACN manufactures high quality fiber and copper assemblies with an industry-standard or customer-specified configuration. Industry-standard assemblies built include but are not limited to: single mode fiber, multimode fiber, multi-fiber, CATV node assembly, DS1 Telco, DS 3 (734/735) coax, Category 5e and 6, SCSI, Token Ring, and V.35. In addition, APACN's engineering services team works alongside the engineering design departments of our OEM customers to design and manufacturer custom solutions for both in-the-box as well as network connectivity assemblies specific to that customer's product line.

Additional information regarding operations in the segments is set forth in Note Q in the Notes to the Consolidated Financial Statements under Item 8 herein.

Marketing and Distribution

APACN markets its products in the United States through a direct sales team with limited support from a network of manufacturer representative organizations. APACN works closely with its target customers to adapt the company's product platform to the client's unique requirements. APACN offers a high level of customer service and principally brings new products to markets based upon the specific requests of its customers.

Competition

Competitors for the APACN FDS and FSC include but are not limited to ADC Telecommunications, Inc., Corning Cabling Systems, Inc., OFS (Furukawa Electric North America, Inc.), Telect Inc., Fiber Optic Network Solutions (FONS) Corporation (acquired by ADC Telecommunications during fiscal 2006), Alcatel, Inc., and Tyco Electronics, Inc. Nearly all of these firms are substantially larger than APACN and as a result may be able to procure pricing for necessary components and labor at much lower prices. Competition for the custom fiber and copper termination services for cable assemblies is intense. Competitors range from small, family-run businesses to very large contract manufacturing facilities.

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Sources of Materials and Outsourced Labor

Numerous purchased materials, components, and labor, are used in the manufacturing of the Company's products. Most of these are readily available from multiple suppliers. However, some critical components and outsourced labor are purchased from a single or a limited number of suppliers. The loss of access to some components and outsourced labor would have an adverse effect on our ability to deliver products on a timely basis and on our financial performance.

Patents and Intellectual Property

As of March 31, 2007, we had 12 patents issued in the United States and two pending patent applications inside and outside the United States. During the last fiscal year the following patent was sold:
US Patent 5,146,465 "Aluminum gallium nitride laser".

All of our patents relate to the business of our Optronics segment. Some of these patents may be sold as part of the possible sale of an Optronics product line.

We have made significant progress toward improving the active, strategic management of our intellectual property portfolio. The markets for our products are characterized by rapid change and continual innovation that could render our technology and patents obsolete before their statutory protection expires. Several of the companies we compete with have greater research and development resources than we do and could develop technologies and products that are similar or even superior to ours without infringing on our intellectual property.

Environmental Compliance

Because we handle a number of chemicals in our operations, we must comply with federal, state and local laws and regulations regarding the handling and disposal of such chemicals. To date the cost of such compliance has not been material.

Major Customers

Two customers comprised approximately 23% of total sales for the twelve months ended March 31, 2007. No single customer accounted for more than 10% of the Company's sales in fiscal 2006 or 2005.

Backlog

Backlog reflects purchase order commitments for our products received from customers that have yet to be fulfilled. Backlog orders are generally shipped within three months. Optronics had no backlog as of March 31, 2007 or 2006 and a backlog of \$7,200 as of March 31, 2005. APACN had backlogs of \$1,182,576 as of March 31, 2007, \$1,383,206 as of March 31, 2006, and \$429,180 as of March 31, 2005.

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Research and Development

During the fiscal years ended March 31, 2007, 2006, and 2005, Optronics spent approximately \$474,000, \$1,409,000, and \$1,104,000, respectively, on research and development, mainly for the development of compound semiconductor electronic devices. This segment had no research activities sponsored by customers in fiscal years 2007, 2006 or 2005. During the third quarter of fiscal 2007, we suspended our research and development related to the Power Amplifier product. Presently, we are continuing to develop GaN industrial products on a limited basis as we evaluate potential alternatives for this product line. APACN has made no significant expenditures for research and development from its inception through March 31, 2007.

Employees

As of March 31, 2007, Optronics had 28 full-time employees in the combined locations of Blaine, MN, and India. As of March 31, 2007, APACN had 105 full-time employees, mainly in Plymouth, MN. Our future performance is dependent on our ability to attract, train, and retain highly qualified personnel. We have no employment agreements with our employees. The loss of one or more key employees could negatively impact the Company.

In January 2007, the Board of Directors approved a plan to scale-back certain Optronics activities in Blaine, Minnesota, to reduce investment and operating expenses. Specifically, the Company (i) discontinued GaN consumer marketing, except through the Internet, resulting in the termination of three employees, and (ii) reduced working hours of some GaN industrial product employees to half time. In April 2007, three additional employees in GaN industrial products were terminated.

ITEM 1A.

RISK FACTORS.

Factors That May Affect Future Results

The statements contained in this Report on Form 10-K that are not purely historical are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding the Company’s expectations, hopes, beliefs, anticipations, commitments, intentions and strategies regarding the future. Forward-looking statements include, but are not limited to, statements contained in “Item 1. Business” and “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Actual results could differ from those projected in any forward-looking statements for the reasons, among others, detailed below. We believe that many of the risks detailed here are part of doing business in the industry in which we compete and will likely be present in all periods reported. The fact that certain risks are characteristic to the industry does not lessen the significance of the risk. The forward-looking statements are made as of the date of this Report as Form 10-K and we assume no obligation to update the forward-looking statements or to update the reasons why actual results could differ from those projected in the forward-looking statements.

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Our Results of Operations

Unless we generate significant revenue growth, our expenses and negative cash flow will significantly harm our financial position.

We have not been profitable since fiscal 1990. As of March 31, 2007, we had an accumulated deficit of \$39 million. We may incur operating losses for the foreseeable future, and these losses may be substantial. Further, we may continue to incur negative operating cash flow in the future. We have funded our operations primarily through the sale of equity securities and borrowings. The probable discontinuation of the Optronics business unit will result in a significant reduction in the fixed costs associated with manufacturing, sales and marketing, product development and administrative expenses. We will need to demonstrate continued growth in revenues while containing costs and operating expenses at APACN if we are to achieve profitability.

Acquisitions or investments could have an adverse affect on our business.

We acquired assets in India in March 2005 as part of a strategy to take advantage of lower manufacturing costs in India. As stated earlier, the Company is evaluating options for the potential disposal of this operation. We intend to continue reviewing acquisition and investment prospects. There are inherent risks associated with making acquisitions and investments including but not limited to:

- Challenges associated with integrating the operations, personnel, etc., of an acquired company;
 - Potentially dilutive issuances of equity securities;
 - Reduced cash balances and or increased debt and debt service costs;
- Risks associated with geographic or business markets different than those we are familiar with; and
 - Diversion of management attention from current responsibilities.

Our Products and Introduction of New Products

We must introduce new products and product enhancements to increase revenue.

The successful operation of our business depends on our ability to anticipate market needs and develop and introduce new products and product enhancements that respond to technological changes or evolving industry standards on a timely and cost-effective basis. Our products are complex, and new products may take longer to develop than originally anticipated. These products may contain defects or have unacceptable manufacturing yields when first introduced or as new versions are released. Our products could quickly become obsolete as new technologies are introduced or as other firms introduce lower cost alternatives. We must continue to develop leading-edge products and introduce them to the commercial market quickly in order to be successful. Our failure to produce technologically competitive products in a cost-effective manner and on a timely basis will seriously harm our business, financial condition and results of operations.

Our products may infringe on the intellectual property rights of others.

Our products are sophisticated and rely on complicated manufacturing processes. We have received multiple patents on aspects of our design and manufacturing processes and we have applied for several more. Third parties may still assert claims that our products or processes infringe upon their intellectual property. Defending our interests against these claims, even if they lack merit, may be time consuming, result in expensive litigation and divert management attention from operational matters. If such a claim were successful, we could be prevented from manufacturing or selling our current products, be forced to redesign our products, or be forced to license the relevant intellectual

property at a significant cost. Any of these actions could harm our business, financial condition or results of operations.

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We may make additional strategic changes in our product portfolio, but our strategic changes and restructuring programs may not yield the benefits that we expect.

In connection with the downturn in the communications industry we have divested or closed product lines and businesses that either were not profitable or did not match our new strategic focus. As necessary, we may make further divestitures or closures of product lines and businesses. We may also make strategic acquisitions.

The impact of potential changes to our product portfolio and the effect of such changes on our business, operating results and financial condition, are unknown at this time. If we acquire other businesses in our areas of strategic focus, we may have difficulty assimilating these businesses and their products, services, technologies and personnel into our operations. These difficulties could disrupt our ongoing business, distract our management and workforce, increase our expenses and adversely affect our operating results and financial condition. In addition to these integration risks, if we acquire new businesses, we may not realize all of the anticipated benefits of these acquisitions, and we may not be able to retain key management, technical and sales personnel after an acquisition. Divestitures or elimination of existing businesses or product lines could also have disruptive effects and may cause us to incur material expenses.

Manufacturing and Operations

Our dependence on outside manufacturers may result in product delivery delays.

We have increased our reliance on the use of contract manufacturers to make our products. If these contract manufacturers do not fulfill their obligations or if we do not properly manage these relationships, our existing customer relationships may suffer.

We may be required to rapidly increase our manufacturing capacity to deliver our products to our customers in a timely manner.

Manufacturing of our products is a complex and precise process. We have limited experience in rapidly increasing our manufacturing capacity or in manufacturing products at high volumes. If demand for our products increases, we will be required to hire, train and manage additional manufacturing personnel and improve our production processes in order to increase our production capacity. There are numerous risks associated with rapidly increasing capacity, including:

- Difficulties in achieving adequate yields from new manufacturing lines,
- Difficulty maintaining the precise manufacturing processes required by our products while increasing capacity,
- The inability to timely procure and install the necessary equipment, and
- Lack of availability of qualified manufacturing personnel.