

LOEWS CORP  
Form 10-Q  
August 01, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF**  
**THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended June 30, 2016**

**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 1-6541**

**LOEWS CORPORATION**

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

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

**667 Madison Avenue, New York, N.Y. 10065-8087**

**(Address of principal executive offices) (Zip Code)**

**(212) 521-2000**

**(Registrant's telephone number, including area code)**

**13-2646102**  
**(I.R.S. Employer**  
**Identification No.)**

**NOT APPLICABLE**

**(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes

No

Not Applicable

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

Yes

No

Class  
Common stock, \$0.01 par value

Outstanding at July 22, 2016  
337,106,639 shares

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****Loews Corporation and Subsidiaries****CONSOLIDATED CONDENSED BALANCE SHEETS****(Unaudited)**

	<b>June 30, 2016</b>	December 31, 2015
<b>(Dollar amounts in millions, except per share data)</b>		
<b>Assets:</b>		
Investments:		
Fixed maturities, amortized cost of \$38,285 and \$37,407	<b>\$ 42,307</b>	\$ 39,701
Equity securities, cost of \$642 and \$824	<b>667</b>	752
Limited partnership investments	<b>3,355</b>	3,313
Other invested assets, primarily mortgage loans	<b>696</b>	824
Short term investments	<b>5,334</b>	4,810
<b>Total investments</b>	<b>52,359</b>	49,400
Cash	<b>348</b>	440
Receivables	<b>8,616</b>	8,041
Property, plant and equipment	<b>15,126</b>	15,477
Goodwill	<b>348</b>	351
Other assets	<b>1,766</b>	1,699
Deferred acquisition costs of insurance subsidiaries	<b>620</b>	598
<b>Total assets</b>	<b>\$ 79,183</b>	\$ 76,006
<b>Liabilities and Equity:</b>		
Insurance reserves:		
Claim and claim adjustment expense	<b>\$ 22,975</b>	\$ 22,663
Future policy benefits	<b>11,140</b>	10,152
Unearned premiums	<b>3,865</b>	3,671
<b>Total insurance reserves</b>	<b>37,980</b>	36,486
Payable to brokers	<b>1,310</b>	567
Short term debt	<b>330</b>	1,040
Long term debt	<b>10,735</b>	9,520
Deferred income taxes	<b>604</b>	382

Other liabilities	<b>5,193</b>	5,201
<b>Total liabilities</b>	<b>56,152</b>	53,196
Commitments and contingent liabilities		
Preferred stock, \$0.10 par value:		
Authorized 100,000,000 shares		
Common stock, \$0.01 par value:		
Authorized 1,800,000,000 shares		
Issued 339,941,534 and 339,897,547 shares	<b>3</b>	3
Additional paid-in capital	<b>3,197</b>	3,184
Retained earnings	<b>14,724</b>	14,731
Accumulated other comprehensive income (loss)	<b>119</b>	(357)
	<b>18,043</b>	17,561
Less treasury stock, at cost (2,552,593 shares)	<b>(98)</b>	
<b>Total shareholders' equity</b>	<b>17,945</b>	17,561
Noncontrolling interests	<b>5,086</b>	5,249
<b>Total equity</b>	<b>23,031</b>	22,810
<b>Total liabilities and equity</b>	<b>\$ 79,183</b>	\$ 76,006

*See accompanying Notes to Consolidated Condensed Financial Statements.*

**Table of Contents****Loews Corporation and Subsidiaries****CONSOLIDATED CONDENSED STATEMENTS OF INCOME****(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>(In millions, except per share data)</b>				
<b>Revenues:</b>				
Insurance premiums	\$ 1,730	\$ 1,735	\$ 3,429	\$ 3,422
Net investment income	587	510	1,009	1,098
Investment gains (losses):				
Other-than-temporary impairment losses	(15)	(31)	(38)	(43)
Other net investment gains	16	29	11	51
Total investment gains (losses)	1	(2)	(27)	8
Contract drilling revenues	357	617	801	1,217
Other revenues	632	575	1,268	1,168
Total	3,307	3,435	6,480	6,913
<b>Expenses:</b>				
Insurance claims and policyholders' benefits	1,339	1,469	2,747	2,808
Amortization of deferred acquisition costs	305	314	612	617
Contract drilling expenses	198	344	411	695
Other operating expenses (Note 4)	1,611	879	2,518	2,128
Interest	130	134	273	265
Total	3,583	3,140	6,561	6,513
Income (loss) before income tax	(276)	295	(81)	400
Income tax expense	(12)	(48)	(8)	(104)
Net income (loss)	(288)	247	(89)	296
Amounts attributable to noncontrolling interests	223	(77)	126	(17)
Net income (loss) attributable to Loews Corporation	\$ (65)	\$ 170	\$ 37	\$ 279
<b>Basic and diluted net income (loss) per share</b>	<b>\$ (0.19)</b>	<b>\$ 0.46</b>	<b>\$ 0.11</b>	<b>\$ 0.75</b>

<b>Dividends per share</b>	<b>\$ 0.0625</b>	\$ 0.0625	<b>\$ 0.125</b>	\$ 0.125
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**Weighted average shares outstanding:**

Shares of common stock	<b>338.72</b>	369.61	<b>338.91</b>	371.21
Dilutive potential shares of common stock		0.36	<b>0.19</b>	0.36

Total weighted average shares outstanding assuming dilution	<b>338.72</b>	369.97	<b>339.10</b>	371.57
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*See accompanying Notes to Consolidated Condensed Financial Statements.*

**Table of Contents****Loews Corporation and Subsidiaries****CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(Unaudited)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>(In millions)</b>				
Net income (loss)	<b>\$ (288)</b>	<b>\$ 247</b>	<b>\$ (89)</b>	<b>\$ 296</b>
Other comprehensive income (loss), after tax				
Changes in:				
Net unrealized gains (losses) on investments with other-than-temporary impairments	<b>(1)</b>	<b>(4)</b>	<b>4</b>	<b>(5)</b>
Net other unrealized gains (losses) on investments	<b>321</b>	<b>(363)</b>	<b>549</b>	<b>(253)</b>
Total unrealized gains (losses) on available-for-sale investments	<b>320</b>	<b>(367)</b>	<b>553</b>	<b>(258)</b>
Unrealized gains on cash flow hedges		<b>1</b>	<b>1</b>	<b>4</b>
Pension liability	<b>5</b>	<b>43</b>	<b>13</b>	<b>47</b>
Foreign currency	<b>(48)</b>	<b>49</b>	<b>(34)</b>	<b>(47)</b>
Other comprehensive income (loss)	<b>277</b>	<b>(274)</b>	<b>533</b>	<b>(254)</b>
Comprehensive income (loss)	<b>(11)</b>	<b>(27)</b>	<b>444</b>	<b>42</b>
Amounts attributable to noncontrolling interests	<b>191</b>	<b>(48)</b>	<b>69</b>	<b>9</b>
Total comprehensive income (loss) attributable to Loews Corporation	<b>\$ 180</b>	<b>\$ (75)</b>	<b>\$ 513</b>	<b>\$ 51</b>

*See accompanying Notes to Consolidated Condensed Financial Statements.*



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## Loews Corporation and Subsidiaries

## CONSOLIDATED CONDENSED STATEMENTS OF EQUITY

(Unaudited)

	Loews Corporation Shareholders							Noncontrolling Interests
	Total	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury		
<b>(In millions)</b>								
Balance, January 1, 2015	\$ 24,650	\$ 4	\$ 3,481	\$ 15,515	\$ 280	\$ -	\$ 5,370	
Net income	296			279			17	
Other comprehensive loss	(254)				(228)		(26)	
Dividends paid	(156)			(46)			(110)	
Issuance of equity securities by subsidiary	115		(2)		1		116	
Purchases of subsidiary stock from noncontrolling interests	(26)		3				(29)	
Purchases of Loews treasury stock	(305)					(305)		
Issuance of Loews common stock	7		7					
Stock-based compensation	12		12					
Other	(7)		(18)	(1)			12	
Balance, June 30, 2015	\$ 24,332	\$ 4	\$ 3,483	\$ 15,747	\$ 53	\$ (305)	\$ 5,350	
<b>Balance, January 1, 2016</b>	<b>\$ 22,810</b>	<b>\$ 3</b>	<b>\$ 3,184</b>	<b>\$ 14,731</b>	<b>\$ (357)</b>	<b>\$ -</b>	<b>\$ 5,249</b>	

<b>Net income (loss)</b>	<b>(89)</b>		<b>37</b>		<b>(126)</b>
<b>Other comprehensive income</b>	<b>533</b>		<b>476</b>		<b>57</b>
<b>Dividends paid</b>	<b>(136)</b>		<b>(42)</b>		<b>(94)</b>
<b>Purchases of subsidiary stock from noncontrolling interests</b>	<b>(9)</b>	<b>3</b>			<b>(12)</b>
<b>Purchases of Loews treasury stock</b>	<b>(98)</b>			<b>(98)</b>	
<b>Stock-based compensation</b>	<b>24</b>	<b>23</b>			<b>1</b>
<b>Other</b>	<b>(4)</b>	<b>(13)</b>	<b>(2)</b>		<b>11</b>
<b>Balance, June 30, 2016</b>	<b>\$ 23,031</b>	<b>\$ 3</b>	<b>\$ 3,197</b>	<b>\$ 14,724</b>	<b>\$ 119</b>
					<b>\$ (98)</b>
					<b>\$ 5,086</b>

*See accompanying Notes to Consolidated Condensed Financial Statements.*

**Table of Contents****Loews Corporation and Subsidiaries****CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS****(Unaudited)****Six Months Ended June 30****2016****2015****(In millions)****Operating Activities:**

Net income (loss)	\$ (89)	\$ 296
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities, net	1,389	803
Changes in operating assets and liabilities, net:		
Receivables	(429)	(243)
Deferred acquisition costs	(25)	(8)
Insurance reserves	666	451
Other assets	(87)	(102)
Other liabilities	(106)	(120)
Trading securities	(548)	10
Net cash flow operating activities	771	1,087

**Investing Activities:**

Purchases of fixed maturities	(4,874)	(5,029)
Proceeds from sales of fixed maturities	3,070	2,859
Proceeds from maturities of fixed maturities	1,247	2,304
Purchases of limited partnership investments	(280)	(78)
Proceeds from sales of limited partnership investments	124	85
Purchases of property, plant and equipment	(974)	(1,227)
Dispositions	274	20
Change in short term investments	148	119
Other, net	148	(87)
Net cash flow investing activities	(1,117)	(1,034)

**Financing Activities:**

Dividends paid	(42)	(46)
Dividends paid to noncontrolling interests	(94)	(110)
Purchases of subsidiary stock from noncontrolling interests	(8)	(24)
Purchases of Loews treasury stock	(86)	(287)

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Issuance of Loews common stock		7
Proceeds from sale of subsidiary stock		114
Principal payments on debt	(2,352)	(1,329)
Issuance of debt	2,843	1,503
Other, net	(1)	6
<b>Net cash flow financing activities</b>	<b>260</b>	<b>(166)</b>
Effect of foreign exchange rate on cash	(6)	(2)
<b>Net change in cash</b>	<b>(92)</b>	<b>(115)</b>
Cash, beginning of period	440	364
<b>Cash, end of period</b>	<b>\$ 348</b>	<b>\$ 249</b>

*See accompanying Notes to Consolidated Condensed Financial Statements.*

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Loews Corporation and Subsidiaries

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****(Unaudited)****1. Basis of Presentation**

Loews Corporation is a holding company. Its subsidiaries are engaged in the following lines of business: commercial property and casualty insurance (CNA Financial Corporation ( CNA ), a 90% owned subsidiary); the operation of offshore oil and gas drilling rigs (Diamond Offshore Drilling, Inc. ( Diamond Offshore ), a 53% owned subsidiary); transportation and storage of natural gas and natural gas liquids and gathering and processing of natural gas (Boardwalk Pipeline Partners, LP ( Boardwalk Pipeline ), a 51% owned subsidiary); and the operation of a chain of hotels (Loews Hotels Holding Corporation ( Loews Hotels ), a wholly owned subsidiary). Unless the context otherwise requires, the terms Company, Loews and Registrant as used herein mean Loews Corporation excluding its subsidiaries and the term Net income (loss) attributable to Loews Corporation as used herein means Net income (loss) attributable to Loews Corporation shareholders.

In the opinion of management, the accompanying unaudited Consolidated Condensed Financial Statements reflect all adjustments (consisting of only normal recurring accruals) necessary to present fairly the Company's financial position as of June 30, 2016 and December 31, 2015, results of operations and comprehensive income for the three and six months ended June 30, 2016 and 2015 and changes in shareholders' equity and cash flows for the six months ended June 30, 2016 and 2015. Net income (loss) for the second quarter and first half of each of the years is not necessarily indicative of net income (loss) for that entire year. These Consolidated Condensed Financial Statements should be read in conjunction with the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

The Company presents basic and diluted net income (loss) per share on the Consolidated Condensed Statements of Income. Basic net income (loss) per share excludes dilution and is computed by dividing net income (loss) attributable to common stock by the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Shares attributable to employee stock-based compensation plans of 4.7 million, 3.7 million, 5.1 million and 3.6 million shares were not included in the diluted weighted average shares amounts for the three and six months ended June 30, 2016 and 2015 because the effect would have been antidilutive.

**Accounting changes** In April of 2015, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The updated accounting guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, rather than as a deferred asset. As required, the Company's Consolidated Condensed Balance Sheet has been retrospectively adjusted to reflect the effect of the adoption of the updated accounting guidance, which resulted in a decrease of \$23 million in Other assets and Long term debt at December 31, 2015.

**Recently issued ASUs** In May of 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The core principle of the new accounting guidance is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The new accounting guidance provides a five-step analysis of transactions to determine when and how revenue is recognized and requires enhanced disclosures

about revenue. In August of 2015, the FASB formally amended the effective date of this update to annual reporting periods beginning after December 15, 2017, including interim periods, and it can be adopted either retrospectively or with a cumulative effect adjustment at the date of adoption. The Company is currently evaluating the effect that adopting this new accounting guidance will have on its consolidated financial statements.

In May of 2015, the FASB issued ASU 2015-09, Financial Services – Insurance (Topic 944): Disclosures about Short-Duration Contracts. The updated accounting guidance requires enhanced disclosures to provide additional information about insurance liabilities for short-duration contracts. The guidance is effective for annual periods

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beginning after December 15, 2015 and for interim periods beginning after December 15, 2016. The Company is currently evaluating the effect the updated guidance will have on its financial statement disclosures, but expects to provide additional incurred and paid claims development information by accident year, quantitative information about claim frequency and the history of claims duration for significant lines of business within the annual financial statements.

In January of 2016, the FASB issued ASU 2016-01, Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The updated accounting guidance requires changes to the reporting model for financial instruments. The guidance is effective for interim and annual periods beginning after December 15, 2017. The Company is currently evaluating the effect the guidance will have on its consolidated financial statements, and expects the primary change to be the requirement for equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income (loss).

In February of 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The updated guidance requires lessees to recognize lease assets and lease liabilities for most operating leases. In addition, the updated guidance requires that lessors separate lease and nonlease components in a contract in accordance with the new revenue guidance in ASU 2014-09. The updated guidance is effective for interim and annual periods beginning after December 15, 2018. The Company is currently evaluating the effect the updated guidance will have on its consolidated financial statements.

In June of 2016, the FASB issued ASU 2016-13, Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The updated accounting guidance requires changes to the recognition of credit losses on financial instruments not accounted for at fair value through net income (loss). The guidance is effective for interim and annual periods beginning after December 15, 2019. The Company is currently evaluating the effect the guidance will have on its consolidated financial statements, and expects the primary changes to be the use of the expected credit loss model for the mortgage loan portfolio and reinsurance receivables and the presentation of credit losses within the available-for-sale fixed maturities portfolio through an allowance method rather than as a direct write-down. The expected credit loss model will require a financial asset to be presented at the net amount expected to be collected. The allowance method for available-for-sale debt securities will allow the Company to record reversals of credit losses when the estimate of credit losses declines.

**2. Investments**

Net investment income is as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2016	2015	June 30, 2016	2015
<b>(In millions)</b>				
Fixed maturity securities	\$ 449	\$ 452	\$ 895	\$ 895
Limited partnership investments	47	50	7	210
Short term investments	2		5	3
Equity securities	4	3	7	6

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Income (loss) from trading portfolio (a)	<b>87</b>	11	<b>102</b>	(4)
Other	<b>13</b>	9	<b>22</b>	17
Total investment income	<b>602</b>	525	<b>1,038</b>	1,127
Investment expenses	<b>(15)</b>	(15)	<b>(29)</b>	(29)
Net investment income	<b>\$ 587</b>	\$ 510	<b>\$ 1,009</b>	\$ 1,098

(a) Includes net unrealized gains (losses) related to changes in fair value on trading securities still held of \$60, \$(10), \$81 and \$(17) for the three and six months ended June 30, 2016 and 2015.



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Investment gains (losses) are as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2016	2015	June 30, 2016	2015
<b>(In millions)</b>				
Fixed maturity securities	\$ 4	\$ (12)	\$ (13)	
Equity securities	3	(1)	(2)	\$ (1)
Derivative instruments	(6)	11	(13)	10
Short term investments and other			1	(1)
Investment gains (losses) (a)	\$ 1	\$ (2)	\$ (27)	\$ 8

(a) Includes gross realized gains of \$44, \$36, \$89 and \$70 and gross realized losses of \$37, \$49, \$104 and \$71 on available-for-sale securities for the three and six months ended June 30, 2016 and 2015.

The components of net other-than-temporary impairment ( OTTI ) losses recognized in earnings by asset type are as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2016	2015	June 30, 2016	2015
<b>(In millions)</b>				
Fixed maturity securities available-for-sale:				
Corporate and other bonds	\$ 13	\$ 11	\$ 29	\$ 16
States, municipalities and political subdivisions		13		18
Asset-backed:				
Residential mortgage-backed	1	5	1	6
Other asset-backed	1	1	3	1
Total asset-backed	2	6	4	7
Total fixed maturities available-for-sale	15	30	33	41
Equity securities available-for-sale - common stock			5	1
Short term investments		1		1
Net OTTI losses recognized in earnings	\$ 15	\$ 31	\$ 38	\$ 43



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The amortized cost and fair values of securities are as follows:

June 30, 2016	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Unrealized OTTI Losses (Gains)
<b>(In millions)</b>					
<b>Fixed maturity securities:</b>					
Corporate and other bonds	\$ 17,613	\$ 1,684	\$ 93	\$ 19,204	\$ (1)
States, municipalities and political subdivisions	11,661	2,114	2	13,773	(25)
<b>Asset-backed:</b>					
Residential mortgage-backed	4,994	215	20	5,189	(21)
Commercial mortgage-backed	2,080	91	8	2,163	
Other asset-backed	928	8	5	931	
<b>Total asset-backed</b>	<b>8,002</b>	<b>314</b>	<b>33</b>	<b>8,283</b>	<b>(21)</b>
U.S. Treasury and obligations of government-sponsored enterprises	81	11		92	
Foreign government	438	22		460	
Redeemable preferred stock	33	2		35	
<b>Fixed maturities available-for-sale</b>	<b>37,828</b>	<b>4,147</b>	<b>128</b>	<b>41,847</b>	<b>(47)</b>
<b>Fixed maturities trading</b>	<b>457</b>	<b>4</b>	<b>1</b>	<b>460</b>	
<b>Total fixed maturities</b>	<b>38,285</b>	<b>4,151</b>	<b>129</b>	<b>42,307</b>	<b>(47)</b>
<b>Equity securities:</b>					
Common stock	20	5	2	23	
Preferred stock	97	6	3	100	
<b>Equity securities available-for-sale</b>	<b>117</b>	<b>11</b>	<b>5</b>	<b>123</b>	<b>-</b>
<b>Equity securities trading</b>	<b>525</b>	<b>108</b>	<b>89</b>	<b>544</b>	
<b>Total equity securities</b>	<b>642</b>	<b>119</b>	<b>94</b>	<b>667</b>	<b>-</b>
<b>Total</b>	<b>\$ 38,927</b>	<b>\$ 4,270</b>	<b>\$ 223</b>	<b>\$ 42,974</b>	<b>\$ (47)</b>

December 31, 2015

(In millions)

<b>Fixed maturity securities:</b>					
Corporate and other bonds	\$ 17,097	\$ 1,019	\$ 347	\$ 17,769	

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States, municipalities and political subdivisions	11,729	1,453	8	13,174	\$ (4)
Asset-backed:					
Residential mortgage-backed	4,935	154	17	5,072	(37)
Commercial mortgage-backed	2,154	55	12	2,197	
Other asset-backed	923	6	8	921	
Total asset-backed	8,012	215	37	8,190	(37)
U.S. Treasury and obligations of government-sponsored enterprises					
	62	5		67	
Foreign government	334	13	1	346	
Redeemable preferred stock	33	2		35	
Fixed maturities available-for-sale					
	37,267	2,707	393	39,581	(41)
Fixed maturities, trading	140		20	120	
Total fixed maturities	37,407	2,707	413	39,701	(41)
Equity securities:					
Common stock	46	3	1	48	
Preferred stock	145	7	3	149	
Equity securities available-for-sale					
	191	10	4	197	-
Equity securities, trading	633	56	134	555	
Total equity securities	824	66	138	752	-
Total	\$ 38,231	\$ 2,773	\$ 551	\$ 40,453	\$ (41)

The net unrealized gains on investments included in the tables above are recorded as a component of Accumulated other comprehensive income ( AOCI ). When presented in AOCI, these amounts are net of tax and noncontrolling interests and any required Shadow Adjustments. To the extent that unrealized gains on fixed income securities supporting certain products within CNA's Life & Group Non-Core business would result in a premium deficiency if

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realized, a related increase in Insurance reserves is recorded, net of tax and noncontrolling interests, as a reduction of net unrealized gains through Other comprehensive income ( Shadow Adjustments ). As of June 30, 2016 and December 31, 2015, the net unrealized gains on investments included in AOCI were correspondingly reduced by Shadow Adjustments of \$1.5 billion and \$996 million.

The available-for-sale securities in a gross unrealized loss position are as follows:

	Less than 12 Months	Gross Unrealized Estimated Fair Value	12 Months or Longer	Gross Unrealized Estimated Fair Value	Total Estimated Fair Value	Gross Unrealized Losses
<b>June 30, 2016</b>						
<b>(In millions)</b>						
<b>Fixed maturity securities:</b>						
<b>Corporate and other bonds</b>	<b>\$ 1,032</b>	<b>\$ 43</b>	<b>\$ 562</b>	<b>\$ 50</b>	<b>\$ 1,594</b>	<b>\$ 93</b>
<b>States, municipalities and political subdivisions</b>	<b>68</b>	<b>2</b>	<b>10</b>		<b>78</b>	<b>2</b>
<b>Asset-backed:</b>						
<b>Residential mortgage-backed</b>	<b>293</b>	<b>8</b>	<b>234</b>	<b>12</b>	<b>527</b>	<b>20</b>
<b>Commercial mortgage-backed</b>	<b>386</b>	<b>7</b>	<b>118</b>	<b>1</b>	<b>504</b>	<b>8</b>
<b>Other asset-backed</b>	<b>306</b>	<b>5</b>	<b>5</b>		<b>311</b>	<b>5</b>
<b>Total asset-backed</b>	<b>985</b>	<b>20</b>	<b>357</b>	<b>13</b>	<b>1,342</b>	<b>33</b>
<b>Foreign government</b>	<b>8</b>		<b>5</b>		<b>13</b>	
<b>Total fixed maturity securities</b>	<b>2,093</b>	<b>65</b>	<b>934</b>	<b>63</b>	<b>3,027</b>	<b>128</b>
<b>Common stock</b>	<b>4</b>	<b>2</b>			<b>4</b>	<b>2</b>
<b>Preferred stock</b>	<b>23</b>	<b>3</b>			<b>23</b>	<b>3</b>
<b>Total</b>	<b>\$ 2,120</b>	<b>\$ 70</b>	<b>\$ 934</b>	<b>\$ 63</b>	<b>\$ 3,054</b>	<b>\$ 133</b>

December 31, 2015

(In millions)

<b>Fixed maturity securities:</b>						
<b>Corporate and other bonds</b>	<b>\$ 4,882</b>	<b>\$ 302</b>	<b>\$ 174</b>	<b>\$ 45</b>	<b>\$ 5,056</b>	<b>\$ 347</b>
<b>States, municipalities and political subdivisions</b>	<b>338</b>	<b>8</b>	<b>75</b>		<b>413</b>	<b>8</b>
<b>Asset-backed:</b>						
<b>Residential mortgage-backed</b>	<b>963</b>	<b>9</b>	<b>164</b>	<b>8</b>	<b>1,127</b>	<b>17</b>

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Commercial mortgage-backed	652	10	96	2	748	12
Other asset-backed	552	8	5		557	8
Total asset-backed	2,167	27	265	10	2,432	37
U.S. Treasury and obligations of government-sponsored enterprises	4				4	
Foreign government	54	1			54	1
Redeemable preferred stock	3				3	
Total fixed maturity securities	7,448	338	514	55	7,962	393
Common stock	3	1			3	1
Preferred stock	13	3			13	3
Total	\$ 7,464	\$ 342	\$ 514	\$ 55	\$ 7,978	\$ 397

Based on current facts and circumstances, the Company believes the unrealized losses presented in the table above are not indicative of the ultimate collectibility of the current amortized cost of the securities, but rather are attributable to changes in interest rates, credit spreads and other factors. The Company has no current intent to sell securities with unrealized losses, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost; accordingly, the Company has determined that there are no additional OTTI losses to be recorded as of June 30, 2016.

The following table presents the activity related to the pretax credit loss component reflected in Retained earnings on fixed maturity securities still held as of June 30, 2016 and 2015 for which a portion of an OTTI loss was recognized in Other comprehensive income.

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015

**(In millions)**

Beginning balance of credit losses on fixed maturity securities	\$ 48	\$ 61	\$ 53	\$ 62
Reductions for securities sold during the period	(7)	(2)	(12)	(3)
Ending balance of credit losses on fixed maturity securities	\$ 41	\$ 59	\$ 41	\$ 59

**Contractual Maturity**

The following table presents available-for-sale fixed maturity securities by contractual maturity.

	June 30, 2016		December 31, 2015	
	Cost or Amortized Cost	Estimated Fair Value	Cost or Amortized Cost	Estimated Fair Value

**(In millions)**

Due in one year or less	\$ 1,817	\$ 1,855	\$ 1,574	\$ 1,595
Due after one year through five years	8,616	9,114	7,738	8,082
Due after five years through ten years	14,583	15,466	14,652	14,915
Due after ten years	12,812	15,412	13,303	14,989
Total	\$ 37,828	\$ 41,847	\$ 37,267	\$ 39,581

Actual maturities may differ from contractual maturities because certain securities may be called or prepaid. Securities not due at a single date are allocated based on weighted average life.

**Table of Contents****Derivative Financial Instruments**

A summary of the aggregate contractual or notional amounts and gross estimated fair values related to derivative financial instruments follows. The contractual or notional amounts for derivatives are used to calculate the exchange of contractual payments under the agreements and may not be representative of the potential for gain or loss on these instruments. Gross estimated fair values of derivative positions are currently presented in Equity securities, Receivables and Payable to brokers on the Consolidated Condensed Balance Sheets.

	June 30, 2016			December 31, 2015		
	Contractual/ Notional	Estimated Fair Value		Contractual/ Notional	Estimated Fair Value	
	Amount	Asset	(Liability)	Amount	Asset	(Liability)
<b>(In millions)</b>						
<b>Without hedge designation:</b>						
Equity markets:						
Options purchased	\$ 229	\$ 24		\$ 501	\$ 16	
Options written	198		\$ (10)	614		\$ (28)
Futures long				312		(1)
Futures short	51		(1)			
Interest rate risk:						
Futures long				63		
Foreign exchange:						
Currency forwards long				133	2	
Currency forwards short				152		
Currency options long	250	1		550	7	
Commodities:						
Futures long	62		(1)			
Swaps short	50					
Embedded derivative on funds withheld liability	177		(8)	179	5	

**3. Fair Value**

Fair value is the price that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following fair value hierarchy is used in selecting inputs, with the highest priority given to Level 1, as these are the most transparent or reliable:

Level 1 Quoted prices for identical instruments in active markets.



Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable in active markets.

Level 3 Valuations derived from valuation techniques in which one or more significant inputs are not observable.

Prices may fall within Level 1, 2 or 3 depending upon the methodology and inputs used to estimate fair value for each specific security. In general, the Company seeks to price securities using third party pricing services. Securities not priced by pricing services are submitted to independent brokers for valuation and, if those are not available, internally developed pricing models are used to value assets using a methodology and inputs the Company believes market participants would use to value the assets. Prices obtained from third-party pricing services or brokers are not adjusted by the Company.

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The Company performs control procedures over information obtained from pricing services and brokers to ensure prices received represent a reasonable estimate of fair value and to confirm representations regarding whether inputs are observable or unobservable. Procedures include: (i) the review of pricing service or broker pricing methodologies, (ii) back-testing, where past fair value estimates are compared to actual transactions executed in the market on similar dates, (iii) exception reporting, where period-over-period changes in price are reviewed and challenged with the pricing service or broker based on exception criteria, (iv) detailed analysis, where the Company performs an independent analysis of the inputs and assumptions used to price individual securities and (v) pricing validation, where prices received are compared to prices independently estimated by the Company.

The fair values of CNA's life settlement contracts are included in Other assets on the Consolidated Condensed Balance Sheets. Equity options purchased are included in Equity securities, and all other derivative assets are included in Receivables. Derivative liabilities are included in Payable to brokers. Assets and liabilities measured at fair value on a recurring basis are presented in the following tables:

June 30, 2016	Level 1	Level 2	Level 3	Total
<b>(In millions)</b>				
<b>Fixed maturity securities:</b>				
<b>Corporate and other bonds</b>		\$ 18,962	\$ 242	\$ 19,204
<b>States, municipalities and political subdivisions</b>		13,771	2	13,773
<b>Asset-backed:</b>				
<b>Residential mortgage-backed</b>		5,055	134	5,189
<b>Commercial mortgage-backed</b>		2,152	11	2,163
<b>Other asset-backed</b>		886	45	931
<b>Total asset-backed</b>		8,093	190	8,283
<b>U.S. Treasury and obligations of government-sponsored enterprises</b>	\$ 91	1		92
<b>Foreign government</b>		460		460
<b>Redeemable preferred stock</b>	35			35
<b>Fixed maturities available-for-sale</b>	126	41,287	434	41,847
<b>Fixed maturities trading</b>		454	6	460
<b>Total fixed maturities</b>	\$ 126	\$ 41,741	\$ 440	\$ 42,307
<b>Equity securities available-for-sale</b>	\$ 104		\$ 19	\$ 123
<b>Equity securities trading</b>	542		2	544
<b>Total equity securities</b>	\$ 646	\$ -	\$ 21	\$ 667
<b>Short term investments</b>	\$ 4,289	\$ 950		\$ 5,239
<b>Other invested assets</b>	53	5		58

<b>Receivables</b>		<b>\$ 1</b>	<b>1</b>
<b>Life settlement contracts</b>		<b>67</b>	<b>67</b>
<b>Payable to brokers</b>	<b>(657)</b>		<b>(657)</b>

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December 31, 2015	Level 1	Level 2	Level 3	Total
(In millions)				
<b>Fixed maturity securities:</b>				
Corporate and other bonds		\$ 17,601	\$ 168	\$ 17,769
States, municipalities and political subdivisions		13,172	2	13,174
<b>Asset-backed:</b>				
Residential mortgage-backed		4,938	134	5,072
Commercial mortgage-backed		2,175	22	2,197
Other asset-backed		868	53	921
Total asset-backed		7,981	209	8,190
U.S. Treasury and obligations of government-sponsored enterprises	\$ 66	1		67
Foreign government		346		346
Redeemable preferred stock	35			35
Fixed maturities available-for-sale	101	39,101	379	39,581
Fixed maturities trading		35	85	120
Total fixed maturities	\$ 101	\$ 39,136	\$ 464	\$ 39,701
Equity securities available-for-sale	\$ 177		\$ 20	\$ 197
Equity securities trading	554		1	555
Total equity securities	\$ 731	\$ -	\$ 21	\$ 752
Short term investments	\$ 3,600	\$ 1,134		\$ 4,734
Other invested assets	102	44		146
Receivables		9	\$ 3	12
Life settlement contracts			74	74
Payable to brokers	(196)			(196)

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The following tables present reconciliations for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2016 and 2015:

2016	Balance April 1	Net Realized Gains (Losses) Included in Net Income	Net Change in Unrealized Gains (Losses) Included in OCI	Purchases	Sales	Settlements	Transfers		Balance, June 30	Unrealized Gains (Losses) Recognized in Net Income  (Loss) on Level 3 Assets and Liabilities Held at June 30
							into Level 3	out of Level 3		
<b>(In millions)</b>										
<b>Fixed maturity securities:</b>										
<b>Corporate and other bonds</b>										
	\$ 193	\$ 1	\$ 3	\$ 94	\$ (20)	\$ (7)		\$ (22)	\$ 242	
<b>States, municipalities and political subdivisions</b>										
	2								2	
<b>Asset-backed:</b>										
<b>Residential mortgage-backed</b>										
	128	1	(1)	10		(4)			134	
<b>Commercial mortgage-backed</b>										
	27					(9)	\$ 3	(10)	11	
<b>Other asset-backed</b>										
	50		2	35	(25)	(1)		(16)	45	
<b>Total asset-backed</b>	<b>205</b>	<b>1</b>	<b>1</b>	<b>45</b>	<b>(25)</b>	<b>(14)</b>	<b>3</b>	<b>(26)</b>	<b>190</b>	<b>\$ -</b>
<b>Fixed maturities available-for-sale</b>										
	400	2	4	139	(45)	(21)	3	(48)	434	
<b>Fixed maturities trading</b>										
	3	4			(1)				6	4
<b>Total fixed maturities</b>	<b>\$ 403</b>	<b>\$ 6</b>	<b>\$ 4</b>	<b>\$ 139</b>	<b>\$ (46)</b>	<b>\$ (21)</b>	<b>\$ 3</b>	<b>\$ (48)</b>	<b>\$ 440</b>	<b>\$ 4</b>

<b>Equity securities available-for-sale</b>	<b>\$ 19</b>											<b>\$ 19</b>	
<b>Equity securities trading</b>	<b>-</b>	<b>\$ 1</b>		<b>\$ 1</b>								<b>2</b>	<b>\$ 1</b>
<b>Total equity securities</b>	<b>\$ 19</b>	<b>\$ 1</b>	<b>\$ -</b>	<b>\$ 1</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 21</b>	<b>\$ 1</b>	
<b>Life settlement contracts</b>	<b>\$ 72</b>	<b>\$ 6</b>						<b>\$ (11)</b>				<b>\$ 67</b>	<b>\$ (3)</b>
<b>Derivative financial instruments, net</b>		<b>(2)</b>						<b>\$ 3</b>			<b>1</b>		<b>(3)</b>

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2015	Balance April 1	Net Realized Gains (Losses) and Net Change in Unrealized Gains (Losses) Included in					Transfers		Balance, June 30	Unrealized Gains (Losses) Recognized in Net Income on Level 3 Assets and Liabilities Held at June 30
		Net Income	OCI	Purchases	Sales	Settlements	into Level 3	out of Level 3		
(In millions)										
Fixed maturity securities:										
Corporate and other bonds	\$ 186	\$ (2)	\$ (1)			\$ (7)		\$ (35)	\$ 141	\$ (3)
States, municipalities and political subdivisions	86					(1)			85	
Asset-backed:										
Residential mortgage-backed	232	1	(2)			(11)		(13)	207	
Commercial mortgage-backed	64	1	(1)	\$ 9		(1)	\$ 17	(2)	87	
Other asset-backed	553	2	1	47	\$ (90)	(17)		(6)	490	
Total asset-backed	849	4	(2)	56	(90)	(29)	17	(21)	784	-
Fixed maturities available-for-sale	1,121	2	(3)	56	(90)	(37)	17	(56)	1,010	(3)
Fixed maturities trading	89								89	
Total fixed maturities	\$ 1,210	\$ 2	\$ (3)	\$ 56	\$ (90)	\$ (37)	\$ 17	\$ (56)	\$ 1,099	\$ (3)
Equity securities available-for-sale	\$ 13		\$ 3						\$ 16	
Equity securities trading	1								1	
Total equity securities	\$ 14	\$ -	\$ 3	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 17	\$ -
Life settlement contracts	\$ 79	\$ 4				\$ (8)			\$ 75	\$ (2)





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2016	Balance, January 1	Net Realized Gains (Losses) and Net Change in Unrealized Gains (Losses) Included in					Transfers into Level 3		Transfers out of Level 3		Balance, June 30	Unrealized Gains (Losses) Recognized in Net Income (Loss) on Level 3 Assets and Liabilities Held at June 30
		Net Income	OCI	Purchases	Sales	Settlements	Level 3	Level 3	Level 3	Level 3		
<b>(In millions)</b>												
<b>Fixed maturity securities:</b>												
Corporate and other bonds	\$ 168	\$ 7	\$ 147	\$ (36)	\$ (10)			\$ (34)		\$ 242		
States, municipalities and political subdivisions	2									2		
<b>Asset-backed:</b>												
Residential mortgage-backed	134	\$ 2	(1)	10		(9)		(2)		134		
Commercial mortgage-backed	22			9		(9)	\$ 3	(14)		11		
Other asset-backed	53		2	35	(25)	(1)	2	(21)		45		
<b>Total asset-backed</b>	<b>209</b>	<b>2</b>	<b>1</b>	<b>54</b>	<b>(25)</b>	<b>(19)</b>	<b>5</b>	<b>(37)</b>		<b>190</b>	<b>\$ -</b>	
<b>Fixed maturities available-for-sale</b>	<b>379</b>	<b>2</b>	<b>8</b>	<b>201</b>	<b>(61)</b>	<b>(29)</b>	<b>5</b>	<b>(71)</b>		<b>434</b>		
<b>Fixed maturities trading</b>	<b>85</b>	<b>5</b>		<b>2</b>	<b>(86)</b>					<b>6</b>	<b>4</b>	
<b>Total fixed maturities</b>	<b>\$ 464</b>	<b>\$ 7</b>	<b>\$ 8</b>	<b>\$ 203</b>	<b>\$ (147)</b>	<b>\$ (29)</b>	<b>\$ 5</b>	<b>\$ (71)</b>		<b>\$ 440</b>	<b>\$ 4</b>	
<b>Equity securities available-for-sale</b>	<b>\$ 20</b>		<b>\$ (1)</b>							<b>\$ 19</b>		
	<b>1</b>	<b>\$ 1</b>		<b>\$ 1</b>	<b>\$ (1)</b>					<b>2</b>	<b>\$ 1</b>	

**Equity securities trading**

<b>Total equity securities</b>	\$ 21	\$ 1	\$ (1)	\$ 1	\$ (1)	\$ -	\$ -	\$ -	\$ 21	\$ 1
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**Life settlement contracts**

	\$ 74	\$ 10			\$ (17)			\$ 67	\$ (3)
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**Derivative financial instruments, net**

	3	(3)		\$ (2)	\$ 3			1	(3)
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	Net Realized Gains (Losses) and Net Change in Unrealized Gains (Losses)							Transfers into	Transfers out of Level 3	Balance, June 30	Unrealized Gains (Losses) Recognized in Net Income on Level 3 Assets and Liabilities Held at June 30
2015	Balance, January 1	Net Income	OCI	Purchases	Sales	Settlements	Level 3			June 30	June 30
(In millions)											
Fixed maturity securities:											
Corporate and other bonds	\$ 162	\$ (1)	\$ (1)	\$ 12	\$ (12)	\$ (21)	\$ 37	\$ (35)	\$ 141	\$ (3)	
States, municipalities and political subdivisions	94	1				(10)			85		
Asset-backed:											
Residential mortgage-backed	189	2	(2)	72		(21)		(33)	207		
Commercial mortgage-backed	83	2		15		(2)	17	(28)	87		
Other asset-backed	655	3	10	82	(234)	(20)		(6)	490		
Total asset-backed	927	7	8	169	(234)	(43)	17	(67)	784	-	
Fixed maturities available-for-sale	1,183	7	7	181	(246)	(74)	54	(102)	1,010	(3)	
Fixed maturities trading	90				(1)				89		
Total fixed maturities	\$ 1,273	\$ 7	\$ 7	\$ 181	\$ (247)	\$ (74)	\$ 54	\$ (102)	\$ 1,099	\$ (3)	
Equity securities available-for-sale	\$ 16								\$ 16		
Equity securities trading	1								1		

Total equity securities	\$ 17	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 17	\$ -
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Life settlement contracts	\$ 82	\$ 17									\$ 75	\$ (1)
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Net realized and unrealized gains and losses are reported in Net income (loss) as follows:

Major Category of Assets and Liabilities	Consolidated Condensed Statements of Income Line Items
Fixed maturity securities available-for-sale	Investment gains (losses)
Fixed maturity securities, trading	Net investment income
Equity securities available-for-sale	Investment gains (losses)
Equity securities, trading	Net investment income
Other invested assets	Investment gains (losses) and Net investment income
Derivative financial instruments held in a trading portfolio	Net investment income
Derivative financial instruments, other	Investment gains (losses) and Other revenues
Life settlement contracts	Other revenues

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Securities may be transferred in or out of levels within the fair value hierarchy based on the availability of observable market information and quoted prices used to determine the fair value of the security. The availability of observable market information and quoted prices varies based on market conditions and trading volume. During the three and six months ended June 30, 2016 and 2015 there were no transfers between Level 1 and Level 2. The Company's policy is to recognize transfers between levels at the beginning of quarterly reporting periods.

**Valuation Methodologies and Inputs**

The following section describes the valuation methodologies and relevant inputs used to measure different financial instruments at fair value, including an indication of the level in the fair value hierarchy in which the instruments are generally classified.

*Fixed Maturity Securities*

Level 1 securities include highly liquid and exchange traded bonds and redeemable preferred stock, valued using quoted market prices. Level 2 securities include most other fixed maturity securities as the significant inputs are observable in the marketplace. All classes of Level 2 fixed maturity securities are valued using a methodology based on information generated by market transactions involving identical or comparable assets, a discounted cash flow methodology or a combination of both when necessary. Common inputs for all classes of fixed maturity securities include prices from recently executed transactions of similar securities, marketplace quotes, benchmark yields, spreads off benchmark yields, interest rates and U.S. Treasury or swap curves. Specifically for asset-backed securities, key inputs include prepayment and default projections based on past performance of the underlying collateral and current market data. Fixed maturity securities are primarily assigned to Level 3 in cases where broker/dealer quotes are significant inputs to the valuation and there is a lack of transparency as to whether these quotes are based on information that is observable in the marketplace. Level 3 securities also include private placement debt securities whose fair value is determined using internal models with inputs that are not market observable.

*Equity Securities*

Level 1 equity securities include publicly traded securities valued using quoted market prices. Level 2 securities are primarily non-redeemable preferred stocks and common stocks valued using pricing for similar securities, recently executed transactions and other pricing models utilizing market observable inputs. Level 3 securities are primarily priced using broker/dealer quotes and internal models with inputs that are not market observable.

*Derivative Financial Instruments*

Exchange traded derivatives are valued using quoted market prices and are classified within Level 1 of the fair value hierarchy. Level 2 derivatives primarily include currency forwards valued using observable market forward rates. Over-the-counter derivatives, principally interest rate swaps, total return swaps, commodity swaps, equity warrants and options, are valued using inputs including broker/dealer quotes and are classified within Level 2 or Level 3 of the valuation hierarchy, depending on the amount of transparency as to whether these quotes are based on information that is observable in the marketplace.

*Short Term Investments*

Securities that are actively traded or have quoted prices are classified as Level 1. These securities include money market funds and treasury bills. Level 2 primarily includes commercial paper, for which all inputs are market observable. Fixed maturity securities purchased within one year of maturity are valued consistent with fixed maturity

securities discussed above. Short term investments as presented in the tables above differ from the amounts presented in the Consolidated Condensed Balance Sheets because certain short term investments, such as time deposits, are not measured at fair value.

**Table of Contents***Other Invested Assets*

Level 1 securities include exchange traded open-end funds valued using quoted market prices.

*Life Settlement Contracts*

The fair values of life settlement contracts are determined as the present value of the anticipated death benefits less anticipated premium payments based on contract terms that are distinct for each insured, as well as CNA's own assumptions for mortality, premium expense, and the rate of return that a buyer would require on the contracts, as no comparable market pricing data is available.

**Significant Unobservable Inputs**

The following tables present quantitative information about the significant unobservable inputs utilized by the Company in the fair value measurement of Level 3 assets. Valuations for assets and liabilities not presented in the tables below are primarily based on broker/dealer quotes for which there is a lack of transparency as to inputs used to develop the valuations. The quantitative detail of unobservable inputs from these broker quotes is neither provided nor reasonably available to the Company.

June 30, 2016	Estimated	Valuation Techniques	Unobservable	Range	
	Fair Value		Inputs	(Weighted Average)	
(In millions)					
<b>Fixed maturity securities</b>	\$ 226	Discounted cash flow	Credit spread	1%	40% (6%)
<b>Life settlement contracts</b>	67	Discounted cash flow	Discount rate risk premium		9%
			Mortality assumption	55%	1,676% (162%)
December 31, 2015					
<b>Fixed maturity securities</b>	\$ 138	Discounted cash flow	Credit spread	3%	184% (6%)
<b>Life settlement contracts</b>	74	Discounted cash flow	Discount rate risk premium		9%
			Mortality assumption	55%	1,676% (164%)

For fixed maturity securities, an increase to the credit spread assumptions would result in a lower fair value measurement. For life settlement contracts, an increase in the discount rate risk premium or decrease in the mortality assumption would result in a lower fair value measurement.





**Table of Contents****Financial Assets and Liabilities Not Measured at Fair Value**

The carrying amount, estimated fair value and the level of the fair value hierarchy of the Company's financial assets and liabilities which are not measured at fair value on the Consolidated Condensed Balance Sheets are presented in the following tables. The carrying amounts and estimated fair values of short term debt and long term debt exclude capital lease obligations. The carrying amounts reported on the Consolidated Condensed Balance Sheets for cash and short term investments not carried at fair value and certain other assets and liabilities approximate fair value due to the short term nature of these items.

<b>June 30, 2016</b> <b>(In millions)</b>	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>			<b>Total</b>
		<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
<b>Assets:</b>					
Other invested assets, primarily mortgage loans	\$ 610			\$ 638	\$ 638
<b>Liabilities:</b>					
Short term debt	329		\$ 327	2	329
Long term debt	10,721		10,267	648	10,915

December 31, 2015

<b>Assets:</b>					
Other invested assets, primarily mortgage loans	\$ 678			\$ 688	\$ 688
<b>Liabilities:</b>					
Short term debt	1,038		\$ 1,050	2	1,052
Long term debt	9,507		8,538	595	9,133

The following methods and assumptions were used in estimating the fair value of these financial assets and liabilities.

The fair value of mortgage loans, included in Other invested assets, was based on the present value of the expected future cash flows discounted at the current interest rate for similar financial instruments, adjusted for specific loan risk.

Fair value of debt was based on observable market prices when available. When observable market prices were not available, the fair value of debt was based on observable market prices of comparable instruments adjusted for differences between the observed instruments and the instruments being valued or is estimated using discounted cash flow analyses, based on current incremental borrowing rates for similar types of borrowing arrangements.

**4. Property, Plant and Equipment****Diamond Offshore***Sale of Assets*

In February of 2016, Diamond Offshore entered into a ten-year agreement with a subsidiary of GE Oil & Gas ( GE ) to provide services with respect to certain blowout preventer and related well control equipment on four newly-built drillships. Such services include management of maintenance, certification and reliability with respect to such equipment. In connection with the contractual services agreement with GE, Diamond Offshore will sell the well control equipment to a GE affiliate and subsequently lease back such equipment pursuant to separate ten-year operating leases. During the six months ended June 30, 2016, Diamond Offshore executed three sale and leaseback transactions and received \$158 million in proceeds, which was less than the carrying value of the equipment. The

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resulting difference was recorded as prepaid rent with no gain or loss recognized on the transactions, and will be amortized over the terms of the operating leases. Future commitments under the operating leases and contractual services agreements are estimated to aggregate approximately \$491 million over the term of the agreements. Diamond Offshore expects to complete the remaining sale and leaseback transaction in the third quarter of 2016.

*Asset Impairments*

During the second quarter of 2016, in response to the continuing decline in industry-wide utilization for semisubmersible rigs, further exacerbated by additional and more frequent contract cancellations by customers, declining dayrates, as well as the results of a third-party strategic review of Diamond Offshore's long-term business plan completed in the second quarter of 2016, Diamond Offshore reassessed its projections for a recovery in the offshore drilling market. As a result, Diamond Offshore concluded that an expected market recovery is now likely further in the future than had previously been estimated. Consequently, Diamond Offshore believes its cold-stacked rigs, as well as those rigs expected to be cold-stacked in the near term after they come off contract, will likely remain cold-stacked for an extended period of time. Diamond Offshore also believes that the re-entry costs for these rigs will be higher than previously estimated, negatively impacting the undiscounted, projected probability-weighted cash flow projections utilized in its impairment analysis. In addition, in response to the declining market, Diamond Offshore also reduced anticipated market pricing and expected utilization of these rigs after reactivation. In the second quarter of 2016, Diamond Offshore evaluated 15 of its drilling rigs with indications that their carrying amounts may not be recoverable. Based on updated assumptions and analyses, Diamond Offshore determined that the carrying values of eight of these rigs, consisting of three ultra-deepwater, three deepwater and two mid-water semisubmersible rigs, were impaired.

Diamond Offshore estimated the fair value of the eight impaired rigs using an income approach. The fair value of each rig was estimated based on a calculation of the rig's discounted future net cash flows over its remaining economic life, which utilized significant unobservable inputs, including, but not limited to, assumptions related to estimated dayrate revenue, rig utilization, estimated reactivation and regulatory survey costs, as well as estimated proceeds that may be received on ultimate disposition of the rig. The fair value estimates were representative of Level 3 fair value measurements due to the significant level of estimation involved and the lack of transparency as to the inputs used. During the second quarter of 2016, Diamond Offshore recognized an impairment loss of \$672 million (\$263 million after tax and noncontrolling interests).

As of June 30, 2016, there were seven rigs in Diamond Offshore's drilling fleet for which there were no indications that their carrying amounts may not be recoverable and, thus, were not evaluated for impairment at this time. If market fundamentals in the offshore oil and gas industry deteriorate further, Diamond Offshore may be required to recognize additional impairment losses in future periods.

During the first quarter of 2015, Diamond Offshore evaluated 17 of its drilling rigs with indications that their carrying amounts may not be recoverable. Based on this evaluation, Diamond Offshore determined that seven mid-water semisubmersibles as well as an older drillship were impaired and an impairment loss was recognized aggregating \$359 million (\$158 million after tax and noncontrolling interests) for the six months ended June 30, 2015.

See Note 6 of the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 for further discussion of Diamond Offshore's 2015 asset impairments.

**Table of Contents****5. Claim and Claim Adjustment Expense Reserves**

CNA's property and casualty insurance claim and claim adjustment expense reserves represent the estimated amounts necessary to resolve all outstanding claims, including claims that are incurred but not reported (IBNR) as of the reporting date. CNA's reserve projections are based primarily on detailed analysis of the facts in each case, CNA's experience with similar cases and various historical development patterns. Consideration is given to such historical patterns as field reserving trends and claims settlement practices, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions including inflation and public attitudes. All of these factors can affect the estimation of claim and claim adjustment expense reserves.

Establishing claim and claim adjustment expense reserves, including claim and claim adjustment expense reserves for catastrophic events that have occurred, is an estimation process. Many factors can ultimately affect the final settlement of a claim and, therefore, the necessary reserve. Changes in the law, results of litigation, medical costs, the cost of repair materials and labor rates can all affect ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement amount can be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably estimable than long-tail claims, such as workers' compensation, general liability and professional liability claims. Adjustments to prior year reserve estimates, if necessary, are reflected in the results of operations in the period that the need for such adjustments is determined. There can be no assurance that CNA's ultimate cost for insurance losses will not exceed current estimates.

Catastrophes are an inherent risk of the property and casualty insurance business and have contributed to material period-to-period fluctuations in CNA's results of operations and/or equity. CNA reported catastrophe losses, net of reinsurance, of \$85 million and \$60 million for the three months ended June 30, 2016 and 2015 and \$121 million and \$89 million for the six months ended June 30, 2016 and 2015. Catastrophe losses in 2016 resulted primarily from U.S. weather-related events and the Fort McMurray wildfires.

**Net Prior Year Development**

The following tables and discussion present net prior year development.

Three Months Ended June 30, 2016	Specialty	Commercial	International	Total
<b>(In millions)</b>				
<b>Pretax (favorable) unfavorable net prior year claim and allocated claim adjustment expense reserve development</b>	\$ (65)	\$ (18)	\$ (15)	\$ (98)
<b>Pretax (favorable) unfavorable premium development</b>	(7)	(2)	1	(8)
<b>Total pretax (favorable) unfavorable net prior year development</b>	\$ (72)	\$ (20)	\$ (14)	\$ (106)

Three Months Ended June 30, 2015

Pretax (favorable) unfavorable net prior year claim and allocated claim adjustment expense reserve development	\$ (13)	\$ 16	\$ (8)	\$ (5)
Pretax (favorable) unfavorable premium development	(2)	(11)	(2)	(15)
Total pretax (favorable) unfavorable net prior year development	\$ (15)	\$ 5	\$ (10)	\$ (20)

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Six Months Ended June 30, 2016

	Specialty	Commercial	International	Total
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**(In millions)**

Pretax (favorable) unfavorable net prior year claim and allocated claim adjustment expense reserve development	\$ (99)	\$ (32)	\$ (19)	\$ (150)
Pretax (favorable) unfavorable premium development	(18)	(4)		(22)
<b>Total pretax (favorable) unfavorable net prior year development</b>	<b>\$ (117)</b>	<b>\$ (36)</b>	<b>\$ (19)</b>	<b>\$ (172)</b>

Six Months Ended June 30, 2015

Pretax (favorable) unfavorable net prior year claim and allocated claim adjustment expense reserve development	\$ (11)	\$ 11	\$ (12)	\$ (12)
Pretax (favorable) unfavorable premium development	(8)	(12)	14	(6)
<b>Total pretax (favorable) unfavorable net prior year development</b>	<b>\$ (19)</b>	<b>\$ (1)</b>	<b>\$ 2</b>	<b>\$ (18)</b>

**Specialty**

The following table and discussion present further detail of the net prior year claim and allocated claim adjustment expense reserve development ( development ) recorded for the Specialty segment:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Medical professional liability	\$ (23)	\$ (6)	\$ (30)	\$ 8
Other professional liability and management liability	(41)	(1)	(50)	(4)
Surety				1
Warranty	3	1	5	1
Other	(4)	(7)	(24)	(17)
	<b>\$ (65)</b>	<b>\$ (13)</b>	<b>\$ (99)</b>	<b>\$ (11)</b>

**(In millions)**

Total pretax (favorable) unfavorable  
development

*Three Months*

**2016**

Favorable development in medical professional liability was due to lower than expected severity for individual healthcare professionals and allied facilities for accident years 2014 and prior.

Favorable development in other professional liability and management liability was primarily related to lower than expected frequency of claims in accident years 2010 through 2015, mainly driven by professional services. This was partially offset by unfavorable development in accident year 2015 related to an increase in management liability frequency of larger claims.

**2015**

Overall, favorable development in medical professional liability was primarily due to lower than expected severity for individual healthcare professionals and allied facilities in accident years 2009 through 2012. Unfavorable development was recorded related to increased claim frequency in the aging services business in accident years 2009 and 2010.

Favorable development of \$38 million was recorded in other professional liability and management liability related to lower than expected severity for professional services primarily in accident years 2010 and prior. Unfavorable development of \$37 million was recorded primarily related to increased claim frequency on public company management liability in accident years 2012 through 2014.

Favorable development for other coverages was primarily due to better than expected claim frequency in property coverages provided to Specialty customers in accident year 2014.

**Table of Contents*****Six Months*****2016**

Favorable development for medical professional liability was primarily due to lower than expected severities for individual healthcare professionals, allied facilities, and hospitals in accident years 2011 and prior. This was partially offset by unfavorable development in accident years 2012 and 2013 related to higher than expected large loss emergence in hospitals and higher than expected severity in accident years 2014 and 2015 in the aging services business.

Favorable development in other professional liability and management liability was primarily related to lower than expected frequency of claims in accident years 2010 through 2015, mainly driven by professional services. Additional favorable development was related to favorable outcomes on larger claims in 2013 and prior in professional services. This was partially offset by unfavorable development in accident years 2014 and 2015 related to an increase in management liability frequency of larger claims.

Favorable development for other coverages was due to better than expected claim frequency in property coverages provided to Specialty customers in accident year 2015.

**2015**

Overall, unfavorable development for medical professional liability was primarily related to increased claim frequency in the aging services business for accident years 2009 through 2014, partially offset by lower than expected severity in accident years 2010 and prior. Additional favorable development was due to lower than expected severity for individual healthcare professionals and allied facilities in accident years 2009 through 2012.

Favorable development of \$41 million was recorded in other professional liability and management liability primarily related to lower than expected severity in accident years 2010 and prior for professional services. Unfavorable development of \$37 million was recorded primarily related to increased claim frequency on public company management liability in accident years 2012 through 2014.

Favorable development for other coverages was primarily due to better than expected claim frequency in property coverages provided to Specialty customers in accident year 2014.

**Commercial**

The following table and discussion present further detail of the development recorded for the Commercial segment:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>(In millions)</b>				
Commercial auto	\$ (20)	\$ 7	\$ (35)	\$ 7



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General liability	(37)	1	(52)	5
Workers compensation	50	24	54	23
Property and other	(11)	(16)	1	(24)
Total pretax (favorable) unfavorable development	\$ (18)	\$ 16	\$ (32)	\$ 11

*Three Months*

**2016**

Favorable development for commercial auto was primarily due to favorable settlements on claims in accident years 2010 through 2014.

Favorable development for general liability was primarily due to better than expected claim settlements in accident years 2012 through 2014 and better than expected severity on umbrella claims in accident years 2010 through 2013.

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Unfavorable development for workers compensation was due to a reduction in estimated recoveries on war hazard claims for Defense Base Act contractors, which was partially offset by favorable development related to lower than expected frequencies for the small and middle market businesses in accident years 2009 through 2014.

Favorable development for property and other was primarily due to better than expected loss emergence in accident years 2013 through 2015.

### **2015**

In the aggregate, the unfavorable loss development of \$16 million was driven by an extra contractual obligation loss and losses associated with premium development. The reserve development discussed below was largely offsetting.

Unfavorable development for workers compensation was primarily due to higher than expected severity related to Defense Base Act contractors in accident years 2008 through 2013.

Favorable development for property and other was primarily due to better than expected loss emergence from 2012 catastrophe events and better than expected claim frequency of large claims in accident year 2014.

### ***Six Months***

#### **2016**

Favorable development for commercial auto was primarily due to favorable settlements on claims in accident years 2010 through 2014.

Favorable development for general liability was primarily due to better than expected claim settlements in accident years 2012 through 2014 and better than expected severity on umbrella claims in accident years 2010 through 2013.

Unfavorable development for workers compensation was due to a reduction in estimated recoveries on war hazard claims for Defense Base Act contractors, which was partially offset by favorable development related to lower than expected frequencies for the small and middle market businesses in accident years 2009 through 2014.

Unfavorable development for property and other was primarily due to higher than expected severity from a 2015 catastrophe event. Favorable development was primarily due to better than expected loss emergence in accident years 2013 through 2015.

#### **2015**

In addition to the favorable property development noted in the three month discussion, there was additional favorable development for property related to better than expected loss emergence from 2014 catastrophe events.

### **International**

The following table and discussion present further detail of the development recorded for the International segment:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>(In millions)</b>				
Medical professional liability	\$ (1)		\$ (1)	
Other professional liability	18	\$ (5)	17	\$ (5)
Liability	(19)	(2)	(19)	(7)
Property & marine	(3)	(8)	(7)	(14)
Other	(10)	7	(9)	14
Total pretax (favorable) unfavorable development	\$ (15)	\$ (8)	\$ (19)	\$ (12)

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***Three Months***

**2016**

Unfavorable development for other professional liability was primarily due to higher than expected large loss emergence in accident years 2011 through 2015.

Favorable development for liability was primarily due to better than expected severity in accident years 2013 and prior.

Favorable development for other coverages was primarily due to better than expected severity in auto liability in accident years 2011 through 2015.

**2015**

Favorable development in property and marine was due to better than expected emergence in accident years 2012 through 2014.

Unfavorable development in other is due to large losses in financial institutions and political risk primarily in accident year 2014.

***Six Months***

**2016**

Unfavorable development for other professional liability was primarily due to higher than expected large loss emergence in accident years 2011 through 2015.

Favorable development for liability was primarily due to better than expected severity in accident years 2013 and prior.

Favorable development for other coverages was primarily due to better than expected severity in auto liability in accident years 2011 through 2015.

**2015**

Favorable development in property and marine was due to better than expected emergence in accident years 2012 through 2014.

Unfavorable development in other is due to large losses in financial institutions and political risk primarily in accident year 2014.

**Asbestos and Environmental Pollution ( A&EP ) Reserves**

In 2010, Continental Casualty Company ( CCC ) together with several of CNA 's insurance subsidiaries completed a transaction with National Indemnity Company ( NICO ), a subsidiary of Berkshire Hathaway Inc., under which substantially all of CNA 's legacy A&EP liabilities were ceded to NICO through a loss portfolio transfer (loss portfolio transfer or LPT ). At the effective date of the transaction, CNA ceded approximately \$1.6 billion of net A&EP claim

and allocated claim adjustment expense reserves to NICO under a retroactive reinsurance agreement with an aggregate limit of \$4.0 billion. The \$1.6 billion of claim and allocated claim adjustment expense reserves ceded to NICO was net of \$1.2 billion of ceded claim and allocated claim adjustment expense reserves under existing third party reinsurance contracts. The NICO LPT aggregate reinsurance limit also covers credit risk on the existing third party reinsurance related to these liabilities. CNA paid NICO a reinsurance premium of \$2.0 billion and transferred to NICO billed third party reinsurance receivables related to A&EP claims with a net book value of \$215 million, resulting in total consideration of \$2.2 billion.

Through December 31, 2013, CNA recognized \$0.9 billion of additional amounts ceded under the LPT. As a result, the cumulative amounts ceded under the LPT exceeded the \$2.2 billion consideration paid, resulting in the NICO LPT moving into a gain position, requiring deferred retroactive reinsurance accounting treatment. This deferred gain is recognized in earnings in proportion to actual paid recoveries under the LPT. Over the life of the contract, there is no economic impact as long as any additional losses incurred are within the limit of the LPT. In a

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period in which a change in the estimate of ceded incurred losses is recognized, the change to the deferred gain is cumulatively recognized in earnings as if the revised estimate was available at the effective date of the LPT.

The following table presents the impact of the loss portfolio transfer on the Consolidated Condensed Statements of Income.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>(In millions)</b>				
Net A&EP adverse development before consideration of LPT	\$ -	\$ 150	\$ 200	\$ 150
Provision for uncollectible third party reinsurance on A&EP				
Additional amounts ceded under LPT	-	150	200	150
Retroactive reinsurance benefit recognized	\$ (9)	(66)	(82)	(71)
Pretax impact of unrecognized deferred retroactive reinsurance benefit	\$ (9)	\$ 84	\$ 118	\$ 79

CNA completed its reserve review of A&EP reserves in the first quarter of 2016. Based upon CNA's review, net unfavorable development prior to cessions to the LPT of \$200 million was recognized. The unfavorable development was driven by an increase in anticipated future expenses associated with determination of coverage, higher anticipated payouts associated with a limited number of historical accounts having significant asbestos exposures and higher than expected severity on pollution claims. This unfavorable development was ceded to NICO under the LPT, however CNA's reported earnings were negatively affected due to the application of retroactive reinsurance accounting, as only a portion of the additional amounts ceded under the LPT were recognized that quarter. All amounts recognized related to the LPT are recorded within Insurance claims and policyholders' benefits in the Consolidated Condensed Statement of Income.

As of June 30, 2016 and December 31, 2015, the cumulative amounts ceded under the LPT were \$2.8 billion and \$2.6 billion. The unrecognized deferred retroactive reinsurance benefit was \$359 million and \$241 million as of June 30, 2016 and December 31, 2015.

NICO established a collateral trust account as security for its obligations to CNA. The fair value of the collateral trust account was \$2.6 billion and \$2.8 billion as of June 30, 2016 and December 31, 2015. In addition, Berkshire Hathaway Inc. guaranteed the payment obligations of NICO up to the full aggregate reinsurance limit as well as certain of NICO's performance obligations under the trust agreement. NICO is responsible for claims handling and billing and collection from third-party reinsurers related to CNA's A&EP claims.



**Table of Contents****6. Income Taxes**

The components of U.S. and foreign income before income tax and a reconciliation between the federal income tax expense at statutory rates and the actual income tax expense is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>(In millions)</b>				
Income (loss) before income tax:				
U.S.	\$ (142)	\$ 129	\$ (103)	\$ 266
Foreign	(134)	166	22	134
Total	\$ (276)	\$ 295	\$ (81)	\$ 400
Income tax expense (benefit) at statutory rate	\$ (97)	\$ 103	\$ (28)	\$ 140
Increase (decrease) in income tax expense resulting from:				
Exempt investment income	(33)	(29)	(64)	(58)
Foreign related tax differential	63	(32)	23	(5)
Valuation allowance	77		77	
Amortization of deferred charges associated with intercompany rig sales to other tax jurisdictions		4		41
Taxes related to domestic affiliate	(2)	4	1	(6)
Partnership earnings not subject to taxes	(11)	(7)	(28)	(20)
Unrecognized tax benefit	5	2	10	5
Other	10	3	17	7
Income tax expense	\$ 12	\$ 48	\$ 8	\$ 104

The effective tax rate is impacted by the change in the relative components of earnings or losses generated in foreign tax jurisdictions with lower tax rates.

In the second quarter of 2016, a valuation allowance of \$77 million was established for the future tax benefit of foreign tax credits in the U.S. which Diamond Offshore no longer expects to be able to realize prior to their expiration.

**7. Debt****CNA Financial**

In the first quarter of 2016, CNA completed a public offering of \$500 million aggregate principal amount of 4.5% senior notes due March 1, 2026 and used the net proceeds to repay the entire \$350 million outstanding principal amount of its 6.5% senior notes due August 15, 2016.



### **Diamond Offshore**

In the first quarter of 2016, Diamond Offshore cancelled its commercial paper program and repaid the \$287 million in commercial paper outstanding at December 31, 2015 with proceeds from Eurodollar loans under its revolving credit agreement. As of June 30, 2016, there was \$327 million outstanding under the revolving credit agreement.

### **Boardwalk Pipeline**

In May of 2016, Boardwalk Pipeline completed a public offering of \$550 million aggregate principal amount of 6.0% senior notes due June 1, 2026 and used the proceeds to reduce borrowings under its revolving credit facility.

### **Loews**

In March of 2016, the Company completed a public offering of \$500 million aggregate principal amount of 3.8% senior notes due April 1, 2026 and repaid in full the entire \$400 million aggregate principal amount of its 5.3% senior notes at maturity.

**Table of Contents****8. Shareholders' Equity****Accumulated other comprehensive income (loss)**

The tables below display the changes in Accumulated other comprehensive income ( AOCI ) by component for the three and six months ended June 30, 2015 and 2016:

	OTTI				Foreign	Total
	Gains	Unrealized	Cash Flow	Pension	Currency	Accumulat
	(Losses)	Gains (Losses)	Hedges	Liability	Translation	Other
		on Investments				Comprehens
						Income
(in millions)						(Loss)
Balance, April 1, 2015	\$ 31	\$ 944	\$ (3)	\$ (636)	\$ (38)	\$ 298
Changes during the period						
Other comprehensive income (loss) before reclassifications, net of tax of \$2, \$5, \$0, \$(18)	(4)	(370)		37	49	(288)
Classification changes from accumulated other comprehensive income, after tax of \$0, \$(5), \$0, and \$0		7	1	6		14
Other comprehensive income (loss) attributable to controlling interests	(4)	(363)	1	43	49	(274)
Balance, June 30, 2015	\$ 28	\$ 619	\$ (3)	\$ (598)	\$ 7	\$ 53

Balance, April 1, 2016	\$ 29	\$ 554	\$ (2)	\$ (643)	\$ (64)	\$ (126)
Other comprehensive income (loss) before reclassifications, net of tax of \$1,544, \$0, \$0	(1)	322			(48)	273
Classification (gains) losses on accumulated other comprehensive income, after tax of \$0, \$6, \$0, \$(4)		(1)		5		4
Other comprehensive income (loss) attributable to controlling interests	(1)	321	-	5	(48)	277
		(37)		(1)	6	(32)
Balance, June 2016	\$ 28	\$ 838	\$ (2)	\$ (639)	\$ (106)	\$ 119

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	OTTI				Foreign	Total
	Gains	Unrealized	Cash Flow	Pension	Currency	Accumulat
	(Losses)	Gains (Losses)	Hedges	Liability	Translation	Other
		on Investments				Comprehens
(in millions)						Income
						(Loss)
Balance, January 1, 2015	\$ 32	\$ 846	\$ (6)	\$ (641)	\$ 49	\$ 280
Change during the period						
Comprehensive income (loss) before reclassifications, net of tax of \$2, \$4, \$1, \$(18)	(5)	(251)	(2)	37	(47)	(268)
Classification (gains) losses						
on accumulated						
Comprehensive income, after tax of \$0, \$(5), \$(2), and \$0		(2)	6	10		14
Change during the period	(5)	(253)	4	47	(47)	(254)
Balance of equity						
attributable to						
controlling						
interests	1	26	(1)	(5)	5	26
Balance, June 30, 2015	\$ 28	\$ 619	\$ (3)	\$ (598)	\$ 7	\$ 53
Balance, January 1, 2016	\$ 24	\$ 347	\$ (3)	\$ (649)	\$ (76)	\$ (357)
Change during the period	2	539			(34)	507
Comprehensive income (loss)						

ore assifications, r tax of \$(1), 2), \$0, \$0 \$0						
lassification osses from mulated er prehensive me, after tax (1), \$(1), \$0, and \$0	2	10	1	13		26
er prehensive me (loss)	4	549	1	13	(34)	533
ounts tributable to controlling rests		(58)		(3)	4	(57)
ance, June 2016	\$ 28	\$ 838	\$ (2)	\$ (639)	\$ (106)	\$ 119

Amounts reclassified from AOCI shown above are reported in Net income (loss) as follows:

Major Category of AOCI	Affected Line Item
OTTI gains (losses)	Investment gains (losses)
Unrealized gains (losses) on investments	Investment gains (losses)
Cash flow hedges	Other revenues and Contract drilling expenses
Pension liability	Other operating expenses

**Table of Contents****Subsidiary Equity Transactions**

Loews purchased 0.3 million shares of CNA common stock at an aggregate cost of \$8 million during the six months ended June 30, 2016. The Company's percentage ownership interest in CNA remained unchanged as a result of these transactions, at 90%. The Company's purchase price of the shares was lower than the carrying value of its investment in CNA, resulting in an increase to Additional paid-in capital ( APIC ) of \$3 million.

**Treasury Stock**

The Company repurchased 2.6 million and 7.6 million shares of Loews common stock at aggregate costs of \$98 million and \$305 million during the six months ended June 30, 2016 and 2015.

**9. Benefit Plans**

The Company has several non-contributory defined benefit plans and postretirement benefit plans covering eligible employees and retirees.

The following table provides the components of net periodic benefit cost for the plans:

	<b>Pension Benefits</b>			
	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	2015	<b>2016</b>	2015
<b>(In millions)</b>				
Service cost	\$ 2	\$ 4	\$ 4	\$ 8
Interest cost	32	32	64	64
Expected return on plan assets	(44)	(49)	(88)	(97)
Amortization of unrecognized net loss	12	12	23	23
Settlement charge	1		2	
Net periodic benefit cost	\$ 3	\$ (1)	\$ 5	\$ (2)

	<b>Other Postretirement Benefits</b>			
	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	2015	<b>2016</b>	2015
<b>(In millions)</b>				

Interest cost			\$ 1	\$ 1
Expected return on plan assets	\$ (1)	\$ (1)	(2)	(2)
Amortization of unrecognized prior service benefit	(1)	(3)	(2)	(5)
Amortization of unrecognized net loss		1		1
Net periodic benefit cost	\$ (2)	\$ (3)	\$ (3)	\$ (5)

## 10. Business Segments

The Company's segments are CNA Financial's core property and casualty commercial insurance operations which include Specialty, Commercial and International; CNA's Other Non-Core operations; Diamond Offshore; Boardwalk Pipeline; Loews Hotels; and Corporate and other. The Company's reportable segments are primarily based on its individual operating subsidiaries. Each of the principal operating subsidiaries is headed by a chief executive officer who is responsible for the operation of its business and has the duties and authority commensurate with that position. Investment gains (losses) and the related income taxes, excluding those of CNA, are included in the Corporate and other segment. For additional disclosures regarding the composition of the Company's segments see Note 20 of the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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The following tables set forth the Company's consolidated revenues and income (loss) by business segment:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>(In millions)</b>				
<b>Revenues (a):</b>				
CNA Financial:				
Property and Casualty:				
Specialty	\$ 928	\$ 904	\$ 1,793	\$ 1,821
Commercial	876	883	1,678	1,778
International	214	220	429	426
Other Non-Core	330	320	651	654
Total CNA Financial	2,348	2,327	4,551	4,679
Diamond Offshore	390	632	861	1,259
Boardwalk Pipeline	308	299	655	629
Loews Hotels	189	167	352	306
Corporate and other	72	10	61	40
Total	\$ 3,307	\$ 3,435	\$ 6,480	\$ 6,913

**Income (loss) before income tax and noncontrolling interests (a):**

CNA Financial:				
Property and Casualty:				
Specialty	\$ 250	\$ 206	\$ 430	\$ 413
Commercial	146	122	241	308
International	(27)	35	(17)	48
Other Non-Core	(79)	(198)	(306)	(290)
Total CNA Financial	290	165	348	479
Diamond Offshore	(657)	106	(574)	(181)
Boardwalk Pipeline	65	38	164	115
Loews Hotels	4	14	13	24
Corporate and other	22	(28)	(32)	(37)
Total	\$ (276)	\$ 295	\$ (81)	\$ 400



**Net income (loss) (a):**

## CNA Financial:

## Property and Casualty:

Specialty	\$ 150	\$ 124	\$ 257	\$ 247
Commercial	86	72	142	182
International	(21)	19	(13)	28
Other Non-Core	(26)	(91)	(137)	(123)
Total CNA Financial	189	124	249	334
Diamond Offshore	(290)	45	(247)	(81)
Boardwalk Pipeline	17	12	48	37
Loews Hotels	1	8	4	13
Corporate and other	18	(19)	(17)	(24)
Total	\$ (65)	\$ 170	\$ 37	\$ 279

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(a) Investment gains (losses) included in Revenues, Income (loss) before income tax and noncontrolling interests and Net income (loss) are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>Revenues and Income (loss) before income tax and noncontrolling interests:</b>				
CNA Financial:				
Property and Casualty:				
Specialty	\$ 4		\$ (7)	\$ 4
Commercial	8	\$ 2	(10)	6
International	4	1	8	2
Other Non-Core	(3)	(5)	(6)	(4)
Total CNA Financial	13	(2)	(15)	8
Corporate and other	(12)		(12)	
Total	\$ 1	\$ (2)	\$ (27)	\$ 8

**Net income (loss):**

CNA Financial:				
Property and Casualty:				
Specialty	\$ 3	\$ 1	\$ (4)	\$ 3
Commercial	4		(6)	3
International	3		6	1
Other Non-Core	(4)	2	(7)	4
Total CNA Financial	6	3	(11)	11
Corporate and other	(4)		(4)	
Total	\$ 2	\$ 3	\$ (15)	\$ 11

**11. Legal Proceedings**

The Company and its subsidiaries are parties to litigation arising in the ordinary course of business. The outcome of this litigation will not, in the opinion of management, materially affect the Company's results of operations or equity.

**12. Commitments and Contingencies****CNA Financial**

In the course of selling business entities and assets to third parties, CNA agreed to guarantee the performance of certain obligations of a previously owned subsidiary and to indemnify purchasers for losses arising out of breaches of representation and warranties with respect to the business entities or assets sold, including, in certain cases, losses arising from undisclosed liabilities or certain named litigation. Such guarantee and indemnification agreements in effect for sales of business entities, assets and third party loans may include provisions that survive indefinitely. As of June 30, 2016, the aggregate amount related to quantifiable guarantees was \$375 million and the aggregate amount related to indemnification agreements was \$259 million. Should CNA be required to make payments under the guarantee, it would have the right to seek reimbursement in certain cases from an affiliate of a previously owned subsidiary.

In addition, CNA has agreed to provide indemnification to third party purchasers for certain losses associated with sold business entities or assets that are not limited by a contractual monetary amount. As of June 30, 2016, CNA had outstanding unlimited indemnifications in connection with the sales of certain of its business entities or assets that included tax liabilities arising prior to a purchaser's ownership of an entity or asset, defects in title at the time of sale, employee claims arising prior to closing and in some cases losses arising from certain litigation and undisclosed liabilities. Certain provisions of the indemnification agreements survive indefinitely while others survive until the applicable statutes of limitation expire, or until the agreed upon contract terms expire.

CNA also provided guarantees, if the primary obligor fails to perform, to holders of structured settlement annuities provided by a previously owned subsidiary. As of June 30, 2016, the potential amount of future payments CNA could be required to pay under these guarantees was approximately \$2.0 billion, which will be paid over the lifetime of the annuitants. CNA does not believe any payment is likely under these guarantees, as CNA is the beneficiary of a trust that must be maintained at a level that approximates the discounted reserves for these annuities.

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**13. Consolidating Financial Information**

The following schedules present the Company's consolidating balance sheet information at June 30, 2016 and December 31, 2015, and consolidating statements of income information for the six months ended June 30, 2016 and 2015. These schedules present the individual subsidiaries of the Company and their contribution to the Consolidated Condensed Financial Statements. Amounts presented will not necessarily be the same as those in the individual financial statements of the Company's subsidiaries due to adjustments for purchase accounting, income taxes and noncontrolling interests. In addition, many of the Company's subsidiaries use a classified balance sheet which also leads to differences in amounts reported for certain line items.

The Corporate and other column primarily reflects the parent company's investment in its subsidiaries, invested cash portfolio and corporate long term debt. The elimination adjustments are for intercompany assets and liabilities, interest and dividends, the parent company's investment in capital stocks of subsidiaries, and various reclasses of debit or credit balances to the amounts in consolidation. Purchase accounting adjustments have been pushed down to the appropriate subsidiary.

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Loews Corporation

Consolidating Balance Sheet Information

June 30, 2016	CNA Financial	Diamond Offshore	Boardwalk Pipeline	Loews Hotels	Corporate and Other	Eliminations	Total
<b>(In millions)</b>							
<b>Assets:</b>							
Investments	\$ 46,549	\$ 90	\$ 150	\$ 93	\$ 5,477		\$ 52,359
Cash	289	14	13	13	19		348
Receivables	7,799	328	74	37	399	\$ (21)	8,616
Property, plant and equipment	269	5,849	7,865	1,099	44		15,126
Deferred income taxes	314			3	58	(375)	-
Goodwill	111		237				348
Investments in capital stocks of subsidiaries					15,232	(15,232)	-
Other assets	930	225	317	272	7	15	1,766
Deferred acquisition costs of insurance subsidiaries	620						620
<b>Total assets</b>	<b>\$ 56,881</b>	<b>\$ 6,506</b>	<b>\$ 8,656</b>	<b>\$ 1,517</b>	<b>\$ 21,236</b>	<b>\$ (15,613)</b>	<b>\$ 79,183</b>

**Liabilities and  
Equity:**

Insurance reserves	\$ 37,980						\$ 37,980
Payable to brokers	448				\$ 862		1,310
Short term debt	1	\$ 327		\$ 2			330
Long term debt	2,711	1,980	\$ 3,626	644	1,774		10,735
Deferred income taxes	2	115	799	48		\$ (360)	604

<b>Other liabilities</b>	<b>3,878</b>	<b>467</b>	<b>509</b>	<b>67</b>	<b>293</b>	<b>(21)</b>	<b>5,193</b>
<b>Total liabilities</b>	<b>45,020</b>	<b>2,889</b>	<b>4,934</b>	<b>761</b>	<b>2,929</b>	<b>(381)</b>	<b>56,152</b>
<b>Total shareholders equity</b>	<b>10,638</b>	<b>1,928</b>	<b>1,550</b>	<b>754</b>	<b>18,307</b>	<b>(15,232)</b>	<b>17,945</b>
<b>Noncontrolling interests</b>	<b>1,223</b>	<b>1,689</b>	<b>2,172</b>	<b>2</b>			<b>5,086</b>
<b>Total equity</b>	<b>11,861</b>	<b>3,617</b>	<b>3,722</b>	<b>756</b>	<b>18,307</b>	<b>(15,232)</b>	<b>23,031</b>
<b>Total liabilities and equity</b>	<b>\$ 56,881</b>	<b>\$ 6,506</b>	<b>\$ 8,656</b>	<b>\$ 1,517</b>	<b>\$ 21,236</b>	<b>\$ (15,613)</b>	<b>\$ 79,183</b>

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Loews Corporation

## Consolidating Balance Sheet Information

December 31, 2015	CNA Financial	Diamond Offshore	Boardwalk Pipeline	Loews Hotels	Corporate and Other	Eliminations	Total
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(In millions)

**Assets:**

Investments	\$ 44,699	\$ 117		\$ 81	\$ 4,503		\$ 49,400
Cash	387	13	\$ 4	12	24		440
Receivables	7,384	409	93	35	96	\$ 24	8,041
Property, plant and equipment	333	6,382	7,712	1,003	47		15,477
Deferred income taxes	662			3	68	(733)	-
Goodwill	114		237				351
Investments in capital stocks of subsidiaries					15,129	(15,129)	-
Other assets	848	233	319	282		17	1,699
Deferred acquisition costs of insurance subsidiaries	598						598
<b>Total assets</b>	<b>\$ 55,025</b>	<b>\$ 7,154</b>	<b>\$ 8,365</b>	<b>\$ 1,416</b>	<b>\$ 19,867</b>	<b>\$ (15,821)</b>	<b>\$ 76,006</b>

**Liabilities and  
Equity:**

Insurance reserves	\$ 36,486						\$ 36,486
Payable to brokers	358				\$ 209		567
Short term debt	351	\$ 287		\$ 2	400		1,040
Long term debt	2,213	1,980	\$ 3,458	590	1,279		9,520
Deferred income taxes	5	276	766	47		\$ (712)	382
	3,883	496	510	70	222	20	5,201



Other liabilities

Total liabilities	43,296	3,039	4,734	709	2,110	(692)	53,196
Total shareholders equity	10,516	2,195	1,517	705	17,757	(15,129)	17,561
Noncontrolling interests	1,213	1,920	2,114	2			5,249
Total equity	11,729	4,115	3,631	707	17,757	(15,129)	22,810
Total liabilities and equity	\$ 55,025	\$ 7,154	\$ 8,365	\$ 1,416	\$ 19,867	\$ (15,821)	\$ 76,006

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Loews Corporation

Consolidating Statement of Income Information

Six Months Ended June 30, 2016	CNA Financial	Diamond Offshore	Boardwalk Pipeline	Loews Hotels	Corporate and Other	Eliminations	Total
<b>(In millions)</b>							
<b>Revenues:</b>							
Insurance premiums	\$ 3,429						\$ 3,429
Net investment income	937				\$ 72		1,009
Intercompany interest and dividends					632	\$ (632)	-
Investment losses	(15)	\$ (12)					(27)
Contract drilling revenues		801					801
Other revenues	200	60	\$ 655	\$ 352	1		1,268
<b>Total</b>	<b>4,551</b>	<b>849</b>	<b>655</b>	<b>352</b>	<b>705</b>	<b>(632)</b>	<b>6,480</b>
<b>Expenses:</b>							
Insurance claims and policyholders benefits	2,747						2,747
Amortization of deferred acquisition costs	612						612
Contract drilling expenses		411					411
Other operating expenses	756	974	403	328	57		2,518
Interest	88	50	88	11	36		273
<b>Total</b>	<b>4,203</b>	<b>1,435</b>	<b>491</b>	<b>339</b>	<b>93</b>	<b>-</b>	<b>6,561</b>
Income (loss) before income tax	348	(586)	164	13	612	(632)	(81)
Income tax (expense) benefit	(71)	100	(35)	(9)	7		(8)
Net income (loss)	277	(486)	129	4	619	(632)	(89)
	(28)	235	(81)				126

**Amounts attributable to noncontrolling interests**

<b>Net income (loss) attributable to Loews Corporation</b>	<b>\$ 249</b>	<b>\$ (251)</b>	<b>\$ 48</b>	<b>\$ 4</b>	<b>\$ 619</b>	<b>\$ (632)</b>	<b>\$ 37</b>
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Loews Corporation

Consolidating Statement of Income Information

Six Months Ended June 30, 2015	CNA Financial	Diamond Offshore	Boardwalk Pipeline	Loews Hotels	Corporate and Other	Eliminations	Total
(In millions)							
<b>Revenues:</b>							
Insurance premiums	\$ 3,422						\$ 3,422
Net investment income	1,058	\$ 1			\$ 39		1,098
Intercompany interest and dividends					650	\$ (650)	-
Investment gains	8						8
Contract drilling revenues		1,217					1,217
Other revenues	191	41	\$ 629	\$ 306	1		1,168
<b>Total</b>	<b>4,679</b>	<b>1,259</b>	<b>629</b>	<b>306</b>	<b>690</b>	<b>(650)</b>	<b>6,913</b>

**Expenses:**

Insurance claims and policyholders benefits	2,808						2,808
Amortization of deferred acquisition costs	617						617
Contract drilling expenses		695					695
Other operating expenses	697	696	423	272	40		2,128
Interest	78	49	91	10	37		265
<b>Total</b>	<b>4,200</b>	<b>1,440</b>	<b>514</b>	<b>282</b>	<b>77</b>	<b>-</b>	<b>6,513</b>
Income (loss) before income tax	479	(181)	115	24	613	(650)	400
Income tax (expense) benefit	(107)	22	(21)	(11)	13		(104)
Net income (loss)	372	(159)	94	13	626	(650)	296
Amounts attributable to noncontrolling interests	(38)	78	(57)				(17)
Net income (loss) attributable to Loews	\$ 334	\$ (81)	\$ 37	\$ 13	\$ 626	\$ (650)	\$ 279

Corporation

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

Management's discussion and analysis of financial condition and results of operations ( MD&A ) should be read in conjunction with our Consolidated Condensed Financial Statements included in Item 1 of this Report, Risk Factors included in Part II, Item 1A of this Report, and the Consolidated Financial Statements, Risk Factors, and MD&A included in our Annual Report on Form 10-K for the year ended December 31, 2015. This MD&A is comprised of the following sections:

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<b>OVERVIEW</b>	

We are a holding company. Our subsidiaries are engaged in the following lines of business:

commercial property and casualty insurance (CNA Financial Corporation ( CNA ), a 90% owned subsidiary);

operation of offshore oil and gas drilling rigs (Diamond Offshore Drilling, Inc. ( Diamond Offshore ), a 53% owned subsidiary);

transportation and storage of natural gas and natural gas liquids and gathering and processing of natural gas (Boardwalk Pipeline Partners, LP ( Boardwalk Pipeline ), a 51% owned subsidiary); and

operation of a chain of hotels (Loews Hotels Holding Corporation ( Loews Hotels ), a wholly owned subsidiary).

Unless the context otherwise requires, references in this Report to Loews Corporation, the Company, Parent Company, we, our, us or like terms refer to the business of Loews Corporation excluding its subsidiaries.

### **Consolidated Financial Results**

Net loss for the three months ended June 30, 2016 was \$65 million, or \$0.19 per share, compared to net income of \$170 million, or \$0.46 per share, in the prior year period. Net income for the six months ended June 30, 2016 was \$37 million, or \$0.11 per share, compared to \$279 million, or \$0.75 per share, in the prior year period.

Results include asset impairment charges at Diamond Offshore Drilling, Inc. of \$267 million (after tax and noncontrolling interests) for the three and six months ended June 30, 2016 and \$158 million (after tax and noncontrolling interests) for the six months ended June 30, 2015.

Book value per share excluding accumulated other comprehensive income (AOCI) increased to \$52.84 at June 30, 2016 from \$52.72 at December 31, 2015.

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### ***Three Months Ended June 30, 2016 Compared to 2015***

Results for the three months ended June 30, 2016 decreased \$235 million as compared to the prior year due to an asset impairment charge at Diamond Offshore partially offset by higher earnings at CNA and improved results from the parent company investment portfolio due to higher income from equity securities.

CNA's earnings increased due to the impact of a \$49 million charge (after tax and noncontrolling interests) in 2015 related to the 2010 retroactive reinsurance agreement to cede its legacy asbestos and environmental pollution liabilities (loss portfolio transfer or LPT). CNA's earnings also benefited from increased favorable net prior year development.

Diamond Offshore's earnings decreased due to an asset impairment charge of \$680 million (\$267 million after tax and noncontrolling interests) related to the carrying value of Diamond Offshore's drilling rigs. Absent this charge, Diamond Offshore's earnings declined due to a substantial reduction in the number of rigs operating as compared to the year ago period partially offset by lower depreciation expense resulting mainly from the asset impairment charges recorded in 2015.

Boardwalk Pipeline's earnings increased partially due to new rates in effect following the Gulf South rate case and proceeds received from a one-time legal settlement. Additionally, the Evangeline pipeline, which was placed into service in mid-2015, and new growth projects contributed to earnings.

Loews Hotels' earnings decreased due to an impairment charge related to a joint venture property.

### ***Six Months Ended June 30, 2016 Compared to 2015***

Net income for the six months ended June 30, 2016 decreased primarily due to lower earnings at CNA and Diamond Offshore partially offset by higher earnings at Boardwalk Pipeline and improved results from the parent company investment portfolio due to higher income from equity securities.

CNA's earnings decreased due to lower net investment income driven by limited partnership investment results, realized investment losses in 2016 as compared to gains in 2015 and a higher LPT charge in 2016 as compared to the prior year period. These items were partially offset by increased favorable net prior year development.

Diamond Offshore's earnings decreased due to increased asset impairment charges. Excluding these impairment charges, year-over-year earnings decreased as a result of a substantial reduction in the number of operating rigs partially offset by revenue earned by newbuild drillships and lower depreciation expense as a result of the asset impairment charges recorded in 2015.

The change in Boardwalk Pipeline's and Loews Hotels' results are primarily due to the reasons discussed above in the three month comparison.

## **Parent Company Structure**

We are a holding company and derive substantially all of our cash flow from our subsidiaries. We rely upon our invested cash balances and distributions from our subsidiaries to generate the funds necessary to meet our obligations and to declare and pay any dividends to our shareholders. The ability of our subsidiaries to pay dividends is subject to, among other things, the availability of sufficient earnings and funds in such subsidiaries, applicable state laws, including in the case of the insurance subsidiaries of CNA, laws and rules governing the payment of dividends by



regulated insurance companies and compliance with covenants in their respective loan agreements. Claims of creditors of our subsidiaries will generally have priority as to the assets of such subsidiaries over our claims and those of our creditors and shareholders.

### **CRITICAL ACCOUNTING ESTIMATES**

Certain accounting estimates require us to make judgments that affect the amounts reflected in the Consolidated Condensed Financial Statements. Such estimates and judgments necessarily involve varying, and possibly significant, degrees of uncertainty. Accordingly, certain amounts currently recorded in the financial statements will likely be adjusted in the future based on new available information and changes in other facts and circumstances. See the Critical Accounting Estimates section and the Results of Operations by Business Segment – CNA Financial – Reserves Estimates and Uncertainties section of our MD&A included under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015 for further information.

**Table of Contents****RESULTS OF OPERATIONS BY BUSINESS SEGMENT**

Unless the context otherwise requires, references to net operating income (loss), net realized investment results and net income (loss) reflect amounts attributable to Loews Corporation shareholders.

**CNA Financial**

The following table summarizes the results of operations for CNA for the three and six months ended June 30, 2016 and 2015 as presented in Note 13 of the Notes to Consolidated Condensed Financial Statements included in Item 1 of this Report. For further discussion of Net investment income and Net realized investment results, see the Investments section of this MD&A.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
<b>(In millions)</b>				
<b>Revenues:</b>				
Insurance premiums	\$ 1,730	\$ 1,735	\$ 3,429	\$ 3,422
Net investment income	502	500	937	1,058
Investment gains (losses)	13	(2)	(15)	8
Other revenues	103	94	200	191
<b>Total</b>	<b>2,348</b>	<b>2,327</b>	<b>4,551</b>	<b>4,679</b>
<b>Expenses:</b>				
Insurance claims and policyholders benefits	1,339	1,469	2,747	2,808
Amortization of deferred acquisition costs	305	314	612	617
Other operating expenses	376	340	756	697
Interest	38	39	88	78
<b>Total</b>	<b>2,058</b>	<b>2,162</b>	<b>4,203</b>	<b>4,200</b>
Income before income tax	290	165	348	479
Income tax expense	(80)	(27)	(71)	(107)
<b>Net income</b>	<b>210</b>			

<b>Changes in operating assets and liabilities, net of effect of acquisitions:</b>				
Accounts receivable	(2,451)	804	-	(1,647)
Related party receivables	(240)	-	-	(240)
Inventory	(1,293)	291	-	(1,002)
Prepaid and other current assets	88	290	-	378
Other assets	(449)	179	-	(270)
Accounts payable	3,479	39	-	3,518
Accrued expenses and other current liabilities	(3,730)	53	-	(3,677)
<b>Total change in operating assets and liabilities</b>	<b>(4,596)</b>	<b>1,656</b>	<b>-</b>	<b>(2,940)</b>
<b>Net cash used for operating activities of continuing operations</b>				
	(612)	1,488	332	2,432
<b>Net cash used for operating activities of discontinued operations</b>				
	-	(1,488)	-	(1,488)
<b>Net cash used for operating activities</b>				
	(5,929)	-	-	(5,929)
<b>Cash flows from investing activities:</b>				
Purchase of property, plant and equipment	(760)	4	-	(756)
Cash purchase of businesses, net of cash acquired	(500)	-	-	(500)
Funding of restricted cash	(98)	-	-	(98)
Purchase of marketable securities	(50)	-	-	(50)
Sale of marketable securities	2,400	-	-	2,400
Investing activities of discontinued operations	-	(4)	-	(4)
<b>Net cash provided by investing activities</b>	<b>\$ 992</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 992</b>

(1) See Note 7 "Discontinued Operations and Restructuring Charges" in Notes to the Condensed Consolidated Financial Statements.

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	As Previously Reported	EMD Discontinued Operations Adjustment (1)	Stock Compensation Expense Adjustment	As Restated
<i>(Continued from previous page)</i>				
<b>Cash flows from financing activities:</b>				
Payments on capital lease obligations	(8)	-	-	(8)
Proceeds from exercise of stock options	436	-	-	436
Proceeds from employee stock purchase plan	326	-	-	326
Convertible debt/equity issuance costs	(103)	-	-	(103)
Net cash provided by financing activities	651	-	-	651
Net decrease in cash and cash equivalents	(4,286)	-	-	(4,286)
Cash and cash equivalents at beginning of period	19,525	-	-	19,525
Cash and cash equivalents at end of period	\$ 15,239	\$ -	\$ -	\$ 15,239

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

Cash paid during the period for interest	\$ 2,466	\$ -	\$ -	\$ 2,466
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**NON-CASH INVESTING AND FINANCING ACTIVITIES:**

Acquisition of property and equipment under capital leases	\$ 70	\$ -	\$ -	\$ 70
Issuance of common stock in conjunction with an acquisition	\$ 2,325	\$ -	\$ -	\$ 2,325

(1) See Note 7 "Discontinued Operations and Restructuring Charges" in Notes to the Condensed Consolidated Financial Statements.

**NOTE 19. Subsequent Events**Relocation of Headquarters and Departure and Appointment of Certain Officers

Shortly after the Company sold both its New Jersey-based EMD division and its GELcore joint venture, we announced the relocation of our headquarters to Albuquerque, New Mexico. Three officers of the Company decided against relocation and resigned.

- Mr. Thomas G. Werthan, an Executive Vice President and Chief Financial Officer of the Company, resigned and left the Company on February 19, 2007. Mr. Werthan joined the Company in June 1992. Mr. Werthan will continue to be a member of the Board of Directors, a position he has held since joining the Company. In February 2007, Mr. Adam Gushard, former Vice President of Finance, was appointed Interim Chief Financial Officer. As discussed in Note 10, Receivables, of the Notes to Consolidated Financial Statements, in connection with Mr. Werthan's resignation and pursuant to the terms of his promissory note, the Board of Directors forgave a loan he had with the Company. Mr. Werthan was responsible for the personal taxes related to the loan forgiveness.

- Mr. Howard W. Brodie, an Executive Vice President, Chief Legal Officer and Secretary of the Company, resigned and left the Company on April 27, 2007. Mr. Brodie joined the Company in 1999. In April 2007, Mr. Keith Kosco was appointed Chief Legal Officer and Secretary of the Company.
- Dr. Richard A. Stall, Executive Vice President and the Chief Technology Officer of the Company, resigned and left the Company on June 27, 2007. Dr. Stall co-founded the Company in 1984. On December 18, 2006, after ten years of service on the Board, Dr. Stall resigned his seat on the Board. Dr. John Iannelli, Ph.D. joined the Company in January 2003 through the acquisition of Ortel from Agere Systems and was appointed Chief Technology Officer in June 2007.

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Strategic Investment in WorldWater & Solar Technologies Corporation (“WorldWater”)

On April 9, 2007, EMCORE delivered a letter to WorldWater advising them that subject to the matters set forth therein, EMCORE would make additional investments in WorldWater. Subject to signing definitive agreements, EMCORE intends to (1) purchase 5,000,000 shares of WorldWater's common stock at \$0.50 per share, with a five year warrant to purchase 1,250,000 shares of the WorldWater's common stock at \$0.50, under the terms of a Confidential Private Placement Memorandum prepared by WorldWater and dated as of March 2007 and (2) complete the \$4,500,000 Tranche B investment previously agreed to in the Investment Agreement, dated November 29, 2006 between EMCORE and WorldWater provided that the purchase of shares pursuant to the Tranche B Investment will occur at a purchase price of \$0.40 per share and EMCORE will be entitled to 25% warrant coverage at \$0.40 per share. Subsequent to April 9, 2007, material changes were made to the terms of the proposed offering discussed in (1) above, and we elected not to participate.

Restructuring of the Company’s 5% Convertible Senior Subordinated Notes due 2011

On April 9, 2007, the Company entered into a First Supplemental Indenture (the “2004 Supplemental Indenture”) with Deutsche Bank Trust Company Americas, as trustee (the “Trustee”), which amends the Indenture, dated as of February 24, 2004 (the “2004 Indenture”), between the Company and the Trustee, governing the Company’s 5% Convertible Senior Subordinated Notes due 2011 issued thereunder (the “2004 Notes”). Also on April 9, 2007, the Company entered into a First Supplemental Indenture (the “2005 Supplemental Indenture” and together with the 2004 Supplemental Indenture, the “Supplemental Indentures”) with the Trustee, which amends the Indenture, dated as of November 16, 2005 (the “2005 Indenture” and together with the 2004 Indenture, the “Indentures”), between the Company and the Trustee, governing the Company’s 5% Convertible Senior Subordinated Notes due 2011 issued thereunder (the “2005 Notes” and together with the 2004 Notes, the “Notes”).

Each Supplemental Indenture, among other things, increased the interest rate of the applicable Notes to 5.5% from 5.0%, reduced the Conversion Price (as defined in the applicable Indenture) from \$8.06 to \$7.01, provided for an increase in the Conversion Rate (as defined in the applicable Supplemental Indenture) in the event of a Non-Stock Change of Control (as defined in the applicable Supplemental Indenture), amended the restriction on payment of dividends, amended the definition of “Events of Default” and provided for an additional payment in certain circumstances in which the Company fails to comply with its reporting obligations under the applicable Indenture. The Supplemental Indentures also provided a waiver of the Company’s failure to file certain reports with the SEC.

In order to give effect to the Supplemental Indentures, the Company entered into a Consent to Amendment and Waiver, dated as of April 9, 2007 (the “2004 Consent”), with certain holders of the 2004 Notes (the “2004 Consenting Holders”), and a Consent to Amendment and Waiver, dated as of April 9, 2007 (the “2005 Consent” and together with the 2004 Consent, the “Consents”), with the holder of the 2005 Notes (together with the 2004 Consenting Holders, the “Consenting Holders”), pursuant to which holders of at least a majority of the outstanding 2004 Notes and at least a majority of the 2005 Notes consented to the execution and delivery of the 2004 Supplemental Indenture and the 2005 Supplemental Indenture, respectively. The Consenting Holders also waived any and all Defaults (as defined in the applicable Indenture) and Events of Default (as defined in the applicable Indenture) relating to any failure of the Company to observe or perform any covenant or agreement contained in the Notes or the Indentures as a result of the Company’s failure to file with the SEC, or with the Trustee, its Annual Report on Form 10-K for the year ended September 30, 2006, its Annual Report on Form 10-Q for the quarter ended December 31, 2006 and/or any other reports that the Company fails to file in a timely manner for reasons in whole or in part directly or indirectly attributable to or arising out of the Company’s review of its historical stock option grants as initially reported in the Company’s Current Report on Form 8-K filed with the SEC on November 6, 2006. The Consenting Holders agree to rescind any notice of acceleration delivered to the Company with respect to such failure to file.

The Consents also provided the Company with the option to repurchase an aggregate of \$11.4 million of the outstanding principal amount of the Notes held by the Consenting Holders at a purchase price equal to \$1,000 per \$1,000 principal amount of the Notes purchased, plus accrued and unpaid interest, if any, to but excluding the date of purchase. The Company exercised this option and repurchased \$11.4 million of its outstanding notes on April 13, 2007. Accordingly, the Company classified the \$11.4 million principal repayment as a current liability as of December 31, 2006 and September 30, 2006.

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Acquisition of Opticomm Corporation

In April 2007, EMCORE acquired privately-held Opticomm Corporation of San Diego, California, including its fiber optic video, audio and data networking business, technologies, and intellectual property. EMCORE paid \$4.0 million initial consideration for all of the shares of Opticomm. EMCORE also agreed to an additional earn-out payment based on Opticomm's 2007 revenues. Opticomm is one of the leading specialists in the field of fiber optic video, audio and data networking for the commercial, governmental and industrial sectors.

Option Grant Modification for Affected Former Employees

Under the terms of option agreements issued under the 2000 Plan, terminated employees who have vested and exercisable stock options have 90 days after the date of termination to exercise the options. In November 2006, the Company announced suspension of reliance on previously issued financial statements which in turn caused the Form S-8 registration statements for shares of common stock issuable under the option plans not to be available. Therefore, terminated employees were precluded from exercising their options during the remaining contractual term. This November 2006 modification did not have any accounting impact as there was no incremental compensation in accordance with SFAS 123(R).

To address this issue with affected former employees under the 2000 Plan, EMCORE's Board of Directors agreed in April 2007 to approve an option grant "modification" for these individuals by extending the normal 90-day exercise period after termination date to a date after which EMCORE becomes compliant with its SEC filings and the registration of the option shares is once again effective. The Company is preparing a plan of communication with its terminated employees relating to the tolling arrangement which is expected to be finalized as soon as reasonably practicable. We will account for the April 2007 modification of stock options as additional compensation expense in accordance with SFAS 123(R).

Section 409A

Section 409A of the Internal Revenue Code ("Section 409A") states that options granted with an exercise price below the fair market value are subject to a 20% excise tax on any gains derived from the exercise of such options if the options vested subsequent to December 31, 2004 and were exercised subsequent to December 31, 2005 (the "Affected Options"). The Company has taken certain actions to address the adverse tax consequences under Section 409A and a comparable provision of the California Tax Code ("California Section 409A") resulting to individuals that received Affected Options. The Company participated in a Federal Internal Revenue Service and a California Franchise Tax Board program and paid the Section 409A and California Section 409A taxes and interest on behalf of these non-executives. The Company incurred and recorded approximately \$0.3 million in the second quarter of fiscal 2007 in connection with its participation in these programs.



Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934. These forward-looking statements are based largely on our current expectations and projections about future events and financial trends affecting the financial condition of our business. These forward-looking statements may be identified by the use of terms and phrases such as "expects", "anticipates", "intends", "plans", "believes", "estimates", "targets", "can", "may", "could", "will", variations of these terms and similar phrases. Management cautions that these forward-looking statements are subject to business, economic, and other risks and uncertainties, both known and unknown, that may cause actual results to be materially different from those discussed in these forward-looking statements. The cautionary statements made in this Report should be read as being applicable to all forward-looking statements wherever they appear in this Report. This discussion should be read in conjunction with the consolidated financial statements, including the related notes.*

*These forward-looking statements include, without limitation, any and all statements or implications regarding:*

- *The ability of EMCORE Corporation ("EMCORE") to remain competitive and a leader in its industry and the future growth of the company, the industry, and the economy in general;*
  - *Difficulties in integrating recent or future acquisitions into our operations;*
- *The expected level and timing of benefits to EMCORE from on-going cost reduction efforts, including (i) expected cost reductions and their impact on our financial performance, (ii) our continued leadership in technology and manufacturing in its markets, and (iii) our belief that the cost reduction efforts will not impact product development or manufacturing execution;*
  - *Expected improvements in our product and technology development programs;*
- *Whether our products will (i) be successfully introduced or marketed, (ii) be qualified and purchased by our customers, or (iii) perform to any particular specifications or performance or reliability standards; and/or*
- *Guidance provided by EMCORE regarding our expected financial performance in current or future periods, including, without limitation, with respect to anticipated revenues, income, or cash flows for any period in fiscal 2007 and subsequent periods.*

*These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those projected, including without limitation, the following:*

- *EMCORE's cost reduction efforts may not be successful in achieving their expected benefits, or may negatively impact our operations;*
- *The failure of our products (i) to perform as expected without material defects, (ii) to be manufactured at acceptable volumes, yields, and cost, (iii) to be qualified and accepted by our customers, and (iv) to successfully compete with products offered by our competitors; and/or*
- *Other risks and uncertainties described in EMCORE's filings with the Securities and Exchange Commission ("SEC") such as: cancellations, rescheduling, or delays in product shipments; manufacturing capacity constraints; lengthy sales and qualification cycles; difficulties in the production process; changes in semiconductor industry growth; increased competition; delays in developing and commercializing new products; and other factors.*

*Neither management nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. Forward-looking statements are made only as of the date of this Report and subsequent facts or circumstances may contradict, obviate, undermine, or otherwise fail to support or substantiate such statements. We assume no obligation to update the matters discussed in this Quarterly Report on Form 10-Q to conform such statements to actual results or to changes in our expectations, except as required by applicable law or regulation.*

### **Financial Statement Restatements**

This Quarterly Report on Form 10-Q for the period ended December 31, 2006 reflects a restatement for additional stock-based compensation expense, under the appropriate accounting treatment for stock options, for the three month period ended December 31, 2005. This Quarterly Report also reflects the reclassification of the results of operations of EMCORE's Electronic Materials & Device ("EMD") division to discontinued operations (see Note 7, Discontinued Operations and Restructuring Charges, of the Notes to Condensed Consolidated Financial Statements). We have not amended and we do not intend to amend any of our other previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q.

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**Business Overview**

EMCORE Corporation (the “Company”, “we”, or “EMCORE”) is a leading provider of compound semiconductor-based components and subsystems for the broadband, fiber optic, satellite and terrestrial solar power markets. We have two operating segments: Fiber Optics and Photovoltaics. EMCORE's Fiber Optics segment offers optical components, subsystems and systems that enable the transmission of video, voice and data over high-capacity fiber optic cables for high-speed data and telecommunications, cable television (“CATV”) and fiber-to-the-premises (“FTTP”) networks. EMCORE's Photovoltaics segment provides solar products for satellite and terrestrial applications. For satellite applications, EMCORE offers high-efficiency compound semiconductor-based gallium arsenide (“GaAs”) solar cells, covered interconnect cells (“CICs”) and fully integrated solar panels. For terrestrial applications, EMCORE offers its high-efficiency GaAs solar cells for use in solar power concentrator systems. For specific information about our company, our products or the markets we serve, please visit our website at <http://www.emcore.com>. We were established in 1984 as a New Jersey corporation.

**Management Summary**

Our principal objective is to maximize shareholder value by leveraging our expertise in advanced compound semiconductor technologies to be a leading provider of high-performance, cost-effective product solutions in each of the markets we serve.

We target market opportunities that we believe have large potential growth and where the favorable performance characteristics of our products and high volume production efficiencies may give us a competitive advantage over our competitors. We believe that as compound semiconductor production costs continue to be reduced, existing and new customers will be compelled to increase their use of these products because of their attractive performance characteristics and superior value.

With several strategic acquisitions and divestures in the past year, EMCORE has developed a strong business focus and comprehensive product portfolios in two main sectors: Fiber Optics and Photovoltaics.

**Fiber Optics**

Our fiber optics products enable information that is encoded on light signals to be transmitted, routed (switched) and received in communication systems and networks. Our fiber optics products provide our customers with increased capacity to offer more services, at increased data transmission distance, speed and bandwidth with lower noise video receive and lower power consumption. Our Fiber Optics segment primarily targets the following markets:

- **Cable Television (CATV) Networks** - We are a market leader in providing radio frequency (RF) over fiber products for the CATV industry. Our products are used in hybrid fiber coaxial (HFC) networks that enable cable service operators to offer multiple advanced services to meet the expanding demand for high-speed Internet, on-demand and interactive video and other advanced services, such as high-definition television (HDTV) and voice over IP (VoIP).
- **Fiber-to-the-Premises (FTTP) Networks** - Telecommunications companies are increasingly extending their optical infrastructure to the customer’s location in order to deliver higher bandwidth services. We have developed and maintained customer qualified FTTP components and subsystem products to support plans by telephone companies to offer voice, video and data services through the deployment of new fiber-based access networks.

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**Data Communications Networks** - We provide leading-edge optical components and modules for data applications that enable switch-to-switch, router-to-router and server-to-server backbone connections at aggregate speeds of 10 gigabits per second (G) and above.

• **Telecommunications Networks** - Our leading-edge optical components and modules enable high-speed (up to an aggregate 40G) optical interconnections that drive advanced architectures in next-generation carrier class switching and routing networks. Our products are used in equipment in the network core and key metro optical nodes of voice telephony and Internet infrastructures.

• **Satellite Communications (Satcom) Networks** - We are a leading provider of optical components and systems for use in equipment that provides high-performance optical data links for the terrestrial portion of satellite communications networks.

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- **Storage Area Networks** - Our high performance optical components are also used in high-end data storage solutions to improve the performance of the storage infrastructure.
- **Video Transport** - Our video transport product line offers solutions for broadcasting, transportation, IP television (IPTV), mobile video and security & surveillance applications over private and public networks. EMCORE's video, audio, data and RF transmission systems serve both analog and digital requirements, providing cost-effective, flexible solutions geared for network reconstruction and expansion.
- **Defense and Homeland Security** - Leveraging our expertise in RF module design and high-speed parallel optics, we provide a suite of ruggedized products that meet the reliability and durability requirements of the Government and defense markets. Our specialty defense products include fiber optic gyro components used in precision guided munitions, ruggedized parallel optic transmitters and receivers, high-frequency RF fiber optic link components for towed decoy systems, optical delay lines for radar systems, EDFAs, terahertz spectroscopy systems and other products.
- **Consumer Products** - We intend to extend our optical technology into the consumer market by integrating our VCSELs into optical computer mice and ultra short data links. We are in production with customers on several products and currently qualifying our products with additional customers. An optical computer mouse with laser illumination is superior to LED-based illumination in that it reveals surface structures that a LED light source cannot uncover. VCSELs enable computer mice to track with greater accuracy, on more surfaces and with greater responsiveness than existing LED-based solutions.

Photovoltaics

We believe our high-efficiency compound semiconductor GaAs solar cell products provide our customers with compelling cost and performance advantages over traditional silicon-based solutions. These include higher solar cell efficiency, allowing for greater conversion of light into electricity, an increased ability to benefit from use in solar concentrator systems, ability to withstand high heat environments and reduced overall footprint. Our Photovoltaics segment serves two primary markets: Satellite Solar Power Generation and Terrestrial Solar Power Generation.

- **Satellite Solar Power Generation.** We are a leader in providing solar power generation solutions to the global communications satellite industry and U.S. Government space programs. We provide advanced compound semiconductor solar cell and solar panel products, which are more resistant to radiation levels in space and generate substantially more power from sunlight than silicon-based solutions. Space power systems using our multi-junction solar cells weigh less per unit of power than traditional silicon-based solar cells. These performance characteristics increase satellite useful life, increase satellites' transmission capacity and reduce launch costs. Our products provide our customers with higher light to power conversion efficiency for reduced size and launch costs; higher radiation tolerance; and long lifetime in harsh space environments. We design and manufacture multi-junction compound semiconductor solar cells for both commercial and military satellite applications. We currently manufacture and sell one of the most efficient and reliable, radiation resistant advanced triple-junction solar cells in the world, with an average "beginning of life" efficiency of 28.5%. In May 2007, EMCORE announced that it has attained a solar conversion efficiency of 31% for an entirely new class of advanced multi-junction solar cells optimized for space applications. EMCORE is also the only manufacturer to supply true monolithic bypass diodes, for shadow protection, utilizing several EMCORE patented methods. A satellite's operational success and corresponding revenue depend on its available power and its capacity to transmit data. EMCORE also provides covered interconnect cells (CICs) and solar panel lay-down services, giving us the capacity to manufacture complete solar panels. We can provide satellite manufacturers with proven integrated satellite power solutions that considerably improve satellite economics. Satellite manufacturers and solar array integrators rely on EMCORE to meet their satellite power needs with our proven flight heritage.

• **Terrestrial Solar Power Generation.** Solar power generation systems use photovoltaic cells to convert sunlight to electricity and have been used in space programs and, to a lesser extent, in terrestrial applications for several decades. The market for terrestrial solar power generation solutions has grown significantly as solar power generation technologies improve in efficiency, as global prices for non-renewable energy sources (e.g., fossil fuels) continue to rise, and as concern has increased regarding the effect of carbon emissions on global warming. Terrestrial solar power generation has emerged as one of the most rapidly growing renewable energy sources due to certain advantages solar power holds over other energy sources, including reduced environmental impact, elimination of fuel price risk, installation flexibility, scalability, distributed power generation (i.e., electric power is generated at the point of use rather than transmitted from a central station to the user), and reliability. The rapid increase in demand for solar power has created a growing need for highly efficient, reliable and cost-effective solar power concentrator systems.

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EMCORE has adapted its high-efficiency compound semiconductor-based GaAs solar cell products for terrestrial applications, which are intended for use with solar concentrator systems in utility-scale installations. In August 2007, EMCORE announced that it has reached 39% peak conversion efficiency on its terrestrial concentrating solar cell products currently in volume production. This compares favorably to typical efficiency of 15-21% on silicon-based solar cells. We believe that solar concentrator systems assembled using our compound semiconductor solar cells will be competitive with silicon-based solar power generation systems because they are more efficient and, when combined with the advantages of concentration, we believe it will result in a lower cost of power generated. Our multi-junction solar cell technology is not subject to silicon shortages, which has led to increasing prices in the raw materials required for silicon-based solar cells. While the terrestrial power generation market is still developing, we have already fulfilled production orders for one solar concentrator company, and provided samples to several others, including major system manufacturers in Europe and Asia.

Recent investments and strategic partnerships include:

- In November 2006, EMCORE invested \$13.5 million in WorldWater & Solar Technologies Corporation (“WorldWater”, OTC BB: WWAT.OB) a leader in solar electric engineering, water management solutions and solar energy installations and products. This investment represents EMCORE’s first tranche of its intended \$18.0 million investment, in return for convertible preferred stock and warrants of WorldWater, equivalent to approximately 31% equity ownership in WorldWater, or approximately 26.5% on a fully-diluted basis.
- Also in November 2006, EMCORE and WorldWater announced the formation of a strategic alliance and supply agreement under which EMCORE will be the exclusive supplier of high-efficiency multi-junction solar cells, assemblies and concentrator subsystems to WorldWater with expected revenues up to \$100.0 million over the next three years.
- In April 2007, EMCORE delivered a letter to WorldWater advising them that subject to the matters set forth therein, EMCORE would make additional investments in WorldWater. Subject to signing definitive agreements, EMCORE intends to (1) purchase 5,000,000 shares of WorldWater's common stock at \$0.50 per share, with a five year warrant to purchase 1,250,000 shares of the WorldWater's common stock at \$0.50, under the terms of a Confidential Private Placement Memorandum prepared by WorldWater and dated as of March 2007 and (2) complete the \$4,500,000 Tranche B investment previously agreed to in the Investment Agreement, dated November 29, 2006 between EMCORE and WorldWater provided that the purchase of shares pursuant to the Tranche B Investment will occur at a purchase price of \$0.40 per share and EMCORE will be entitled to 25% warrant coverage at \$0.40 per share. Subsequent to April 9, 2007, material changes were made to the terms of the proposed offering discussed in (1) above, and we elected not to participate.

We are committed to the ongoing evaluation of strategic opportunities that can expand our addressable markets and strengthen our competitive position. Where appropriate, we will acquire additional products, technologies, or businesses that are complementary to, or broaden the markets in which we operate. We plan to pursue strategic acquisitions to increase revenues and allow for higher overhead absorption where such acquisitions can improve our gross margins.

Recent acquisitions, all of which are reported with EMCORE’S Fiber Optics operating segment, include:

- On April 13, 2007, EMCORE acquired privately-held Opticomm Corporation, of San Diego, California, including its fiber optic video, audio and data networking business, technologies, and intellectual property. EMCORE paid \$4.0 million initial consideration for all of the shares of Opticomm. EMCORE also agreed to an additional earn-out payment based on Opticomm's 2007 revenues. EMCORE management anticipates that this transaction will provide

approximately \$7.0 million of revenue for calendar year 2007, and upon integration will be operationally profitable. In 2006, Opticomm generated revenues of \$6.3 million. Founded in 1986, Opticomm is one of the leading specialists in the field of fiber optic video, audio and data networking for the commercial, governmental and industrial sectors. Its flagship product is the Optiva platform, a complete line of transmission systems built to address the primary optical communication requirements of the following markets: broadcast and media, security and surveillance, healthcare, traffic and rail and government and military.



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- On January 12, 2006, EMCORE purchased K2 Optronics, Inc. (“K2”), a privately-held company located in Sunnyvale, CA. EMCORE, an investor in K2, paid approximately \$4.1 million in EMCORE common stock, and paid approximately \$0.7 million in transaction-related expenses, to acquire the remaining part of K2 that EMCORE did not already own. Prior to the transaction EMCORE owned a 13.6% equity interest in K2 as a result of a \$1.0 million investment that EMCORE made in K2 in October 2004. In addition, K2 was a supplier to EMCORE of analog external cavity lasers for CATV applications.
- On December 18, 2005, EMCORE acquired the assets of Force, Inc., a privately-held company located in Christiansburg, Virginia. In connection with the asset purchase, EMCORE issued 240,000 shares of EMCORE common stock, no par value, with a market value of \$1.6 million at the measurement date and \$0.5 million in cash. The acquisition included Force’s fiber optic transport and video broadcast products, technical and engineering staff, certain assets and intellectual properties and technologies.
- On November 8, 2005, EMCORE acquired the assets of Phasebridge, Inc., a privately-held company located in Pasadena, California. Founded in 2000, Phasebridge is known as an innovative provider of high performance, high value, miniaturized multi-chip system-in-package optical modules and subsystem solutions for a wide variety of markets, including fiber optic gyroscopes (FOG) for weapons & aerospace guidance, RF over fiber links for device remoting and optical networks, and emerging technologies such as optical RF frequency synthesis and processing and terahertz spectroscopy. In connection with the asset purchase, based on a closing price of \$5.46, EMCORE issued 128,205 shares of EMCORE common stock, no par value, that was valued in the transaction at approximately \$0.7 million. The acquisition included Phasebridge’s products, technical and engineering staff, certain assets and intellectual properties and technologies.

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EMCORE is committed to achieving profitability by increasing revenue through the introduction of new products, reducing our cost structure and lowering the breakeven points of our product lines. We have significantly streamlined our manufacturing operations by focusing on core competencies to identify cost efficiencies. Where appropriate, we transferred the manufacturing of certain product lines to contract manufacturers.

In May 2007, EMCORE announced the opening of a new manufacturing facility in Langfang, China. Our new company, Langfang EMCORE Optoelectronics Co. Ltd., is located approximately 20 miles southeast of Beijing and currently occupies a space of 22,000 square feet with a Class-10,000 clean room for optoelectronic device packaging. Another 60,000 square feet is available for future expansion. We will transfer our most cost sensitive optoelectronic devices to this facility. This facility, along with a strategic alignment with our existing contract-manufacturing partners, should enable us to improve our cost structure and gross margins. We also expect to develop and provide improved service to our global customers using a local presence in Asia.

EMCORE's restructuring programs are designed to further reduce the number of manufacturing facilities, in addition to the divestiture or exit from selected businesses and product lines that were not strategic and/or were not capable of achieving desired revenue or profitability goals. Recent divestitures and facility consolidations include:

- In August 2007, we announced the consolidation of our North American fiber optics engineering and design centers into our main operating sites. EMCORE's engineering facilities in Virginia, Illinois, and Northern California will be consolidated into larger primary sites in Albuquerque, New Mexico and Alhambra, California. The consolidation of these engineering sites will allow EMCORE to leverage resources within engineering, new product introduction, and customer service. The design centers in Virginia and northern California have been closed and the design center in Illinois was vacated in October 2007.
- In October 2006, we announced the move of our corporate headquarters from Somerset, New Jersey to Albuquerque, New Mexico. Financial operations and records have been transferred and the New Jersey facility was vacated in September 2007.
- In October 2006, we consolidated our solar panel operations into a state-of-the-art facility located in Albuquerque, New Mexico. The establishment of a modern solar panel manufacturing facility, adjacent to our solar cell fabrication operations, should facilitate consistency, as well as reduce manufacturing costs. The benefit of having these operations located on one site is expected to provide high quality, high reliability and cost-effective solar components. Solar panel production operations ceased at our California solar panel facility in June 2006 and the facility was vacated in December 2006.
- In August 2006, EMCORE sold its 49% membership interest in GELcore, LLC to General Electric Corporation, which owned the remaining 51% membership interest prior to the transaction, for \$100.0 million in cash.
- In August 2006, EMCORE completed the sale of the assets of its Electronic Materials & Device (EMD) division, including inventory, fixed assets, and intellectual property to IQE, plc, a public limited company organized under the laws of the United Kingdom, for \$16.0 million.
- In April 2005, EMCORE divested product technology focused on gallium nitride-based power electronic devices for the power device industry. The new company, Velox Semiconductor Corporation ("Velox"), initially raised \$6.0 million from various venture capital partnerships. EMCORE contributed intellectual property and equipment in exchange for an initial 19.2% stake in Velox.

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Our results of operations and financial condition have and will continue to be significantly affected by severance, restructuring charges, impairment of long-lived assets and idle facility expenses incurred during facility closing activities. Please refer to Risk Factors under Item 1A and Financial Statements and Supplemental Data under Item 8 in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006, for further discussion of these items.

**Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) 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 financial statements and the reported amounts of revenues and expenses during the reported period. Management develops estimates based on historical experience and on various assumptions about the future that are believed to be reasonable based on the best information available. EMCORE’s reported financial position or results of operations may be materially different under changed conditions or when using different estimates and assumptions, particularly with respect to significant accounting policies, which are discussed below. In the event that estimates or assumptions prove to differ from actual results, adjustments are made in subsequent periods to reflect more current information. EMCORE’s most significant estimates relate to accounts receivable, inventory, goodwill, intangibles, other long-lived assets, warranty accruals, revenue recognition, and valuation of stock-based compensation.

Valuation of Accounts Receivable. EMCORE regularly evaluates the collectibility of its accounts receivable and accordingly maintains allowances for doubtful accounts for estimated losses resulting from the inability of our customers to meet their financial obligation to us. The allowance is based on the age of receivables and a specific identification of receivables considered at risk. EMCORE classifies charges associated with the allowance for doubtful accounts as SG&A expense. If the financial condition of our customers were to deteriorate, additional allowances may be required.

Valuation of Inventory. Inventory is stated at the lower of cost or market, with cost being determined using the standard cost method. EMCORE reserves against inventory once it has been determined that: (i) conditions exist that may not allow the inventory to be sold for its intended purpose, (ii) the inventory’s value is determined to be less than cost, or (iii) the inventory is determined to be obsolete. The charge related to inventory reserves is recorded as a cost of revenue. The majority of the inventory write-downs are related to estimated allowances for inventory whose carrying value is in excess of net realizable value and on excess raw material components resulting from finished product obsolescence. In most cases where EMCORE sells previously written down inventory, it is typically sold as a component part of a finished product. The finished product is sold at market price at the time resulting in higher average gross margin on such revenue. EMCORE does not track the selling price of individual raw material components that have been previously written down or written off, since such raw material components usually are only a portion of the resultant finished products and related sales price. EMCORE evaluates inventory levels at least quarterly against sales forecasts on a significant part-by-part basis, in addition to determining its overall inventory risk. Reserves are adjusted to reflect inventory values in excess of forecasted sales, as well as overall inventory risk assessed by management. We have incurred, and may in the future incur, charges to write-down our inventory. While we believe, based on current information, that the amount recorded for inventory is properly reflected on our balance sheet, if market conditions are less favorable than our forecasts, our future sales mix differs from our forecasted sales mix, or actual demand from our customers is lower than our estimates, we may be required to record additional inventory write-downs.

Valuation of Goodwill and Intangible Assets. Goodwill represents the excess of the purchase price of an acquired business or assets over the fair value of the identifiable assets acquired and liabilities assumed. Intangible assets

consist primarily of intellectual property that has been internally developed or purchased. Purchased intangible assets include existing and core technology, trademarks and trade names, and customer contracts. Intangible assets are amortized using the straight-lined method over estimated useful lives ranging from one to fifteen years.

EMCORE evaluates its goodwill and intangible assets for impairment on an annual basis, or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Circumstances that could trigger an impairment test include but are not limited to: a significant adverse change in the business climate or legal factors; an adverse action or assessment by a regulator; unanticipated competition; loss of key personnel; the likelihood that a reporting unit or significant portion of a reporting unit will be sold or otherwise disposed; results of testing for recoverability of a significant asset group within a reporting unit; and recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit. The determination as to whether a write-down of goodwill or intangible assets is necessary involves significant judgment based on the short-term and long-term projections of the future performance of the reporting unit to which the goodwill or intangible assets are attributed. As of December 31, 2006, we tested for impairment on our goodwill and intangible assets and based on that analysis, we determined that the carrying amount of the reporting units did not exceed their fair value.

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Valuation of Long-lived Assets. EMCORE reviews long-lived assets on an annual basis or whenever events or circumstances indicate that the assets may be impaired. A long-lived asset is considered impaired when its anticipated undiscounted cash flow is less than its carrying value. In making this determination, EMCORE uses certain assumptions, including, but not limited to: (a) estimates of the fair market value of these assets; and (b) estimates of future cash flows expected to be generated by these assets, which are based on additional assumptions such as asset utilization, length of service that assets will be used in our operations, and estimated salvage values. As of December 31, 2006, we tested for impairment of our long-lived assets and based on that analysis, we recorded no impairment charges on any of EMCORE's long-lived assets.

Product Warranty Reserves. EMCORE provides its customers with limited rights of return for non-conforming shipments and warranty claims for certain products. In accordance with SFAS 5, *Accounting for Contingencies*, EMCORE makes estimates of product warranty expense using historical experience rates as a percentage of revenue and accrues estimated warranty expense as a cost of revenue. We estimate the costs of our warranty obligations based on our historical experience of known product failure rates, use of materials to repair or replace defective products and service delivery costs incurred in correcting product failures. In addition, from time to time, specific warranty accruals may be made if unforeseen technical problems arise. Should our actual experience relative to these factors differ from our estimates, we may be required to record additional warranty reserves. Alternatively, if we provide more reserves than we need, we may reverse a portion of such provisions in future periods.

Revenue Recognition. Revenue is recognized upon shipment provided persuasive evidence of a contract exists, (such as when a purchase order or contract is received from a customer), the price is fixed, the product meets its specifications, title and ownership have transferred to the customer, and there is reasonable assurance of collection of the sales proceeds. In those few instances where a given sale involves post shipment obligations, formal customer acceptance documents, or subjective rights of return, revenue is not recognized until all post-shipment conditions have been satisfied and there is reasonable assurance of collection of the sales proceeds. The majority of our products have shipping terms that are free on board (FOB) or free carrier alongside (FCA) shipping point, which means that EMCORE fulfills its delivery obligation when the goods are handed over to the freight carrier at our shipping dock. This means the buyer bears all costs and risks of loss or damage to the goods from that point. In certain cases, EMCORE ships its products cost insurance and freight (CIF). Under this arrangement, revenue is recognized under FCA shipping point terms, but EMCORE pays (and bills the customer) for the cost of shipping and insurance to the customer's designated location. EMCORE accounts for shipping and related transportation costs by recording the charges that are invoiced to customers as revenue, with the corresponding cost recorded as cost of revenue. In those instances where inventory is maintained at a consigned location, revenue is recognized only when our customer pulls product for its use and title and ownership have transferred to the customer. Revenue from time and material contracts is recognized at the contractual rates as labor hours and direct expenses are incurred. EMCORE also generates service revenue from hardware repairs and calibrations that is recognized as revenue upon completion of the service. Any cost of warranties and remaining obligations that are inconsequential or perfunctory are accrued when the corresponding revenue is recognized.

Distributors - EMCORE uses a number of distributors around the world. In accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition*, EMCORE recognizes revenue upon shipment of product to these distributors. Title and risk of loss pass to the distributors upon shipment, and our distributors are contractually obligated to pay EMCORE on standard commercial terms, just like our other direct customers. EMCORE does not sell to its distributors on consignment and, except in the event of a product discontinuance, does not give distributors a right of return.

Solar Panel Contracts - EMCORE records revenues from certain solar panel contracts using the percentage-of-completion method. Revenue is recognized in proportion to actual costs incurred compared to total

anticipated costs expected to be incurred for each contract. If estimates of costs to complete long-term contracts indicate a loss, a provision is made for the total loss anticipated. EMCORE has numerous contracts that are in various stages of completion. Such contracts require estimates to determine the appropriate cost and revenue recognition. EMCORE uses all available information in determining dependable estimates of the extent of progress towards completion, contract revenues, and contract costs. Estimates are revised as additional information becomes available.

*Government R&D Contracts* - R&D contract revenue represents reimbursement by various U.S. Government entities, or their contractors, to aid in the development of new technology. The applicable contracts generally provide that EMCORE may elect to retain ownership of inventions made in performing the work, subject to a non-exclusive license retained by the U.S. Government to practice the inventions for governmental purposes. The R&D contract funding may be based on a cost-plus, cost reimbursement, cost-share, or a firm-fixed price arrangement. The amount of funding under each R&D contract is determined based on cost estimates that include both direct and indirect costs. Cost-plus funding is determined based on actual costs plus a set margin. As we incur costs under cost reimbursement type contracts, we record revenue. Contract costs include material, labor, special tooling and test equipment, subcontracting costs, as well as an allocation of indirect costs. For cost-share contracts, the actual costs of performance are divided between the U.S. Government and EMCORE based on the R&D contract terms. An R&D contract is considered complete when all significant costs have been incurred, milestones have been reached, and any reporting obligations to the customer have been met.

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**Stock-Based Compensation.** EMCORE records stock-based compensation under SFAS 123(R). The fair value of each option grant is estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach. The option-pricing model requires the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. EMCORE's expected term represents the period that stock-based awards are expected to be outstanding and is determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of its stock-based awards. The expected stock price volatility is based on EMCORE's historical stock prices.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by U.S. GAAP. There also are areas in which management's judgment in selecting any available alternative would not produce a materially different result. For complete discussion of our accounting policies and other required U.S. GAAP disclosures, we refer you to our Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

**Results of Operations**

The following table sets forth the consolidated statements of operations data of EMCORE expressed as a percentage of total revenues for the three months ended December 31, 2006 and 2005.

**Statement of Operations Data****For the three months ended December 31,**

	<b>2006</b>	<b>2005</b>
Revenue	100.0%	100.0%
Cost of revenue	85.8	82.2
Gross profit	14.2	17.8
Operating expenses:		
Selling, general and administrative	32.4	19.7
Research and development	17.1	12.0
Total operating expenses	49.5	31.7
Operating loss	(35.3)	(13.9)
Other (income) expenses:		
Interest (income) expense, net	(1.0)	2.7
Loss from convertible subordinated notes exchange offer	-	3.0
Equity in net income of unconsolidated affiliates	-	(1.0)
Total other (income) expenses	(1.0)	4.7
Loss from continuing operations	(34.3)	(18.6)
Discontinued operations		
Loss from discontinued operations	-	(0.6)
Net loss	(34.3%)	(19.2%)

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**Comparison of three months ended December 31, 2006 and 2005**

**Consolidated Revenue**

For the three months ended December 31, 2006, EMCORE's consolidated revenue increased \$3.0 million or 8% to \$38.7 million from \$35.7 million, as reported in the prior year. For the three months ended December 31, 2006, international sales increased \$7.0 million or 120%, when compared to the prior year. For the three months ended December 31, 2006, revenue from government contracts decreased \$0.4 million or 11% to \$3.1 million from \$3.5 million, as reported in the prior year. A comparison of revenue achieved at each of EMCORE's operating segments follows:

*Fiber Optics.*

Over the past several years, communications networks have experienced dramatic growth in data transmission traffic due to worldwide Internet access, e-mail, and e-commerce. As Internet content expands to include full motion video on-demand, HDTV, multi-channel high quality audio, online video conferencing, image transfer, online multi-player gaming, and other broadband applications, the delivery of such data will place a greater demand on available bandwidth and require the support of higher capacity networks. The bulk of this traffic, which continues to grow at a very high rate, is already routed through the optical networking infrastructure used by local and long distance carriers, as well as internet service providers. Optical fiber offers substantially greater bandwidth capacity, is less error prone, and is easier to administer than older copper wire technologies. As greater bandwidth capability is delivered closer to the end user, increased demand for higher content, real-time, interactive visual and audio content is expected. We believe that EMCORE is well positioned to benefit from the continued deployment of these higher capacity fiber optic networks. Customers for the Fiber Optics segment include: Avago Technologies, Inc., Alcatel, Aurora Networks, BUPT-GUOAN Broadband, C-Cor Electronics, Cisco Systems, Inc., Finisar, Hewlett-Packard Corporation, Intel Corporation, Jabil, JDSU, Motorola, Network Appliance, Sycamore Networks, Inc., and Tellabs.

For the three months ended December 31, 2006, EMCORE's fiber optic revenues increased \$0.3 million or 1% to \$25.3 million from \$25.0 million, as reported in the prior year. Lower digital fiber-optic module and component sales due to customer inventory management were offset by increased sales volume of CATV, SATCOM, TELECOM and FTTP components. The communications industry in which we participate continues to be dynamic. The driving factor is the competitive environment that exists between cable operators, telephone companies, and satellite and wireless service providers. Each are rapidly investing capital to deploy a converging multi-service network capable of delivering "triple play services", i.e. digitalized video, voice and data content, bundled as a service provided by a single communication provider. As a market leader in RF transmission over fiber products for the CATV industry, EMCORE enables cable companies to offer multiple forms of communications to meet the expanding demand for high-speed Internet, on-demand and interactive video, and other new services (such as HDTV and VOIP). Television is also undergoing a major transformation, as the U.S. Government requires television stations to broadcast exclusively in digital format, abandoning the analog format used for decades. Although the transition date for digital transmissions is not expected for several years, the build-out of these television networks has already begun. To support the telephone companies plan to offer competing video, voice and data services through the deployment of new fiber-based systems, EMCORE has developed and maintains customer qualified FTTP components and subsystem products. Our CATV and FTTP products include broadcast analog and digital fiber optic transmitters, quadrature amplitude modulation (QAM) transmitters, video receivers, and passive optical network (PON) transceivers. Government contract revenues for the three months ended December 31, 2006 and 2005 totaled \$0.2 million and \$0.1 million, respectively. Fiber optics revenue represented 65% and 70% of EMCORE's total revenues for the three months ended December 31, 2006 and 2005, respectively.



*Photovoltaics.*

EMCORE provides advanced compound semiconductor solar cell products and solar panels, which are more resistant to radiation levels in space and convert substantially more power from sunlight than silicon-based solutions. EMCORE's Photovoltaics segment designs and manufactures multi-junction compound semiconductor solar cells for both commercial and military satellite applications. Customers for the Photovoltaics segment include Boeing, General Dynamics, the Indian Space Research Organization ("ISRO"), Lockheed Martin, and Space Systems/Loral.

For the three months ended December 31, 2006, EMCORE's photovoltaic revenues increased \$2.7 million or 25% to \$13.4 million from \$10.7 million, as reported in the prior year. Increased sales volume of solar cells, solar panels, and service revenue from government research contracts were the reason for the significant increase in quarter over quarter revenues. Government contract revenues for photovoltaics products were \$2.9 million and \$3.3 million for the three months ended December 31, 2006 and 2005, respectively. Photovoltaics revenue represented 35% and 30% of EMCORE's total revenues for the three months ended December 31, 2006 and 2005, respectively.

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We see additional areas for growth resulting from the joint venture between ISRO and EADS Astrium for the manufacture of GEO communication satellites. EMCORE is a leading supplier of solar cell products to ISRO, and we anticipate increased activity with that customer. Government and military procurement remains steady, and we have succeeded in gaining market share in that area. We have recently been awarded solar panel government contracts for military and science missions, and this represents an expansion of our customer base.

EMCORE had been engaged in a multi-year cost reimbursable solar cell development and production contract for a major U.S. aerospace corporation. It was previously reported that the contract would exceed \$40.0 million in development and production revenues over the next several years. Although we recognized significant revenues for this program during fiscal 2007, our customer notified us in August 2007 that their program had been terminated by the U.S. Government for its convenience. We adjusted our order backlog accordingly and this will have no effect on our fiscal 2008 revenue guidance. In fiscal 2008, we expect to recognize additional revenue from this program related to contract termination costs. We also expect revenue in fiscal 2008 from a new U.S. Government contract that has similar technical contract requirements.

In February 2006, EMCORE was awarded a subcontract to participate in the Defense Advanced Research Projects Agency (DARPA) Very High Efficiency Solar Cell (VHSEC) program to more than double the efficiency of terrestrial solar cells within the next fifty months. EMCORE was selected by the University of Delaware, the prime contractor for the DARPA VHSEC program, to develop advanced III-V multi-junction solar cells in Phase I of the program effort. The VHSEC program will provide up to \$53.0 million in funding, which will be awarded to program participants in various phases over the next several years.

In August 2007, EMCORE was awarded a follow-on production order from Green and Gold Energy (GGE) for three million solar cells for use in GGE's SunCube™ terrestrial concentrator system. This 105 MW purchase order represents the largest procurement of concentrator solar cells in the industry to date and is a follow-on order to an initial 5 MW order placed earlier in 2007. All hardware ordered under this contract is to be shipped by December 2008.

**Gross Profit**

For the three months ended December 31, 2006, gross profit decreased to \$5.5 million compared to \$6.3 million, as reported in the prior year. Compared to the prior year, gross margins decreased to 14% from 18%. On a segment basis, margins for Fiber Optics decreased from 22% to 18% due to unabsorbed fixed overhead from reduced customer demand of 10Gb/s Ethernet transceivers and chip level products. Margins for the Photovoltaics segment increased slightly to 8% from 7% as reported in the prior year.

Actions designed to improve our gross margins (through product mix improvements, cost reductions associated with product transfers and product rationalization, maximizing production yields on high-performance devices and quality improvements, among other things) continue to be a principal focus for us. The establishment of a modern solar panel manufacturing facility, adjacent to our solar cell fabrication operations, should facilitate consistency, as well as reduce manufacturing costs. The benefit of having these operations located at one site is expected to provide high quality, high reliability and cost-effective solar components. Solar panel production operations ceased at our California solar panel facility in June 2006 and the facility was vacated in December 2006. We focus our activities on developing new process control and yield management tools that enable us to accelerate the adoption of new technologies into full-volume production, while minimizing their associated risks.

On October 1, 2005, EMCORE adopted SFAS 123(R) and incurred stock-based compensation expense as more fully described in Note 3 – Equity to EMCORE's condensed consolidated financial statements. For both the three months

ended December 31, 2006 and 2005, gross profit included the effect of \$0.3 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R).

### **Operating Expenses**

*Selling, General and Administrative.* For the three months ended December 31, 2006, SG&A expenses increased \$5.4 million or 76% to \$12.5 million from \$7.1 million, as reported in the prior year. Consistent with prior years, SG&A expense includes corporate overhead expenses. As a percentage of revenue, SG&A increased from 20% to 32%.

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The increase in SG&A expenses is primarily due to:

- acquisitions of Phasebridge Inc., Force Inc., and K2 Optronics, Inc.;
- stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) totaling \$1.6 million for the three months ended December 31, 2006 compared to \$0.6 million for the three months ended December 31, 2005;
  - professional fees incurred associated with our review of historical stock option grants;
  - costs associated with the new terrestrial solar power division;
- legal costs associated with the Company's patent infringement lawsuits against Optium Corporation; and
  - continued investment in personnel strategic to our business.

*Research and Development.* Our R&D efforts have been sharply focused to maintain our technological leadership position by working to improve the quality and attributes of our product lines. We also invest significant resources to develop new products and production technology to expand into new market opportunities by leveraging our existing technology base and infrastructure. Our efforts are focused on designing new proprietary processes and products, on improving the performance of our existing materials, components, and subsystems, and on reducing costs in the product manufacturing process. In addition to using our internal capacity to develop and manufacture products for our target markets, EMCORE continues to expand its portfolio of products and technologies through acquisitions.

For the three months ended December 31, 2006, R&D expenses increased \$2.3 million or 53% to \$6.6 million from \$4.3 million, as reported in the prior year. The increase in R&D is primarily due to \$1.8 million of expense related to the Company's new terrestrial solar power division. In the Photovoltaics market, EMCORE has developed a high efficiency solar cell product for terrestrial applications. During both the three months ended December 31, 2006 and 2005, R&D included stock-based compensation expense of \$0.4 million. As a percentage of revenue, R&D increased from 12% to 17%. We believe that recently completed R&D projects have the potential to greatly improve our competitive position and drive revenue growth in the next few years.

As part of the ongoing effort to cut costs, many of our projects are to develop lower cost versions of our existing products and of our existing processes, while improving quality. Also, we have implemented a program to focus research and product development efforts on projects that we expect to generate returns within one year. Our technology and product leadership is an important competitive advantage. Driven by current and anticipated demand, we will continue to invest in new technologies and products that offer our customers increased efficiency, higher performance, improved functionality, and/or higher levels of integration. In fiscal 2007, we expect R&D spending to significantly increase as we invest in solar power concentrator system development.

**Other Income & Expenses**

*Interest Income.* EMCORE realized a significant increase in interest income due to an increase in cash, cash equivalents and marketable securities, primarily as a result of the sale of EMCORE's 49% membership interest in GELcore, LLC for \$100.0 million to General Electric Corporation on August 31, 2006.

*Loss from Convertible Subordinated Notes Exchange Offer.* In November 2005, EMCORE exchanged \$14.4 million aggregate principal amount of EMCORE's 5% convertible subordinated notes due in May 2006 for \$16.6 million aggregate principal amount of newly issued convertible senior subordinated notes due May 15, 2011. As a result of this transaction, EMCORE recognized approximately \$1.1 million of expense in the first quarter of fiscal 2006 related to the early extinguishment of debt. EMCORE will also incur additional expense of approximately \$1.1 million over the life of the subordinated notes, which will be charged to interest expense. This charge will increase interest expense by approximately \$50,000 per quarter through May 2011, the maturity date of the convertible subordinated

notes.

*Equity in Net Income of Unconsolidated Affiliates:*

- *GELcore*. For the three months ended December 31, 2005, EMCORE recognized income of \$0.5 million, related to its previously-held investment in GELcore.
- *Velox*. For the three months ended December 31, 2005, EMCORE recognized a loss of \$0.2 million related to Velox. During fiscal 2006, EMCORE reduced its voting percentage and relinquished its Velox Board seat, and its right to a Velox Board seat. As a result of these modifications, EMCORE reported its investment in Velox under the cost method of accounting rather than the equity method of accounting. Under the cost method of accounting, the Velox investment is carried at cost and adjusted only for other-than-temporary declines in fair value, distribution of earnings and additional investments. As of December 31, 2006, EMCORE's net investment in Velox amounted to approximately \$1.0 million.

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**Liquidity and Capital Resources**

***Working Capital***

As of December 31, 2006, EMCORE had working capital of approximately \$107.0 million compared to \$129.7 million as of September 30, 2006. Cash, cash equivalents, and marketable securities at December 31, 2006 totaled \$87.0 million, which reflects a net decrease of \$37.0 million from September 30, 2006. The decrease was a result of a \$13.5 million cash investment in WorldWater and Solar Technologies Corporation (“Worldwater”), a \$2.4 million semi-annual interest payment on the Company’s outstanding convertible subordinated notes and \$1.2 million for capital equipment purchases. The remaining decrease was primarily due to payment of taxes associated with the income earned on the sale of the Company’s interest in the GELcore joint venture, payment of professional fees incurred associated with our review of historical stock option grants, legal costs associated with the Company’s patent infringement lawsuits against Optium Corporation and certain other increases in working capital requirements.

***Cash Flow***

**Net Cash Used For Operations**

For the three months ended December 31, 2006, net cash used for operations increased \$17.2 million to \$23.1 million from \$5.9 million, as reported in the prior year. For the three months ended December 31, 2006, significant changes in working capital include an increase in receivables of \$10.2 million, an increase in inventory of \$0.5 million, a decrease in accounts payable of \$2.0 million and a decrease in accrued expenses of \$2.9 million. For the three months ended December 31, 2005, changes in working capital include an increase in receivables of \$1.6 million, an increase in inventory of \$1.0 million, an increase in accounts payable of \$3.5 million and a decrease in accrued expenses of \$3.7 million.

**Net Cash Provided by Investing Activities**

For the three months ended December 31, 2006, net cash provided by investing activities increased by \$15.5 million to \$16.5 million from \$1.0 million, as reported in the prior year. Changes in investing cash flows for the three months ended December 31, 2006 and 2005 consisted primarily of:

- Capital expenditures increased to \$1.2 million from \$0.8 million, as reported in the prior year.
- An investment of \$13.7 million, inclusive of \$0.2 million in transaction costs, in WorldWater in return for an amount of convertible preferred stock and warrants of WorldWater, equivalent to an approximately 26.5% fully-diluted ownership in WorldWater.
- Proceeds of \$0.8 million from the quarterly promissory note related to the sale of the EMD division.
- Net sales of \$30.7 million in marketable securities compared to \$2.4 million for the same period in the prior year.

**Net Cash Provided by Financing Activities**

Cash provided by financing activities was \$0.4 million for the three months ended December 31, 2006 compared to \$0.7 million for the three months ended December 31, 2005.

***Financing Transactions***

In May 2001, EMCORE issued \$175.0 million aggregate principal amount of its 5% convertible subordinated notes due in May 2006 (“2006 Notes”). In December 2002, EMCORE purchased \$13.2 million principal amount of the 2006 Notes at prevailing market prices for an aggregate of approximately \$6.3 million, resulting in a gain of approximately \$6.6 million after netting unamortized debt issuance costs of approximately \$0.3 million. In February 2004, EMCORE exchanged approximately \$146.0 million, or 90.2%, of its remaining 2006 Notes for approximately \$80.3 million aggregate principal amount of new 5% convertible senior subordinated notes due May 15, 2011 (“2011 Notes”) and approximately 7.7 million shares of EMCORE common stock. Interest on the 2011 Notes is payable in arrears semiannually on May 15 and November 15 of each year. The notes were convertible into EMCORE common stock at a conversion price of \$8.06 per share, subject to adjustment under customary anti-dilutive provisions. They also are redeemable should EMCORE's common stock price reach \$12.09 per share for at least twenty trading days within a period of any thirty consecutive trading days. As a result of this transaction, EMCORE reduced debt by approximately \$65.7 million, recorded a gain from early debt extinguishment of approximately \$12.3 million.

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In November 2005, EMCORE exchanged \$14.4 million aggregate principal amount of EMCORE's 2006 Notes for \$16.6 million aggregate principal amount of newly issued convertible senior subordinated notes due May 15, 2011 ("New 2011 Notes") pursuant to an Exchange Agreement ("Agreement") with Alexandra Global Master Fund Ltd. ("Alexandra"). The terms of the New 2011 Notes are identical in all material respects to EMCORE's 2011 Notes. The New 2011 Notes are ranked pari passu with the existing 2011 Notes. The New 2011 Notes will be convertible at any time prior to maturity, unless previously redeemed or repurchased by EMCORE, into the shares of EMCORE common stock, no par value, at the conversion rate of 124.0695 shares of common stock per \$1,000 principal amount. The effective conversion rate was \$8.06 per share of common stock, subject to adjustment under customary anti-dilutive provisions. They also are redeemable should EMCORE's common stock price reach \$12.09 per share for at least twenty trading days within a period of any thirty consecutive trading days. As a result of this transaction, EMCORE recognized approximately \$1.1 million of expense in the first quarter of fiscal 2006 related to the early extinguishment of debt. EMCORE will also incur an additional expense of approximately \$1.1 million over the life of the subordinated notes issued to Alexandra, which will be charged to interest expense. Furthermore, the 2006 Notes exchanged by Alexandra represented approximately 91.4% of the \$15.8 million total amount of existing 2006 Notes outstanding at the time of the transaction. EMCORE paid the remaining \$1.4 million of 2006 Notes on the May 15, 2006 maturity date.

On April 9, 2007, the Company entered into a First Supplemental Indenture (the "2004 Supplemental Indenture") with Deutsche Bank Trust Company Americas, as trustee (the "Trustee"), which amends the Indenture, dated as of February 24, 2004 (the "2004 Indenture"), between the Company and the Trustee, governing the Company's 5% Convertible Senior Subordinated Notes due 2011 issued thereunder (the "2004 Notes"). Also on April 9, 2007, the Company entered into a First Supplemental Indenture (the "2005 Supplemental Indenture" and together with the 2004 Supplemental Indenture, the "Supplemental Indentures") with the Trustee, which amends the Indenture, dated as of November 16, 2005 (the "2005 Indenture" and together with the 2004 Indenture, the "Indentures"), between the Company and the Trustee, governing the Company's 5% Convertible Senior Subordinated Notes due 2011 issued thereunder (the "2005 Notes" and together with the 2004 Notes, the "Notes").

Each Supplemental Indenture, among other things, increased the interest rate of the applicable Notes to 5.5% from 5.0%, reduced the Conversion Price (as defined in the applicable Indenture) from \$8.06 to \$7.01, provided for an increase in the Conversion Rate (as defined in the applicable Supplemental Indenture) in the event of a Non-Stock Change of Control (as defined in the applicable Supplemental Indenture), amended the restriction on payment of dividends, amended the definition of "Events of Default" and provided for an additional payment in certain circumstances in which the Company fails to comply with its reporting obligations under the applicable Indenture. The Supplemental Indentures also provided a waiver of the Company's failure to file certain reports with the SEC.

In order to give effect to the Supplemental Indentures, the Company entered into a Consent to Amendment and Waiver, dated as of April 9, 2007 (the "2004 Consent"), with certain holders of the 2004 Notes (the "2004 Consenting Holders"), and a Consent to Amendment and Waiver, dated as of April 9, 2007 (the "2005 Consent" and together with the 2004 Consent, the "Consents"), with the holder of the 2005 Notes (together with the 2004 Consenting Holders, the "Consenting Holders"), pursuant to which holders of at least a majority of the outstanding 2004 Notes and at least a majority of the 2005 Notes consented to the execution and delivery of the 2004 Supplemental Indenture and the 2005 Supplemental Indenture, respectively. The Consenting Holders also waived any and all Defaults (as defined in the applicable Indenture) and Events of Default (as defined in the applicable Indenture) relating to any failure of the Company to observe or perform any covenant or agreement contained in the Notes or the Indentures as a result of the Company's failure to file with the SEC, or with the Trustee, its Annual Report on Form 10-K for the year ended September 30, 2006, its Annual Report on Form 10-Q for the quarter ended December 31, 2006 and/or any other reports that the Company fails to file in a timely manner for reasons in whole or in part directly or indirectly attributable to or arising out of the Company's review of its historical stock option grants as initially reported in the Company's Current Report on Form 8-K filed with the SEC on November 6, 2006. The Consenting Holders agree to



rescind any notice of acceleration delivered to the Company with respect to such failure to file.

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The Consents also provided the Company with the option to repurchase an aggregate of \$11.4 million of the outstanding principal amount of the Notes held by the Consenting Holders at a purchase price equal to \$1,000 per \$1,000 principal amount of the Notes purchased, plus accrued and unpaid interest, if any, to but excluding the date of purchase. The Company exercised this option and repurchased \$11.4 million of its outstanding notes on April 13, 2007. Accordingly, the Company classified the \$11.4 million principal repayment as a current liability as of December 31, 2006 and September 30, 2006.

If our cash flow is inadequate to meet our obligations or we are unable to generate sufficient cash flow or otherwise obtain funds necessary to make required payments on the notes or our other obligations, we would be in default under the terms thereof. Default under any of the note indentures would permit the holders of the notes to accelerate the maturity of the notes and could cause defaults under future indebtedness we may incur. Any such default would have a material adverse effect on our business, prospects, financial condition, results of operations and cash flows. In addition, we cannot assure you that we would be able to repay amounts due in respect of the notes if payment of any of the notes were to be accelerated following the occurrence of an event of default as defined in the respective note indentures.

EMCORE may repurchase 2011 Notes and/or New 2011 Notes through various means, including, but not limited to, one or more open market or privately negotiated transactions in future periods. The timing and amount of repurchase, if any, whether *de minimis* or material, will depend on many factors, including, but not limited to, the availability of capital, the prevailing market price of the notes, and overall market conditions.

In September 2005, EMCORE entered into a non-recourse receivables purchase agreement (“AR Agreement”) with Silicon Valley Bank (“SVBank”). Under the terms of the AR Agreement, EMCORE from time to time may sell, without recourse, certain accounts receivables to SVBank up to a maximum aggregate outstanding amount of \$20.0 million. In September 2006, EMCORE sold approximately \$3.0 million of accounts receivable to SVBank. The AR Agreement expired on December 31, 2006.

**Conclusion**

We believe that our current liquidity should be sufficient to meet our cash needs for working capital through the next twelve months. If cash generated from operations and cash on hand are not sufficient to satisfy EMCORE's liquidity requirements, EMCORE will seek to obtain additional equity or debt financing. Additional funding may not be available when needed, or on terms acceptable to EMCORE. If EMCORE is required to raise additional financing and if adequate funds are not available or not available on acceptable terms, our ability to continue to fund expansion, develop and enhance products and services, or otherwise respond to competitive pressures may be severely limited. Such a limitation could have a material adverse effect on EMCORE's business, financial condition, results of operations, and cash flow.

Due to the Special Committee investigation and resulting restatements, we did not file our periodic reports with the SEC on time and faced the possibility of delisting of our stock from the NASDAQ Global Market. With the filing of our Annual Report and our Quarterly Reports on Form 10-Q thereafter for the quarters ended December 31, 2006, March 31, 2007, and June 30, 2007, we believe we have returned to full compliance with SEC reporting requirements and NASDAQ listing requirements and, therefore, the NASDAQ delisting matter should now be resolved. However, if the SEC has comments on these reports (or other reports that we previously filed) that require us to file amended reports, or if the NASDAQ does not concur that we are in compliance with applicable listing requirements, we may be unable to maintain an effective listing of our stock on NASDAQ. If this happens, the price of our stock and the ability of our shareholders to trade in our stock could be adversely affected. In addition, we would be subject to a number of restrictions regarding the registration of our stock under federal securities laws, which could adversely affect our

business and results of operations.

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Relocation of Headquarters and Departure and Appointment of Certain Officers

Shortly after the Company sold both its New Jersey-based EMD division and its GELcore joint venture, we announced the relocation of our headquarters to Albuquerque, New Mexico. Three officers of the Company decided against relocation and resigned.

- Mr. Thomas G. Werthan, an Executive Vice President and Chief Financial Officer of the Company, resigned and left the Company on February 19, 2007. Mr. Werthan joined the Company in June 1992. Mr. Werthan will continue to be a member of the Board of Directors, a position he has held since joining the Company. In February 2007, Mr. Adam Gushard, former Vice President of Finance, was appointed Interim Chief Financial Officer. As discussed in Note 10, Receivables, of the Notes to Consolidated Financial Statements, in connection with Mr. Werthan's resignation and pursuant to the terms of his promissory note, the Board of Directors forgave a loan he had with the Company. Mr. Werthan was responsible for the personal taxes related to the loan forgiveness.
- Mr. Howard W. Brodie, an Executive Vice President, Chief Legal Officer and Secretary of the Company, resigned and left the Company on April 27, 2007. Mr. Brodie joined the Company in 1999. In April 2007, Mr. Keith Kosco was appointed Chief Legal Officer and Secretary of the Company.
- Dr. Richard A. Stall, Executive Vice President and the Chief Technology Officer of the Company, resigned and left the Company on June 27, 2007. Dr. Stall co-founded the Company in 1984. On December 18, 2006, after ten years of service on the Board, Dr. Stall resigned his seat on the Board. Dr. John Iannelli, Ph.D. joined the Company in January 2003 through the acquisition of Ortel from Agere Systems and was appointed Chief Technology Officer in June 2007.

In addition, Mr. Scott T. Massie, an Executive Vice President and Chief Operating Officer of the Company, resigned and left the Company on December 29, 2006. Dr. Hong Q. Hou was appointed as President and Chief Operating Officer and was elected to the Company's Board of Directors.

The Company also reported that Mr. Reuben F. Richards will continue to serve as Chief Executive Officer until the Company's Annual Meeting in 2008, at which time he will become Executive Chairman and Chairman of the Board of Directors and Dr. Thomas J. Russell, the current Chairman, will become Chairman Emeritus and Lead Director. The Board of Directors has offered Dr. Hong Q. Hou the position of Chief Executive Officer after Mr. Richards becomes Chairman.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to financial market risks, including changes in currency exchange rates and interest rates. We do not use derivative financial instruments for speculative purposes.

*Currency Exchange Rates.* Although EMCORE enters into transactions denominated in foreign currencies from time to time, the total amount of such transactions is not material. Accordingly, fluctuations in foreign currency values would not have a material adverse effect on our future financial condition or results of operations. However, some of our foreign suppliers may adjust their prices (in \$US) from time to time to reflect currency exchange fluctuations, and such price changes could impact our future financial condition or results of operations. The Company does not currently hedge its foreign currency exposure.

*Interest Rates.* We maintain an investment portfolio in a variety of high-grade (AAA), short-term debt and money market instruments, which carry a minimal degree of interest rate risk. Due in part to these factors, our future

investment income may be slightly less than expected because of changes in interest rates, or we may suffer insignificant losses in principal if forced to sell securities that have experienced a decline in market value because of changes in interest rates. The Company does not currently hedge its interest rate exposure.

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**ITEM 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

The Company intends to maintain disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in reports filed under the Securities Exchange Act of 1934 (the “Act”) is recorded, processed, summarized and reported within the specified time periods and accumulated and communicated to management, including its Chief Executive Officer (Principal Executive Officer) and Interim Chief Financial Officer (Chief Accounting Officer), as appropriate to allow timely decisions regarding required disclosure.

Management, under the supervision and with the participation of its Chief Executive Officer (Principal Executive Officer) and Interim Chief Financial Officer (Chief Accounting Officer), evaluated the effectiveness of the Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) promulgated under the Act), as of the end of the period covered by this report. Based on that evaluation, management concluded that, as of that date, the Company’s disclosure controls and procedures were not effective at the reasonable assurance level because of the identification of material weaknesses in its internal control over financial reporting, as described below, which the Company views as an integral part of its disclosure controls and procedures.

Attached as exhibits to this Quarterly Report on Form 10-Q are certifications of the Company’s Chief Executive Officer (Principal Executive Officer) and Interim Chief Financial Officer (Chief Accounting Officer), which are required in accordance with Rule 13a-14 of the Act. This Disclosure Controls and Procedures section includes information concerning management’s evaluation of disclosure controls and procedures referred to in those certifications and, as such, should be read in conjunction with the certifications of the Company’s Chief Executive Officer (Principal Executive Officer) and Interim Chief Financial Officer (Chief Accounting Officer).

A material weakness is a significant deficiency, or combination of significant deficiencies, in internal controls over financial reporting such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. Management performed an assessment of the effectiveness of the Company’s internal control over financial reporting as of September 30, 2006, utilizing the criteria described in the “Internal Control — Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). The objective of this assessment was to determine whether the Company’s internal control over financial reporting was effective as of September 30, 2006. In its assessment of the effectiveness of internal control over financial reporting as of September 30, 2006, management determined that there were control deficiencies that constituted material weaknesses, as described below.

***(i) Control Activities Relating to Stock Options***

The Company did not maintain effective controls over its granting of stock options and the related recording and disclosure of stock-based compensation expense under APB 25, SFAS 123, SFAS 123(R) and their related interpretations. Specifically, effective controls, including monitoring, were not designed and in place to provide reasonable assurance regarding the existence, completeness, accuracy, valuation and presentation of activity related to the Company’s granting of stock options in the financial statements. These control deficiencies resulted in errors in (i) stock-based compensation expense, additional paid-in capital, related income tax accounts and weighted averaged diluted shares outstanding and (ii) related financial statement disclosures that resulted in the restatement of the Company’s historical financial statements. Accordingly, management determined that in the aggregate these control deficiencies constitute a material weakness in internal control over financial reporting.

***(ii) Control Activities Relating to Non-routine and Non- systematic Transactions***

The Company did not maintain effective controls over non-routine and non-systematic transactions. Specifically, the Company did not properly review and analyze legal expenses, interest income, amortization expense, gross receipts tax and other accruals. In addition, the Company had errors in the classifications of bonuses and discontinued operations. This control deficiency resulted in errors to the Company's financial statements for the fourth quarter of 2006. Accordingly, management determined that this control deficiency constituted a material weakness in internal control over financial reporting.

Due to these material weaknesses, management determined that the Company's internal control over financial reporting was not effective as of September 30, 2006. As of December 31, 2006, management determined that these material weaknesses still existed; however, the Company is continuing to implement significant changes and improvements in the Company's internal control over financial reporting to remediate the control deficiencies that gave rise to the material weaknesses.

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**Changes in Internal Control Over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting, other than those changes discussed below, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Remediation of Material Weaknesses**

Management is committed to remediating the control deficiencies that constitute the material weaknesses described above by implementing changes to the Company's internal control over financial reporting. In addition, management has established procedures to consider the ongoing effectiveness of both the design and operation of the Company's internal control over financial reporting. The Chief Executive Officer and Interim Chief Financial Officer of the Company have taken the responsibility to implement changes and improvements in the Company's internal control over financial reporting and remediate the control deficiencies that gave rise to the material weaknesses. Specifically, these changes include:

***Remediation Activities Relating to Stock Option Grants***

The Board of Directors of the Company adopted a revised Incentive Stock Option Grant Policy on November 13, 2006, that provided that:

- Non-administrative grant responsibilities other than with respect to new-hire options are to be set by the Compensation Committee.
- All new-hire options be issued the later of an employee's first day of employment, or where applicable, the date the Compensation Committee approved the terms of the new-hire grant and have an exercise price of not less than 100% of the fair market value of the Company's stock on that date. The Board will conduct a review of all new-hire grants to ensure compliance with the Company's policies and procedures.
- The grant date for all options awarded to employees other than new-hire options is the date on which the Compensation Committee meets and approves the grants.
- The exercise price of options other than new hire-options should be set at the closing price of the common stock of the Company on the date on which the Compensation Committee approves the grants.
- The Company should, with respect to annual retention grants to employees, maintain the practice of awarding retention grants to senior management on the same date and with the same exercise price as retention grants awarded to non-senior management employees.
- No additions or modifications to options grants should be permitted after the Compensation Committee has approved the option grants.
  - All grants are to be communicated to employees as soon as reasonably practicable after the grant date.



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***Remediation Activities Relating to Non-routine Transactions***

Management has also reevaluated its accounting policies and procedures related to the above mentioned non-routine accounting transactions which aggregated to a material weakness. As part of our review, we have enhanced the review process over non-routine transactions and the related accounting treatment by ensuring that these transactions are subject to a more thorough and detailed review.

**Limitations on the Effectiveness of Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer does not expect that our disclosure controls or our internal controls will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within EMCORE have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with associated policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Table of Contents**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

The Company is subject to various legal proceedings and claims that are discussed below. The Company is also subject to certain other legal proceedings and claims that have arisen in the ordinary course of business and which have not been fully adjudicated. The Company does not believe it has a potential liability related to current legal proceedings and claims that could individually or in the aggregate have a material adverse effect on its financial condition, liquidity or results of operations. However, the results of legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any legal matters or should several legal matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected. The Company settled certain matters during 2007 that did not individually or in the aggregate have a material impact on the Company's results of operations.

**Shareholder Derivative Litigation Relating to Historical Stock Option Practices**

On February 1, 2007, Plaintiff Lewis Edelstein filed a purported stockholder derivative action (the "Federal Court Action") on behalf of the Company against certain of its present and former directors and officers (the "Individual Defendants"), as well as the Company as nominal defendant, in the United States District Court for the District of New Jersey, Edelstein v. Brodie, et. al., Case No. 3:07-cv-00596-FLW-JJH (D.N.J.). On May 22, 2007, Plaintiffs Kathryn Gabaldon and Michael Sackrison each filed a purported stockholder derivative action against the Individual Defendants, and the Company as nominal defendant, in the Superior Court of New Jersey, Somerset County, Gabaldon v. Brodie, et. al., Case No. 3:07-cv-03185-FLW-JJH (D.N.J.) and Sackrison v. Brodie, et. al., Case No. 3:07-cv-00596-FLW-JJH (D.N.J.) (collectively, the "State Court Actions").

Both the Federal Court Action and the State Court Actions alleged, using essentially identical contentions that the Individual Defendants engaged in improprieties and violations of law in connection with the Company's historical issuances of stock options. Each of the actions seeks the same relief on behalf of the Company, including, among other things, damages, equitable relief, corporate governance reforms, an accounting, rescission, restitution and costs and disbursements of the lawsuit. On July 10, 2007, the State Court Actions were removed to the United States District Court for the District of New Jersey.

On September 26, 2007, the plaintiff in the Federal Court Action signed an agreement in principle with the Individual Defendants and the Company to settle that litigation in accordance with the Memorandum of Understanding (the "MOU") filed as Exhibit 10.10 to this Annual Report on Form 10-K. That same day, the plaintiffs in the State Court Actions advised the Federal Court that the settlement embodied in the MOU would also constitute the settlement of the State Court Actions.

The MOU provides that the Company will adhere to certain policies and procedures relating to the issuance of stock options, stock trading by directors, officers and employees, the composition of its Board of Directors, and the functioning of the Board's Audit and Compensation Committees. The MOU also provides for the payment of \$700,000 relating to plaintiff's attorneys' fees, costs and expenses, which the Company's insurance carrier has committed to pay on behalf of the Company. To be fully implemented, the MOU will be embodied in a more detailed stipulation of settlement and will be expressly conditioned on Court approval following a period for comment by potentially affected parties.

We have recorded \$700,000 as a liability for the stipulated settlement as of September 30, 2006 since events that led to the litigation existed as of that date. Although we anticipate that our insurance carrier will cover the stipulated settlement, we have not recorded any receivable, or gain contingency, since the settlement is still contingent upon

certain future events.

### **NASDAQ Delisting Proceeding**

On December 18, 2006, EMCORE received a NASDAQ Staff Determination letter stating that the Company was not in compliance with the filing requirements for continued listing set forth in NASDAQ Marketplace Rule 4310(c)(14) and that its common stock was subject to delisting from The NASDAQ Stock Market. The notice, which the Company expected, was issued as a result of the Company's failure to file its annual report on Form 10-K for the year ended September 30, 2006 with the SEC by the required deadline. The Company had previously filed a Form 12b-25 with the SEC indicating that the Company would be unable to file its Form 10-K by the original filing deadline of December 14, 2006 due to the Company's ongoing review of its prior stock option grants.

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On February 13, 2007, EMCORE received a NASDAQ Staff Determination letter stating that the Company was not in compliance with the filing requirements for continued listing set forth in NASDAQ Marketplace Rule 4310(c)(14) and that its common stock was subject to delisting from The NASDAQ Stock Market. The notice, which the Company expected, was issued as a result of the Company's failure to file its report on Form 10-Q for the fiscal quarter ended December 31, 2006 with the SEC by the required deadline. The Company had previously filed a Form 12b-25 with the SEC indicating that the Company would be unable to file its Form 10-Q by the original filing deadline of February 9, 2007 due to the Company's ongoing review of its prior stock option grants.

The Company attended a hearing before the NASDAQ Listing Qualifications Panel (the "Panel") on February 15, 2007 to review both the Staff Determination letter received by the Company on December 18, 2006 as a result of the Company's inability to file its Form 10-K for the year ended September 30, 2006 by the required deadline and the Staff Determination letter received by the Company on February 13, 2007 as a result of the Company's inability to file its Form 10-Q for the quarter ended December 31, 2006 by the required deadline.

On April 3, 2007, the Company received notice from the NASDAQ Stock Market that the Panel granted the Company's request for continued listing on the NASDAQ Stock Market subject to the Company filing both its Form 10-K for the fiscal year ended September 30, 2006 and its Form 10-Q for the quarter ended December 31, 2006 with the SEC by no later than May 10, 2007.

On May 10, 2007, the Company received notice from the NASDAQ Stock Market that the Panel had granted the Company's request for an extension of the May 10, 2007 deadline. The extension was conditioned on the Company filing its Form 10-K for the fiscal year ended September 30, 2006, its Form 10-Q for the quarter ended December 31, 2006 and all required restatements with the SEC by no later than June 18, 2007.

On May 14, 2007, the Company received a NASDAQ Staff Determination letter stating that the Company was not in compliance with the filing requirements for continued listing set forth in NASDAQ Marketplace Rule 4310(c)(14) and that its common stock was subject to delisting from the NASDAQ Stock Market. The notice, which the Company expected, was issued as a result of the Company's failure to file its report on Form 10-Q for the fiscal quarter ended March 31, 2007 with the SEC by the required deadline. The Company had previously filed a Form 12b-25 with the SEC indicating that the Company would be unable to file its Form 10-Q by the original filing deadline of May 10, 2007 due to the Company's ongoing review of its prior stock option grants.

On May 25, 2007, EMCORE filed an appeal of the May 10, 2007 Panel decision to grant the Company's request for an extension through June 18, 2007. EMCORE appealed the May 25, 2007 decision on the sole ground that the Panel could not grant the Company beyond June 18, 2007 to file the missing Form 10-K, Form 10-Qs and restatements. On June 8, 2007, the Company requested that NASDAQ stay the Panel's May 10, 2007 decision pending the Company's appeal of that action.

On June 15, 2007, the Company received a letter from the NASDAQ Stock Market stating that the NASDAQ Listing and Hearing Review Council (the "Listing Council") has stayed the previously reported May 10, 2007 decision of the Panel and any future Panel determinations to suspend the Company's securities from trading on NASDAQ, pending further review by the Listing Council. Consequently, the Company's securities would continue to be listed and tradable on the NASDAQ Global Market System until further action by the Listing Council to lift the stay, which would not occur prior to August 10, 2007. In addition, the Company was invited to submit any additional information to the Listing Council for consideration in its review by no later August 10, 2007.

On August 10, 2007, the Company submitted a letter, in response to the Listing Council's invitation, requesting that the Listing Council exercise its discretionary authority in favor of granting the Company an additional extension to regain compliance with NASDAQ's filing requirement. The Company is awaiting the Listing Council's response to

this letter.

On August 13, 2007, the Company received a NASDAQ Staff Determination letter stating that the Company was not in compliance with the filing requirements for continued listing set forth in NASDAQ Marketplace Rule 4310(c)(14) and that its common stock was subject to delisting from the NASDAQ Stock Market. The notice, which the Company expected, was issued as a result of the Company's failure to file its Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2007 with the SEC by the required deadline. The Company had previously filed a Notification of Late Filing on Form 12b-25 with the SEC indicating that the Company would be unable to file this Quarterly Report by the original filing deadline of August 9, 2007 due to the Company's ongoing review of its prior stock option grants.

On October 2, 2007, the Company received a NASDAQ Staff Determination letter stating that the Company was not in compliance with holding its annual meeting of shareholders within twelve months of the Company's fiscal year end, as set forth in NASDAQ Marketplace Rules 4350(e) and 4350(g) and that its common stock was subject to delisting from the NASDAQ Stock Market. The notice, which the Company expected, was issued as a result of the Company's failure to hold its annual shareholder meeting by September 30, 2007.

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On October 5, 2007, the Company has received a decision from the Listing Council stating that, pursuant to its discretionary authority, it has granted the Company an exception and allowed the Company until December 4, 2007 to demonstrate compliance with all of the Global Market continued listing requirements (the "Decision"). The Decision requires that the Company file its Form 10-K for the fiscal year ended September 30, 2006 and its Form 10-Q for the quarters ended December 31, 2006, March 31, 2007 and June 30, 2007 with the SEC by the close of business on December 4, 2007. The Decision also provides that if the Company has not filed these delinquent reports with the SEC by the close of business on December 4, 2007, the Company's securities will be suspended at the opening of business on December 6, 2007.

Although we believe the filing of our Annual Report on Form 10-K as of September 30, 2006 and our concurrent filings of the Form 10-Qs for the quarters ended December 31, 2006, March 31, 2007, and June 30, 2007 satisfy the Panel's requirements, we cannot assure you that the Panel will be satisfied with these filings. See the Explanatory Note in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006 for a discussion of stock option restatements that caused the delay in our SEC filings.

### **SEC Investigation**

The Company informed the staff of the SEC of the Special Committee's investigation on November 6, 2006. After the Company's initial contact with the SEC, the SEC opened a non-public investigation concerning the Company's historic option granting practices since the Company's initial public offering. The Company has cooperated fully with the SEC's investigation. Although we cannot predict the outcome of this matter, we do not expect that such matter will have a material adverse effect on our consolidated financial position or results of operations.

### **Indemnification Obligations**

Subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees in connection with the investigation of our historical stock option practices, related government investigation and shareholder litigation. These obligations arise under the terms of our certificate of incorporation, our bylaws, applicable contracts, and New Jersey law. The obligation to indemnify generally means that we are required to pay or reimburse the individuals' reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. We are currently paying or reimbursing legal expenses being incurred in connection with these matters by a number of our current and former directors, officers and employees. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policies that limits its exposure and enables it to recover a portion of any future amounts paid.

### **Intellectual Property Lawsuits**

We protect our proprietary technology by applying for patents where appropriate and in other cases by preserving the technology, related know-how and information as trade secrets. The success and competitive position of our product lines is significantly impacted by our ability to obtain intellectual property protection for our R&D efforts.

We have, from time to time, exchanged correspondence with third parties regarding the assertion of patent or other intellectual property rights in connection with certain of our products and processes. Additionally, on September 11, 2006, we filed a lawsuit against Optium Corporation (Optium) in the United States District Court for the Western District of Pennsylvania for patent infringement. In the suit, EMCORE and JDS Uniphase Corporation (JDSU) allege that Optium is infringing on U.S. patents 6,282,003 and 6,490,071 with its Prisma II 1550nm transmitters. On March 14, 2007, following denial of a motion to add additional claims to its existing lawsuit, EMCORE and JDSU filed a second patent suit in the same court against Optium alleging infringement of JDSU's patent 6,519,374. On March 15,

2007, Optium filed a declaratory judgment action against the Company and JDSU. Optium seeks in this litigation a declaration that certain products of Optium do not infringe United States Patent No. 6,519,374 ("the '374 patent") and that the patent is invalid. The '374 patent is assigned to JDSU and licensed to the Company. Other than the filing of a Complaint, Optium has taken no action in this case, and the Company has not been served.

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**ITEM 1A. RISK FACTORS**

Please see “Item 1A - Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not Applicable

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not Applicable

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not Applicable

**ITEM 5. OTHER INFORMATION**

Not Applicable

**ITEM 6. EXHIBITS.**

<b>Exhibit No.</b>	<b>Description</b>
31.1*	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification by Interim Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification by Interim Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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*\* Filed herewith*



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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.

**EMCORE CORPORATION**

Date: October 30, 2007

By: /s/ Reuben F. Richards,  
Jr.  
Reuben F. Richards, Jr.

Chief Executive Officer  
(Principal Executive Officer)

Date: October 30, 2007

By: /s/ Adam Gushard  
Adam Gushard

Interim Chief Financial Officer  
(Principal Financial and Accounting Officer)

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<b>Exhibit No.</b>	<b>Description</b>
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\* *Filed herewith*