

NEOPHOTONICS CORP  
Form 10-Q  
November 10, 2011  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2011

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: 001-35061

**NeoPhotonics Corporation**

(Exact name of registrant as specified in its charter)

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

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

**94-3253730**  
(I.R.S. Employer  
Identification No.)

**2911 Zanker Road**

**San Jose, California 95134**

(Address of principal executive offices, zip code)

**(408) 232-9200**

(Registrant's telephone number, including area code)

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 ( "Exchange Act" ) 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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:

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

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

As of November 2, 2011, there were 24,754,265 shares of the registrant's Common Stock outstanding.

**Table of Contents**

**NEOPHOTONICS CORPORATION**

**For the Quarter Ended September 30, 2011**

**Table of Contents**

	<b>Page</b>
<b><u>Part I. Financial Information</u></b>	
Item 1. <u>Condensed Consolidated Financial Statements (Unaudited)</u>	1
<u>Condensed Consolidated Balance Sheets as of September 30, 2011 and December 31, 2010 (Unaudited)</u>	1
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2011 and 2010 (Unaudited)</u>	2
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010 (Unaudited)</u>	3
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	4
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	38
Item 4. <u>Controls and Procedures</u>	39
<b><u>Part II. Other Information</u></b>	
Item 1. <u>Legal Proceedings</u>	41
Item 1A. <u>Risk Factors</u>	41
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	65
Item 3. <u>Defaults Upon Senior Securities</u>	66
Item 4. <u>Removed and Reserved</u>	66
Item 5. <u>Other Information</u>	66
Item 6. <u>Exhibits</u>	67
<u>Signatures</u>	68

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****NeoPhotonics Corporation****Condensed Consolidated Balance Sheets****(Unaudited)**

<b>(In thousands, except share and per share data)</b>	<b>September 30, 2011</b>	<b>As of December 31, 2010 *</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 31,502	\$ 25,465
Short-term investments	71,873	0
Restricted cash	2,927	3,027
Accounts receivable, net of allowance for doubtful accounts of \$934 and \$2,270 at September 30, 2011 and December 31, 2010, respectively	58,236	54,374
Inventories	35,877	19,426
Prepaid expenses and other current assets	3,982	7,665
<b>Total current assets</b>	<b>204,397</b>	<b>109,957</b>
Long-term investments	58	0
Property, plant and equipment, net	44,167	43,113
Goodwill	4,323	4,323
Other intangible assets, net	1,610	2,146
Other long-term assets	819	12,956
<b>Total assets</b>	<b>\$ 255,374</b>	<b>\$ 172,495</b>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)</b>		
Current liabilities:		
Accounts payable	\$ 35,746	\$ 29,653
Short-term loans and notes payable	14,510	17,205
Current portion of long-term debt	0	5,924
Accrued and other current liabilities	9,443	13,046
<b>Total current liabilities</b>	<b>59,699</b>	<b>65,828</b>
Long-term debt, net of current portion	0	2,912
Deferred income tax liabilities	557	536
Other noncurrent liabilities	1,420	1,316
<b>Total liabilities</b>	<b>61,676</b>	<b>70,592</b>
Commitments and contingencies (Note 8)		
Redeemable convertible preferred stock:		
Series X redeemable convertible preferred stock, \$0.0025 par value		
At September 30, 2011: no shares authorized, issued or outstanding; At December 31, 2010: 20,000 shares authorized, 18,497 shares issued and outstanding, \$92,487 liquidation preference	0	46,180
Series 1, 2 and 3 redeemable convertible preferred stock, \$0.0025 par value	0	165,361

## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

At September 30, 2011: no shares authorized, issued or outstanding; At December 31, 2010: 7,400,000 shares authorized, 6,639,513 shares issued and outstanding, \$177,960 liquidation preference

	0	211,541
Stockholders' equity (deficit):		
Preferred stock, \$0.0025 par value		
At September 30, 2011: 10,000,000 shares authorized, no shares issued or outstanding; At December 31, 2010: no shares authorized, issued or outstanding	0	0
Common stock, \$0.0025 par value		
At September 30, 2011: 100,000,000 shares authorized, 24,751,665 shares issued and outstanding; At December 31, 2010: 14,000,000 shares authorized, 1,955,280 shares issued and outstanding	62	5
Additional paid-in capital	391,443	93,349
Accumulated other comprehensive income	10,436	12,807
Accumulated deficit	(208,243)	(215,799)
 Total stockholders' equity (deficit)	 193,698	 (109,638)
 Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	 \$ 255,374	 \$ 172,495

\* The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****NeoPhotonics Corporation****Condensed Consolidated Statements of Operations****(Unaudited)**

(In thousands, except share and per share data)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Revenue	\$ 43,961	\$ 47,126	\$ 146,965	\$ 132,888
Cost of goods sold	31,765	32,913	108,570	91,079
Gross profit	12,196	14,213	38,395	41,809
Operating expenses:				
Research and development	7,162	6,091	20,204	16,049
Sales and marketing	2,988	2,677	8,166	7,502
General and administrative	5,957	4,440	14,812	12,397
Amortization of purchased intangible assets	104	286	668	855
Total operating expenses	16,211	13,494	43,850	36,803
Income (loss) from operations	(4,015)	719	(5,455)	5,006
Interest income	77	44	159	163
Interest expense	(52)	(175)	(230)	(565)
Other income (expense), net	159	(105)	14,259	42
Total interest and other income (expense), net	184	(236)	14,188	(360)
Income (loss) before income taxes	(3,831)	483	8,733	4,646
Provision for income taxes	(258)	(405)	(1,177)	(1,725)
Net income (loss)	(4,089)	78	7,556	2,921
Net income attributable to noncontrolling interests	0	0	0	(80)
Net income (loss) attributable to NeoPhotonics Corporation	(4,089)	78	7,556	2,841
Deemed dividend on beneficial conversion of Series X redeemable convertible preferred stock	0	0	(17,049)	0
Accretion of redeemable convertible preferred stock	0	(22)	(7)	(91)
Net income (loss) attributable to NeoPhotonics Corporation common stockholders	\$ (4,089)	\$ 56	\$ (9,500)	\$ 2,750
Net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:				
Basic	\$ (0.17)	\$ 0.00	\$ (0.44)	\$ 0.00
Diluted	\$ (0.17)	\$ 0.00	\$ (0.44)	\$ 0.00
Weighted average shares used to compute net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:				
Basic	24,744,417	1,936,047	21,534,927	1,932,998

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Diluted	24,744,417	2,858,777	21,534,927	2,939,874
---------	------------	-----------	------------	-----------

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****NeoPhotonics Corporation****Consolidated Statements of Cash Flows****(Unaudited)**

	Nine months ended September 30,	
	2011	2010 (As Revised. See Note 1.)
<b>(In thousands)</b>		
<b>Cash flows from operating activities</b>		
Net income	\$ 7,556	\$ 2,921
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	8,159	9,089
Stock-based compensation expense	2,420	1,240
Loss on disposal of fixed assets	140	156
Share of loss of unconsolidated investee	0	176
Gain on sale of unconsolidated investee	(13,867)	0
Allowance for doubtful accounts	93	364
Provision for inventories	449	497
Change in assets and liabilities:		
Accounts receivable	(1,549)	3,435
Inventories	(15,739)	(11,541)
Prepaid expenses and other current assets	1,564	(1,083)
Accounts payable	5,012	7,654
Accrued and other liabilities	(3,790)	(6,778)
Net cash provided by (used in) operating activities	(9,552)	6,130
<b>Cash flows from investing activities</b>		
Purchase of property, plant and equipment	(8,440)	(10,097)
Purchase of securities	(148,860)	0
Proceeds from sale of securities	72,760	0
Proceeds from maturity of securities	3,623	0
Decrease in restricted cash	225	337
Purchase of shares of unconsolidated investee	0	(7,954)
Proceeds from sale of unconsolidated investee, net of direct cost	21,363	0
Cash transferred upon sale of Archcom	0	(1,118)
Net cash used in investing activities	(59,329)	(18,832)
<b>Cash flows from financing activities</b>		
Proceeds from initial public offering of common stock, net of issuance costs	86,528	(2,190)
Proceeds from issuance of preferred stock, net of issuance costs	0	5,978
Proceeds from exercise of stock options	291	47
Proceeds from bank loans	0	6,280
Repayment of bank loans	(11,881)	(15,036)
Proceeds from issuance of notes payable	21,438	20,052
Repayment of notes payable	(21,692)	(20,796)
Net cash provided by (used in) financing activities	74,684	(5,665)
Effect of exchange rates on cash and cash equivalents	234	300



Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Net increase (decrease) in cash and cash equivalents	6,037	(18,067)
Cash and cash equivalents at the beginning of the period	25,465	43,420
Cash and cash equivalents at the end of the period	\$ 31,502	\$ 25,353

*See accompanying Notes to Condensed Consolidated Financial Statements.*

---

**Table of Contents**

**NeoPhotonics Corporation**

**Notes to Condensed Consolidated Financial Statements**

**(Unaudited)**

**Note 1. Basis of presentation**

The condensed consolidated financial statements of NeoPhotonics Corporation ( NeoPhotonics or the Company ) as of September 30, 2011 and December 31, 2010 and for the three and nine months ended September 30, 2011 and 2010, have been prepared in accordance with the instructions on Form 10-Q pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). In accordance with those rules and regulations, the Company has omitted certain information and notes normally provided in its annual consolidated financial statements included in its Annual Report on Form 10-K for the fiscal year ended December 31, 2010. In the opinion of management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring items, except as otherwise noted, necessary for the fair presentation of the Company s financial position and results of operations for the interim periods. These condensed consolidated financial statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2010. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of the results expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated.

*Reverse stock split*

On November 29, 2010, the Company filed its Amended and Restated Certificate of Incorporation which effected a 1-for-25 reverse stock split of all outstanding shares of the Company s stock, including common stock and redeemable convertible preferred stock. Fractional shares of Series X preferred stock were issued. Any fractional shares of common stock and Series 1, 2 and 3 preferred stock resulting from the reverse stock split were settled in cash equal to the fraction of a share to which the holder was entitled. All shares, stock options, warrants to purchase common stock and per share information presented in the condensed consolidated financial statements has been adjusted to reflect the reverse stock split on a retroactive basis for all periods presented and all share information is rounded down to the nearest whole share after reflecting the reverse stock split.

*Initial Public Offering*

In February 2011, the Company completed its initial public offering of 8,625,000 shares of its common stock, including the full underwriters over-allotment option, at a public offering price of \$11.00 per share. Net cash proceeds from the initial public offering were approximately \$84.1 million, after deducting offering expenses and underwriter discounts.

In connection with the closing of the initial public offering, all of the shares of Series 1, Series 2 and Series 3 preferred stock outstanding automatically converted into 6,639,513 shares of common stock on a 1-for-1 basis and all of the shares of Series X preferred stock outstanding automatically converted into 7,398,976 shares of common stock on a 400-for-1 basis.

On February 10, 2011, the Company filed its Amended and Restated Certificate of Incorporation in connection with the closing of its initial public offering. Following the amendment, the Company s authorized capital stock consisted of 110,000,000 shares, comprising: (i) 100,000,000 shares of common stock, par value \$0.0025 per share and (ii) 10,000,000 shares of preferred stock, par value \$0.0025 per share.

*Reclassification of Consolidated Statement of Cash Flows*

The Company made the following reclassifications in the Consolidated Statement of Cash Flows for the nine months ended September 30, 2010:

During the first quarter of 2011, the Company determined that cash payments made in 2010 for initial public offering related expenses had been incorrectly classified as operating cash flow activities on the statements of cash flows, and that such payments should be classified as financing cash flow activities. The Company has revised the 2010 statement of cash flows to correct for the classification. The correction resulted in an increase to Net Cash Provided by Operating Activities of \$2,190,000, with a corresponding increase to Net Cash Used in Financing Activities for the nine months ended September 30, 2010.



---

**Table of Contents**

In addition, for the year ended December 31, 2010, the correction would have resulted in an increase to Net Cash Provided by Operating Activities of \$2,441,000, with a corresponding increase to Net Cash Used in Financing Activities .

During the third quarter of 2011, the Company determined that foreign currency translation adjustments in the third quarter of 2010 had been incorrectly classified on the consolidated statements of cash flows. The Company has revised the 2010 statement of cash flows to correct for the classification. The correction resulted in an increase in Net Cash Provided by Operating Activities of \$977,000 and an increase in Net Cash Used in Investing Activities of \$302,000, with a reduction in Effect of Exchange Rates on Cash and Cash Equivalents of \$1,279,000 for the nine months ended September 30, 2010.

Management has assessed the impact of these corrections on the 2010 interim and annual consolidated statements of cash flows and has concluded that the corrections are not material, either individually, or in the aggregate, to the previously reported cash flows.

**Note 2. Significant Accounting Policies**

There have been no changes in the Company's significant accounting policies for the nine months ended September 30, 2011, as compared to the significant accounting policies described in its Annual Report on Form 10-K for the fiscal year ended December 31, 2010, with the exception of the Company's accounting policies as described below.

*Stock-based compensation*

Effective January 1, 2006, the Company adopted new authoritative accounting guidance for stock-based compensation, which requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments, based on the grant date fair value of the award. The Company adopted the new guidance using the prospective transition method. Under this transition method, beginning January 1, 2006, employee stock-based compensation cost recognized includes: (a) compensation cost for all stock-based payments granted prior to, but not yet vested as of December 31, 2005, based on the intrinsic value method, and (b) compensation cost for all stock-based payments granted or modified subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the new guidance.

The Company grants stock options, stock purchase rights, stock appreciation units and restricted stock units to employees and directors. The stock-based awards are accounted for at fair value as described below.

The Company determines the fair value of stock options on the date of grant utilizing the Black-Scholes option-pricing model. The fair value of the options is recognized over the period during which an employee is required to provide services in exchange for the option award, known as the requisite service period (usually the vesting period) on a straight-line basis.

The first share purchase rights were granted February 2, 2011, the first day NeoPhotonics Corporation common stock was listed on the New York Stock Exchange. The offering period, which extends through November 2011, contains two purchase dates, one in May 2011 and one in November 2011. The Company accounts for the stock purchase rights at the grant date (first day of the offering period) by valuing the two purchase periods separately. The stock purchase rights are accounted for at fair value, utilizing the Black-Scholes option-pricing model. The expense for each purchase period is recognized on a straight-line basis over the requisite service period, from the beginning of the offering period through the respective purchase date.

Beginning in 2007, the Company began granting stock appreciation units. Upon the exercise of a stock appreciation unit, the Company will pay the participant an amount equal to the product of (a) the excess of the per share fair market value of the Company's common stock on the date of exercise over the strike price, multiplied by (b) the number of shares of common stock with respect to which the stock appreciation unit is exercised. Vested stock appreciation units first become exercisable upon the expiration of the lock-up period associated with the initial public offering. Due to the contingent nature of the awards prior to the initial public offering, the Company had not recorded any compensation expense associated with these awards as of December 31, 2010.

---

## **Table of Contents**

Upon completion of the Company's initial public offering, the Company began recognizing stock-based compensation expense for the stock appreciation units. The Company records an expense (credit) and an equal adjustment to the liability for the stock appreciation units equal to the fair value of the vested portion of the awards as of each period end. Each reporting period thereafter, compensation expense will be recorded, based on the remaining service period and the then fair value of the award until vesting of the award is completed. After vesting is completed, the Company will continue to remeasure the fair value of the liability until the award is exercised or expires, with changes in the fair value of the liability recorded in the consolidated statements of operations.

In August 2011, the Company began granting restricted stock units. Restricted stock units are valued at the closing sales price as quoted on the New York Stock Exchange on the date of grant, and are converted into shares of common stock upon vesting on a one-for-one basis. Vesting of restricted stock units is subject to the employee's continuing service to the Company. The compensation expense related to the restricted stock units is determined using the fair value of common stock on the date of grant, and the expense is recognized on a straight-line basis over the vesting period.

Stock-based compensation expense recognized at fair value includes the impact of estimated forfeitures. The Company estimates future forfeitures at the date of grant and revises the estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

### *Financial Instruments*

The following methods were used to estimate the fair value of each class of financial instruments:

*Cash and cash equivalents.* Cash and cash equivalents consist of bank deposits and money market funds used for operational purposes. Cash equivalents are recognized at fair value.

*Short-term and long-term investments.* Short-term investments consist of debt securities and money market funds with maturities of 12 months or less. Long-term investments consist of debt securities with maturities greater than 12 months. Short-term and long-term investments are classified as available-for-sale investments and are recognized at fair value.

The Company regularly reviews its investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is other-than-temporary include: the length of time and extent to which the fair market value has been lower than the cost basis, the financial condition and near-term prospects of the investee, credit quality, likelihood of recovery, and the Company's ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair market value.

Unrealized gains and losses, net of tax, are included in accumulated other comprehensive income as a separate component of stockholders' equity (deficit) on the condensed consolidated balance sheets. The amortization of premiums and discounts on the investments, and realized gains and losses on available-for-sale securities are included in other income (expense), net in the condensed consolidated statements of operations. The Company uses the specific-identification method to determine cost in calculating realized gains and losses upon sale of its debt securities.

*Equity investments.* Equity securities are classified as available-for-sale and are reported at fair market value and unrealized gains and losses are included in accumulated other comprehensive income as a separate component of stockholders' deficit on the condensed consolidated balance sheets. As of December 31, 2010, the Company's investment in equity securities was classified as long-term based on the Company's intent and ability to hold the investment for more than 12 months from the balance sheet date. During the second quarter of 2011, the investee was purchased by another company and, as a result, the Company sold its investment in equity securities.

### *Fair Value Measurements*

Fair value is defined as the price at which an asset could be exchanged in a current transaction between knowledgeable, willing parties. A liability's fair value is defined as the amount that would be paid to transfer the liability to a new obligor, not the amount that would be paid to settle the liability with the creditor. Where available,

---

**Table of Contents**

fair value is based on observable market prices or parameters or derived from such prices or parameters. Where observable prices or inputs are not available, valuation models are applied. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the instruments or market and the instruments' complexity. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The authoritative accounting guidance describes a fair value hierarchy based on three levels of inputs that may be used to measure fair value, of which the first two are considered observable and the last is considered unobservable. These levels of inputs are as follows:

Level 1 Observable inputs such as unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2 Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset or liability. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

Money market funds are valued using quoted market price, and are included in cash and cash equivalents or short-term investments on the Company's condensed consolidated balance sheets.

Marketable securities are valued using quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active, and are included in short-term investments or long-term investments on the Company's condensed consolidated balance sheets.

Equity investments related to the Company's equity shares of a foreign publicly traded company. The Company sold all its equity shares in the unconsolidated investee in the second quarter of 2011. See Note 6 for further details.

The fair value of the short-term loans, notes payable and debt have been calculated using an estimate of the interest rate the Company would have had to pay on the issuance of liabilities with a similar maturity and discounting the cash flows at that rate. The fair values do not necessarily give an indication of the amount that the Company would currently have to pay to extinguish any of this debt. See Note 7 for further details.

*Recent accounting pronouncements*

In September 2009, the Financial Accounting Standards Board, or FASB, reached a final consensus on new revenue recognition guidance regarding revenue arrangements with multiple deliverables. The new accounting guidance addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and how the arrangement consideration should be allocated among the separate units of accounting. The new accounting guidance became effective for the Company beginning January 1, 2011. The adoption of this guidance did not have a material impact on the Company's financial position, results of operations or cash flows.

In January 2010, the FASB issued amended guidance on fair value measurements and disclosures. The new guidance requires additional disclosures regarding fair value measurements, amends disclosures about postretirement benefit plan assets, and provides clarification regarding the level of disaggregation of fair value disclosures by investment class. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for certain Level 3 activity disclosure requirements that will be effective for reporting periods beginning after December 15, 2010. Level 3 assets and liabilities are those whose fair market value inputs are unobservable and reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Accordingly, the Company adopted this amendment for the year ended December 31, 2010, except for the additional Level 3 requirements which were adopted on January 1, 2011. The adoption of this guidance did not have a material impact on the Company's financial position, results of operations or cash flows.

## **Table of Contents**

In April 2010, the FASB issued an accounting standard update which provides guidance on the criteria to be followed in recognizing revenue under the milestone method. The milestone method of recognition allows a vendor who is involved with the provision of deliverables to recognize the full amount of a milestone payment upon achievement, if, at the inception of the revenue arrangement, the milestone is determined to be substantive as defined in the standard. The guidance is effective for the Company on a prospective basis for milestones achieved beginning January 1, 2011. The adoption of this guidance did not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2011, the FASB issued amendments to the FASB Accounting Standard Codification relating to fair value measurements. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments are effective for the Company during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The Company will apply these amendments prospectively beginning in fiscal 2012. The Company is currently evaluating the impact the application of these amendments will have on the consolidated financial statements.

In June 2011, the FASB issued amendments to the FASB Accounting Standard Codification relating to presentation of comprehensive income. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments should be applied retrospectively, and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company will apply the guidance when it becomes effective.

In August 2011, the FASB approved a revised accounting standard update intended to simplify how an entity tests goodwill for impairment. The amendments permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 and early adoption is permitted. The Company is currently evaluating the revised guidance and has not yet determined whether it will early adopt.

### **Note 3. Cash and investments**

The Company began investing in marketable securities in 2011. Prior to 2011, the Company invested in money market funds, classified as cash and cash equivalents. As of December 31, 2010, the amortized cost basis and fair value of the Company's money market funds was \$6,650,000.

**Table of Contents**

The following table summarizes the Company's unrealized gains and losses related to the cash equivalents and investments in marketable securities designated as available-for-sale (in thousands):

	Amortized Cost	As of September 30, 2011 Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Cash and cash equivalents</b>				
Money market funds	\$ 2,020	\$ 0	\$ 0	\$ 2,020
<b>Total investments in cash and cash equivalents</b>	<b>2,020</b>	<b>0</b>	<b>0</b>	<b>2,020</b>
<b>Short-term investments</b>				
Money market funds	14,412	0	0	14,412
Corporate bonds	21,767	7	(457)	21,317
Commercial paper	7,485	0	0	7,485
U.S. federal agencies	17,464	3	(33)	17,434
Foreign bonds and notes	4,524	3	(52)	4,475
Municipal obligations	2,650	1	0	2,651
U.S. treasury bills	4,098	1	0	4,099
<b>Total investments in short-term investments</b>	<b>72,400</b>	<b>15</b>	<b>(542)</b>	<b>71,873</b>
<b>Total investments</b>	<b>\$ 74,420</b>	<b>\$ 15</b>	<b>\$ (542)</b>	<b>\$ 73,893</b>

Realized gains and losses on the sale of marketable securities during the three and nine months ended September 30, 2011 were immaterial.

The following table summarizes the amortized cost and the estimated fair value of the investments in marketable securities, designated as available-for-sale and classified by the contractual maturity date of the security as of September 30, 2011 (in thousands):

	Amortized Cost	Fair Value
Less than 1 year	\$ 50,640	\$ 50,524
Due in 1 to 2 years	12,152	11,817
Due in 2 to 5 years	9,227	9,151
Due after 5 years	2,401	2,401
<b>Total</b>	<b>\$ 74,420</b>	<b>\$ 73,893</b>

The Company may sell its security investments in the future to fund future operations needs. As a result, the Company recorded all its marketable securities in short-term investment as of September 30, 2011, regardless of the contractual maturity date of the securities.

The Company did not recognize any impairment losses on its marketable securities during the three and nine months ended September 30, 2011. As of September 30, 2011, the Company did not have any investments in marketable securities that were in an unrealized loss position for a period in excess of 12 months.

The following table sets forth the fair value of the Company's financial assets as of the date presented (in thousands):

As of September 30, 2011

As of December 31, 2010



Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Money market funds	\$ 16,432	\$ 0	\$ 0	\$ 16,432	\$ 6,650	\$ 0	\$ 0	\$ 6,650
Marketable securities								
Corporate bonds	\$ 0	\$ 21,317	\$ 0	\$ 21,317	\$ 0	\$ 0	\$ 0	\$ 0
Commercial paper	\$ 0	\$ 7,485	\$ 0	\$ 7,485	\$ 0	\$ 0	\$ 0	\$ 0
U.S. federal agencies	\$ 0	\$ 17,434	\$ 0	\$ 17,434	\$ 0	\$ 0	\$ 0	\$ 0
Foreign bonds and notes	\$ 0	\$ 4,475	\$ 0	\$ 4,475	\$ 0	\$ 0	\$ 0	\$ 0
Municipal obligations	\$ 0	\$ 2,651	\$ 0	\$ 2,651	\$ 0	\$ 0	\$ 0	\$ 0
U.S. treasury bills	\$ 0	\$ 4,099	\$ 0	\$ 4,099	\$ 0	\$ 0	\$ 0	\$ 0
Equity investments	\$ 0	\$ 0	\$ 0	\$ 0	\$ 12,724	\$ 0	\$ 0	\$ 12,724

**Table of Contents****Note 4. Net income (loss) per share attributable to NeoPhotonics Corporation common stockholders**

The following table sets forth the computation of the basic and diluted income (loss) per share attributable to NeoPhotonics Corporation common stockholders for the periods indicated (in thousands, except share and per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
<b>Numerator:</b>				
Net income attributable to NeoPhotonics Corporation	\$ (4,089)	\$ 78	\$ 7,556	\$ 2,841
Less: Accretion of redeemable convertible preferred stock	0	(22)	(7)	(91)
Less: deemed dividend on beneficial conversion of Series X redeemable convertible preferred stock	0	0	(17,049)	0
Less: net income attributable to redeemable convertible preferred stockholders	0	(56)	0	(2,750)
Net income (loss) attributable to NeoPhotonics Corporation common stockholders	\$ (4,089)	\$ 0	\$ (9,500)	\$ 0
<b>Denominator:</b>				
Weighted average shares used to compute basic net income (loss) per share attributable to NeoPhotonics Corporation common stockholders	24,744,417	1,936,047	21,534,927	1,932,998
Effect of dilutive securities:				
Common stock options	0	922,730	0	1,006,876
Weighted average shares used to compute diluted net income (loss) per share attributable to NeoPhotonics Corporation common stockholders	24,744,417	2,858,777	21,534,927	2,939,874
Net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:				
Basic	\$ (0.17)	\$ 0.00	\$ (0.44)	\$ 0.00
Diluted	\$ (0.17)	\$ 0.00	\$ (0.44)	\$ 0.00

**Table of Contents**

The Series X preferred stock contained a special conversion feature which was contingent upon completion of an initial public offering. The beneficial conversion feature is measured as the difference between the offering price of \$11.00 per share and the accounting conversion price of \$6.25 per share. At the closing of the initial public offering, a charge of \$17.0 million related to the beneficial conversion feature was recorded to additional paid-in-capital and represents a deemed dividend in calculating net loss attributable to NeoPhotonics Corporation common stockholders for the nine months ended September 30, 2011. For the three and nine months ended September 30, 2011 and 2010, pro forma net income (loss) per share attributable to NeoPhotonics Corporation common stockholders, which assumes all shares of preferred stock are converted to common stock at the beginning of each period on an as converted basis, was as follows (in thousands, except share and per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Net income attributable to NeoPhotonics Corporation	\$ (4,089)	\$ 78	\$ 7,556	\$ 2,841
Pro forma net income per share attributable to NeoPhotonics Corporation common stockholders				
Basic	\$ (0.17)	\$ 0.00	\$ 0.32	\$ 0.18
Diluted	\$ (0.17)	\$ 0.00	\$ 0.32	\$ 0.17
Weighted average shares used to compute pro forma net income per share attributable to NeoPhotonics Corporation common stockholders				
Basic	24,744,417	15,974,536	23,489,002	15,905,704
Diluted	24,744,417	16,897,266	23,767,718	16,912,580

Shares of common stock subject to repurchase resulting from the early exercise of employee stock options are not considered participating securities and are therefore excluded from the basic weighted average common shares outstanding.

The following potentially dilutive securities were excluded from the computation of diluted net loss per share attributable to NeoPhotonics Corporation common stockholders, as their effect would have been antidilutive:

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Employee stock options	738,768	571,667	855,740	528,994
Common stock warrants	4,482	4,482	4,482	4,482
Employee stock purchase plan	33,149	0	76,323	0
Restricted stock units	1,003	0	334	0
Redeemable convertible preferred stock, on an if-converted basis (1)	0	14,038,489	1,975,787	13,950,537
	777,402	14,614,638	2,912,666	14,484,013

(1) For the purposes of the table above, the Series 1, 2 and 3 preferred stock have been converted on a 1-for-1 basis and the Series X preferred stock has been converted on a 400-for-1 basis.

**Note 5. Balance sheet components**

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

*Accounts receivable, net*

Accounts receivable, net consists of the following (in thousands):

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Accounts receivable	\$ 52,602	\$ 53,003
Trade notes receivable	6,568	3,641
Allowance for doubtful accounts	(934)	(2,270)
	\$ 58,236	\$ 54,374

**Table of Contents***Inventories*

Inventories consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Raw materials	\$ 13,240	\$ 8,710
Work in process	5,304	3,316
Finished goods	17,333	7,400
	\$ 35,877	\$ 19,426

*Purchased intangible assets*

Purchased intangible assets consist of the following (in thousands, except years):

	September 30, 2011			December 31, 2010		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Technology and patents	\$ 19,796	\$ (19,655)	\$ 141	\$ 19,108	\$ (19,064)	\$ 44
Customer relationships	6,739	(6,594)	145	6,513	(5,786)	727
Leasehold interest	1,340	(185)	1,155	1,286	(156)	1,130
Noncompete agreements	950	(781)	169	710	(465)	245
	\$ 28,825	\$ (27,215)	\$ 1,610	\$ 27,617	\$ (25,471)	\$ 2,146

Amortization expense relating to technology and patents and the leasehold interest intangible assets is included within cost of goods sold, and customer relationships and the noncompete agreements within operating expenses. The following table presents details of the amortization expense of the Company's purchased intangible assets as reported in the condensed consolidated statements of operations (in thousands):

	Three months ended September 30, 2011		September 30, 2010	
	2011	2010	2011	2010
Cost of goods sold	\$ 7	\$ 323	\$ 66	\$ 1,931
Operating expenses	104	286	668	855
Total	\$ 111	\$ 609	\$ 734	\$ 2,786

The estimated future amortization expense of purchased intangible assets as of September 30, 2011, is as follows (in thousands):

2011 (remaining 3 months)	\$ 111
2012	335
2013	159
2014	48
2015	48
Thereafter	909



**Table of Contents***Accrued and other current liabilities*

Accrued and other current liabilities consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Employee-related	\$ 4,102	\$ 7,385
Other	5,341	5,661
	\$ 9,443	\$ 13,046

*Warranty Accrual*

The Company provides warranties to cover defects in workmanship, materials and manufacturing for a period of one to two years to meet the stated functionality as agreed to in each sales arrangement. Products are tested against specified functionality requirements prior to delivery, but the Company nevertheless from time to time experiences claims under its warranty guarantees. The Company accrues for estimated warranty costs under those guarantees based upon historical experience, and for specific items, at the time their existence is known and the amounts are determinable.

The table below summarizes the movement in the warranty accrual (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Beginning balance	\$ 421	\$ 512	\$ 393	\$ 613
Warranty accruals	71	146	203	285
Settlements and adjustments	(71)	(106)	(175)	(346)
Ending balance	\$ 421	\$ 552	\$ 421	\$ 552

**Note 6. Equity investment**

During the first three quarters of 2010, the Company purchased shares of Ignis ASA ( Ignis ), a Norwegian company traded on the Oslo exchange (Norway stock exchange) in several transactions for total consideration of \$8.1 million. The Company had an ownership percentage in Ignis of 9%, 17% and 23% as of March 31, June 30 and September 30, 2010, respectively. During the fourth quarter of 2010, the Company's ownership percentage in Ignis decreased to 19% due to new shares issued by Ignis.

In the second quarter of 2011, the Company sold all of its shares in Ignis for gross proceeds of \$21.3 million and recognized a gain of \$13.8 million. The gain was included in other income (expense), net in the Company's condensed consolidated statement of operations for the nine months ended September 30, 2011.

The Company had recorded total unrealized gains of \$8.5 million, which became recognized upon the sale of all Ignis shares in June 2011. During the three and nine months ended September 30, 2010, the Company recognized a \$0.2 million loss relating to its share of Ignis' loss in other income (expense), net in the Company's condensed consolidated statements of operations.

**Table of Contents****Note 7. Debt**

The Company records debt at its carrying amount. The following table provides the components of debt, obligations, weighted average interest rate and additional fair value information relating to the Company's outstanding debt instruments (in thousands, except percentages):

	September 30, 2011			December 31, 2010		
	Carrying Amount	Fair Value	Weighted Average Interest Rate	Carrying Amount	Fair Value	Weighted Average Interest Rate
Notes payable	\$ 13,015	\$ 13,015		\$ 12,742	\$ 12,742	
Short-term bank loans	1,495	1,481	5.84%	4,463	4,269	5.23%
<b>Total short-term loans and notes payable</b>	<b>\$ 14,510</b>	<b>\$ 14,496</b>		<b>\$ 17,205</b>	<b>\$ 17,011</b>	
Total long-term debt	0	0	0%	8,836	8,320	4.34%
Less: current portion of long-term debt	0	0		(5,924)	5,689	
Total long-term debt, net of current portion	\$ 0	\$ 0		\$ 2,912	\$ 14,009	

*Notes payable and short-term loans*

The Company's subsidiaries in China have trade notes payable and short-term line of credit facilities from various banking institutions. The trade notes are unsecured, noninterest bearing and are due approximately six months after issuance.

*Long-term debt*

In December 2007, the Company entered into a loan and security agreement with a bank for an available credit facility. The loan and security agreement is secured by substantially all of the Company's U.S. assets, other than intellectual property assets. In December 2008 and December 2009, the loan and security agreement was amended, increasing the amount of credit available under the facility and extending the term of the lending arrangement through December 2011.

As of December 31, 2010, the Company had an \$8.0 million revolving line of credit expiring in December 2011. Amounts available under the revolving line of credit were reduced by any commercial or stand-by letters of credit issued by the bank to guarantee a loan for the Company's subsidiaries in China. The maximum amount for which a letter of credit may be issued was \$5.0 million. As of December 31, 2010, letters of credit for \$5.0 million were outstanding and \$3.0 million was outstanding under the revolving line of credit. The Company repaid the outstanding balance of the revolving line of credit in full in February 2011. In addition, as of December 31, 2010, the Company had a \$9.5 million credit facility based on capital expenditures in the United States, with expected repayment of all amounts by June 2013. As of December 31, 2010, \$5.8 million was outstanding under this credit facility. The Company repaid the outstanding balance of the credit facility in full in March 2011. As of December 31, 2010, \$0 million and \$3.5 million were available to borrow under the revolving line of credit and credit facility, respectively.

In September 2011, the Company entered into a third amendment to the loan and security agreement. The components of the available credit facilities as provided by the September 2011 amendment are as follows:

The original loan and security agreement includes an \$8.0 million revolving line of credit, which was set to expire in December 2011. The September 2011 amendment to the loan and security agreement extends the term of the revolving line of credit through September 2014. In September 2011, the stand-by letters of credit issued by the bank to guarantee a loan for the Company's subsidiaries in China was terminated. As of September 30, 2011, no amounts were outstanding under the revolving line of credit and \$8.0 was available for borrowing.



## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

The original loan and security agreement included a \$9.5 million credit facility based on capital expenditures. Under the September 2011 amendment, this credit facility was terminated.

The September 2011 amendment provides for a new \$20.0 million acquisition advance, expiring in September 2015. Proceeds of the acquisition advance may be used to make permitted business acquisitions. Advances may be drawn in two tranches and are due and payable in equal monthly installments of principal and interest such that all amounts will be repaid by the acquisition line maturity date. The advances will bear interest at a rate of LIBOR plus 2%. As of September 30, 2011, \$0 million was outstanding under the acquisition advance and the total available borrowing capacity under this facility was \$20.0 million.

**Table of Contents**

The September 2011 amendment also provides for a new \$7.0 million equipment line advance for capital expenditures in the United States. Advances may be drawn in four tranches and are due and payable in equal monthly installments of principal and interest such that all amounts will be repaid by September 2015. Borrowings under this facility will bear interest at a rate of LIBOR plus 2%. As of September 30, 2011, \$0 million was outstanding under the acquisition advance and the total available borrowing capacity under this facility was \$7.0 million.

As of September 30, 2011, the Company was in compliance with all of the financial covenants contained in the loan and security agreement and subsequent amendments. The financial covenants include tangible net worth of no less than the base amount, bank debt liquidity coverage of at least 1.50 to 1.00 and liquidity requirements of no less than \$60.0 million.

In connection with the original loan and security agreement, the Company issued a warrant to the lender to purchase 4,482 shares of common stock at an exercise price of \$29.00 per share. As of September 30, 2011, the warrant had not been exercised.

In December 2007, the Company's primary subsidiary in China entered into a term loan agreement with a Chinese bank with a borrowing capacity of up to \$5.0 million. As of December 31, 2010, \$0 million was outstanding under the term loan. In September 2011, this agreement was terminated and therefore no further amounts can be borrowed under this term loan.

**Note 8. Commitments and contingencies***Leases*

The Company leases various facilities under non-cancelable operating leases. In the second quarter of 2011, the Company signed a five-year facilities lease to establish additional production facilities in China. The lease expires in May 2016.

As of September 30, 2011, the future minimum commitments under all operating leases are as follows (in thousands):

2011 (remaining 3 months)	\$ 541
2012	1,862
2013	1,077
2014	914
2015	698
Thereafter	1,949
	\$ 7,041

Rent expense under the Company's operating leases was \$0.6 million and \$0.4 million for the three months ended September 30, 2011 and 2010, respectively, and \$1.7 million and \$1.1 million for the nine months ended September 30, 2011 and 2010, respectively.

*Litigation*

From time to time, the Company is subject to various claims and legal proceedings, either asserted or unasserted, that arise in the ordinary course of business. Management currently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on its financial position, results of operations and statement of cash flows. If, however, an unfavorable ruling were to occur, there may exist a reasonable possibility of a material adverse effect on the Company's financial position, results of operations and cash flows. The Company accrues for losses that it considers probable and for which the loss can be reasonably estimated. In the event that a loss cannot be reasonably estimated, it does not accrue for such losses. The Company continues to monitor these matters; its determination could change, however, and the Company may decide, at some

**Table of Contents**

future date, to establish an appropriate reserve. With respect to any claim or legal proceedings, either asserted or unasserted, management has determined a potential loss is not probable at this time and, accordingly, no amount has been accrued at September 30, 2011. Management makes a determination as to when a potential loss is reasonably possible based on relevant accounting literature and then includes appropriate disclosure of the contingency. Except as otherwise noted, management does not believe that the amount of loss or a range of possible losses is reasonably estimable.

*Indemnification*

In the normal course of business, the Company enters into agreements that contain a variety of representations and warranties and provide for general indemnification. The Company's exposure under these agreements is unknown because it involves claims that may be made against the Company in the future, but have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

*Purchase obligations*

The Company has purchase obligations with certain suppliers for the purchase of goods and services entered in the ordinary course of business. As of September 30, 2011, total outstanding purchase obligations were \$19.6 million, primarily due within the next 12 months.

**Note 9. Stockholders' equity***Redeemable convertible preferred stock*

In connection with the closing of the initial public offering, all of the shares of Series 1, Series 2, Series 3 and Series X preferred stock outstanding automatically converted into shares of common stock. The following table summarizes information related to the Company's redeemable convertible preferred stock prior to conversion into common stock as of December 31, 2010 prior to the effectiveness of the initial public offering in February 2011 (in thousands, except share and per share amounts):

Series	Par Value	Authorized	Issued and Outstanding	Amount <sup>(1)</sup>	Liquidation Value
X	\$ 0.0025	20,000	18,497	\$ 46,180	\$ 92,487
3	\$ 0.0025	4,120,000	3,974,974	99,052	99,376
2	\$ 0.0025	1,440,000	856,452	17,054	28,861
1	\$ 0.0025	1,840,000	1,808,087	49,255	49,723
		7,420,000	6,658,010	\$ 211,541	\$ 270,447

(1) Each of the Series 1, 2 and 3 redeemable convertible preferred stock converted on a 1-for-1 basis into common stock while the Series X convertible preferred stock converted on a 400-for-1 basis.

*Dividends*

No dividends on the convertible preferred stock had been declared by the Board of Directors from inception through their conversion into common stock.

*Common stock*

On February 10, 2011, the Company filed its Amended and Restated Certificate of Incorporation in connection with the closing of its initial public offering. Following the amendment, the Company's authorized

**Table of Contents**

capital stock consists of 110,000,000 shares, comprising: (i) 100,000,000 shares of common stock, par value \$0.0025 per share and (ii) 10,000,000 shares of preferred stock, par value \$0.0025 per share. As of September 30, 2011, the Company had reserved the following shares of authorized but unissued common stock:

	<b>Common Stock</b>
Stock option plans	2,751,130
Stock purchase plan	276,674
Warrants	4,482
	3,032,286

**Equity incentive programs**

In February 2011, in connection with the closing of the Company's initial public offering and execution of the associated underwriting agreement, the Company's 2010 Equity Incentive Plan and 2010 Employee Stock Purchase Plan became effective and shares authorized for issuance under the 2004 Stock Option Plan (described below) were cancelled (except for those shares reserved for issuance upon exercise of outstanding stock options). The 2007 Stock Appreciation Grants Plans (described below) remains in effect, however, the Company does not intend to grant additional stock appreciation units under that plan. In September 2011, the Company adopted the 2011 Inducement Award Plan to provide equity awards to new employees of the Company and its affiliates, including as a result of future business acquisitions.

*Plan descriptions**2004 Stock Option Plan*

The 2004 Stock Option Plan provides for the issuance of options to purchase common stock to eligible employees, consultants and independent directors. As of September 30, 2011, options to purchase 1,885,710 shares were outstanding under the 2004 Stock Option Plan and no shares were available for future grant.

*2007 Stock Appreciation Grants Plan*

The 2007 Stock Appreciation Grants Plan provides for the grant of units ( stock appreciation units ) entitling the holder upon exercise to receive cash in an amount equal to the amount by which the Company's common stock has appreciated in value. The stock appreciation units became exercisable in August 2011 upon expiration of the lock-up period associated with the Company's initial public offering subject to local regulatory compliance requirements. As of September 30, 2011, 269,276 units were outstanding.

*2010 Equity Incentive Plan*

The 2010 Equity Incentive Plan (the 2010 Plan ) provides for the grant of incentive stock options, non-statutory stock options, stock appreciation rights, restricted stock awards, restricted stock unit awards, performance-based stock awards, and other forms of equity compensation, or collectively, stock awards, all of which may be granted to employees, including officers, and to non-employee directors and consultants. Additionally, the 2010 Plan provides for the grant of performance cash awards. Incentive stock options may be granted only to employees. All other awards may be granted to employees, including officers, and to non-employee directors and consultants.

Options granted under the 2010 Plan may be either incentive stock options or nonqualified stock options. Restricted stock units may also be granted under the 2010 Plan. Under the terms of the 2010 Plan, awards may be granted at prices not less than 100% of the fair value of the Company's common stock, as determined by the Company's Board of Directors, on the date of grant for an incentive stock option and not less than 85% of the fair value of the Company's common stock on the date of grant for a non-qualified stock option. Options vest over a period of time as determined by the Board of Directors, generally over a three to four year period, and expire ten years from date of grant.

The number of shares reserved for issuance under the 2010 Plan is 865,420 shares and will automatically increase on January 1st each year, starting on January 1, 2012 and continuing through January 1, 2020, by 3.5% of the total number of shares of the Company's common stock outstanding on December 31 of the preceding calendar



## **Table of Contents**

year, or such lesser number of shares of common stock as determined by the Company's board of directors. The maximum number of shares that may be issued pursuant to the exercise of incentive stock options under the 2010 Incentive Plan is 8,000,000 shares. As of September 30, 2011, stock options to purchase and restricted stock units to convert to a total of 744,960 shares of common stock were outstanding under the 2010 Plan and 120,460 shares were reserved for future issuance.

### *2010 Employee Stock Purchase Plan*

The 2010 Employee Stock Purchase Plan (the "2010 ESPP") initially authorizes the issuance of 342,568 shares of the Company's common stock pursuant to purchase rights granted to employees or to employees of designated affiliates. The number of shares of common stock reserved for issuance will automatically increase on January 1<sup>st</sup> of each year, starting January 1, 2012 and continuing through January 1, 2020, in an amount equal to the lesser of (1) 3.5% of the total number of shares of common stock outstanding on December 31<sup>st</sup> of the preceding calendar year, (2) 600,000 shares of common stock or (3) such lesser number of shares of common stock as determined by the Company's board of directors. The ESPP is intended to qualify as an employee stock purchase plan within the meaning of Section 423 of the Code.

The ESPP will be implemented through a series of offerings of purchase rights to eligible U.S. employees. Except for the initial offering period, the offering period is for 12 months beginning November 16<sup>th</sup> of each year, with two purchase dates on May 15<sup>th</sup> and November 15<sup>th</sup>. The initial offering period began February 2, 2011, the first day NeoPhotonics Corporation common stock was listed on the New York Stock Exchange, and will run through November 15, 2011, with purchase dates on May 15, 2011 and November 15, 2011.

Employees may participate through payroll deductions of 1% to 15% of their earnings. Unless otherwise determined by the Company's board of directors, common stock will be purchased for participating employees at a price per share equal to the lower of (a) 85% of the fair market value of a share of the Company's common stock on the first date of an offering, or (b) 85% of the fair market value of a share of the Company's common stock on the date of purchase. In accordance with the 2010 ESPP, the fair market value of the Company's common stock on the first day of the initial offering period was \$11.00, the price per share at which shares were first sold to the public in the Company's initial public offering, as specified in the Company's prospectus. The Company issued 65,894 shares on the first purchase date of May 15, 2011.

### *2011 Inducement Award Plan*

The 2011 Inducement Award Plan (the "2011 Plan") is a non-shareholder approved stock plan adopted by the Company for the purposes of awarding options, stock appreciation rights, restricted stock grants, restricted stock units and other awards to new employees of the Company and its affiliates. All options shall be designated as nonstatutory stock options.

The number of shares reserved for issuance under the 2011 Plan is 750,000 shares. The exercise price of awards shall be not less than 100% of the fair market value of the Company's common stock on the date of grant. Each stock appreciation right grant will be denominated in shares of common stock equivalents. Options and stock appreciation rights have a maximum term of ten years measured from the date of grant, subject to earlier termination following the individual's cessation of service with the Company. As of September 30, 2011, no awards were outstanding under the 2011 Plan.

**Table of Contents***Stock options and restricted stock units*

The following table summarizes the Company's stock option and restricted stock unit activity during the nine months ended September 30, 2011:

	Shares Available for Grant	Stock Options		Restricted Stock Units	
		Number of Shares	Weighted Average Exercise Price	Number of Units	Weighted Average Grant Date Fair Value
Balance at December 31, 2010	380,016	2,012,637	\$ 5.86	0	\$ 0.00
Authorized for issuance - 2010 Plan	865,420	0	\$ 0.00	0	\$ 0.00
Granted - 2010 Plan	(765,217)	234,642	\$ 7.76	530,575	\$ 6.98
Exercised - 2004 Plan	0	(67,053)	\$ 4.34	0	\$ 0.00
Forfeited or cancelled - 2004 Plan	0	(59,874)	\$ 7.95	0	\$ 0.00
Forfeited or cancelled - 2010 Plan	20,257	(12,987)	\$ 8.08	(7,270)	\$ 7.00
Shares cancelled due to IPO - 2004 Plan	(380,016)	0	\$ 0.00	0	\$ 0.00
Balance at September 30, 2011	120,460	2,107,365	\$ 6.05	523,305	\$ 6.98

The following table summarizes information about stock options outstanding as of September 30, 2011:

	Number of Shares	Options Outstanding		
		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
Vested and expected to vest	2,107,365	\$ 6.05	6.95	\$ 3,605
Exercisable	1,251,720	\$ 4.58	5.70	\$ 3,158

The intrinsic value of options vested and expected to vest and exercisable as of September 30, 2011 is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of September 30, 2011. The intrinsic value of options exercised during the nine months ended September 30, 2011 and 2010, was \$0.4 million and \$0.1 million, respectively, and is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of the exercise date.

The following table summarizes information about restricted stock units outstanding as of September 30, 2011:

	Number of Shares	Restricted Stock Units Outstanding		
		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
Vested and expected to vest	523,305	\$ 0	1.84	\$ 3,600

The intrinsic value of restricted stock units vested and expected to vest as of September 30, 2011 is calculated based on the fair value of the Company's common stock as of September 30, 2011.

**Table of Contents**

*Stock appreciation units*

The following table summarizes the Company's stock appreciation unit activity during the nine months ended September 30, 2011:

	Stock Appreciation Units	Weighted- Average Exercise Price
Stock appreciation units outstanding as of December 31, 2010	301,594	\$ 6.83
Stock appreciation units cancelled	(23,430)	\$ 6.96
Stock appreciation units exercised	(8,888)	\$ 4.25
Stock appreciation units outstanding as of September 30, 2011	269,276	\$ 6.90

The following table summarizes information about stock appreciation units outstanding as of September 30, 2011:

	Number of Units	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
Vested and expected to vest	269,276	\$ 6.90	7.63	\$ 404
Exercisable	124,027	\$ 4.45	6.80	\$ 314

The intrinsic value of stock appreciation units vested and expected to vest and exercisable as of September 30, 2011 is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of September 30, 2011.

**Note 10. Stock-based compensation**

*Stock options*

The following table summarizes the stock-based compensation expense recognized for stock options for the three and nine months ended September 30, 2011 and 2010 (in thousands):

Stock options	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Cost of goods sold	\$ 24	\$ 32	\$ 92	\$ 78
Research and development	118	93	332	283
Sales and marketing	94	92	293	292
General and administrative	180	180	515	587
	\$ 416	\$ 397	\$ 1,232	\$ 1,240

The weighted-average fair value of options granted was \$4.95 and \$9.88 per share for the nine months ended September 30, 2011 and 2010, respectively. At September 30, 2011, the Company has \$3.3 million of unrecognized stock-based compensation expense that will be recognized over the remaining weighted-average period of 2.5 years.





**Table of Contents**

The Company estimated the fair value of all employee stock options using a Black-Scholes valuation model with the following assumptions:

Stock options	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Weighted-average expected term (years)	6.69	6.56	6.69	6.56
Weighted-average volatility	71%	75%	71%	75%
Risk-free interest rate	1.83%-2.13%	2.96%-3.19%	1.83%-2.92%	2.96%-3.19%
Expected dividends	0%	0%	0%	0%

*Expected term.* The expected term was estimated using the Company's historical exercise behavior and expected future exercise behavior.

*Volatility.* Due to the limited history of the trading of the Company's common stock since the initial public offering in February 2011, the expected volatility used by the Company is based on the actual volatility of similar entities. In evaluating similarity, factors such as industry, stage of life cycle, size, and financial leverage are taken into consideration. The term over which volatility was measured was commensurate with the expected term.

*Risk-free interest rate.* The risk-free rate that the Company uses in the Black-Scholes option valuation model is based on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term.

*Expected dividends.* The Company has never declared or paid any cash dividends and does not plan to pay cash dividends in the foreseeable future, and, therefore, used an expected dividend yield of zero in the valuation model.

The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. The Company's estimated forfeiture rate was 9.67% for the three and nine months ended September 30, 2011 and 9.40% for the three and nine months ended September 30, 2010, respectively.

*Stock appreciation units*

Stock appreciation units are remeasured each period at fair value. The following table summarizes the expense (credit) recognized for stock appreciation units for the three and nine months ended September 30, 2011 (in thousands):

Stock appreciation units	Three months ended September 30,		Nine months ended September 30, 2011	
	2011			
Cost of goods sold	\$	(174)	\$	245
Research and development		9		229
Sales and marketing		19		103
General and administrative		(7)		82
	\$	(153)	\$	659

In February 2011, the Company recorded a catch-up expense associated with vested stock appreciation units. Vested stock appreciation units first became exercisable upon the expiration of the lock-up period associated with the initial public offering. Due to the contingent nature of the awards prior to the initial public offering, the Company had not recorded any compensation expense associated with these awards. Therefore, in February 2011, the Company recognized compensation expense representing the number of vested stock appreciation units at that date, multiplied by the fair value of the award. Subsequently, the Company recognizes a charge (credit) for any changes in the fair value of the vested awards.

## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

As of September 30, 2011, the liability for the settlement of the stock appreciation units was \$0.7 million and is included in accrued and other current liabilities on the condensed consolidated balance sheet. The Company had not recognized a liability related to the stock appreciation units as of December 31, 2010.

**Table of Contents**

Based on the fair value of the stock appreciation units as of September 30, 2011, the Company has \$0.4 million of unrecognized stock-based compensation expense that would be recognized over the remaining weighted-average period of 2.3 years.

The Company estimated the fair value of all employee stock appreciation units using a Black-Scholes valuation model with the following assumptions:

Stock appreciation units	Three months ended	Nine months ended
	September 30, 2011	September 30, 2011
Weighted-average expected term (years)	3.78	3.98
Weighted-average volatility	75%	74%
Risk-free interest rate	0.43%-1.23%	0.43%-2.42%
Expected dividends	0%	0%

*Expected term.* Vested stock appreciation units first become exercisable upon the expiration of the lock-up period associated with the initial public offering. Therefore, the Company estimated the term of the award based on an average of the weighted-average exercise period and the remaining contractual term.

*Volatility.* Due to the limited history of the trading of the Company's common stock since the initial public offering in February 2011, the expected volatility used by the Company is based on the actual volatility of similar entities. In evaluating similarity, factors such as industry, stage of life cycle, size, and financial leverage are taken into consideration. The term over which volatility was measured was commensurate with the expected term.

*Risk-free interest rate.* The risk-free rate that the Company uses in the Black-Scholes option valuation model is based on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term.

*Expected dividends.* The Company has never declared or paid any cash dividends and does not plan to pay cash dividends in the foreseeable future, and, therefore, used an expected dividend yield of zero in the valuation model.

*Employee stock purchase plan*

The following tables summarize the components of the expense relating to the 2010 ESPP for the three and nine months ended September 30, 2011 (in thousands):

2010 ESPP	Three months ended	Nine months ended
	September 30, 2011	September 30, 2011
Cost of goods sold	\$ 4	\$ 43
research and development	41	179
Sales and marketing	14	75
General and administrative	8	68
	\$ 67	\$ 365

There were 65,894 shares issued for the first purchase period ended May 15, 2011. At September 30, 2011, there was \$0.0 million of unrecognized stock-based compensation expense that will be recognized over the remaining offering period, through November 2011.

**Table of Contents**

The value of the stock purchase right consists of: (1) the 15% discount on the purchase of the stock, (2) 85% of the call option and (3) 15% of the put option. The call option and put option were valued using the Black-Scholes option pricing model with the following assumptions:

2010 ESPP	Purchase Period Ending	
	May 15, 2011	November 15, 2011
Weighted-average expected term (years)	0.28	0.77
Weighted-average volatility	58%	58%
Risk-free interest rate	0.15%	0.22%
Expected dividends	0%	0%

*Expected term.* The expected term represents the period of time from the beginning of the offering period to the purchase date.

*Volatility.* Due to the limited history of the trading of the Company's common stock since the initial public offering in February 2011, the expected volatility used by the Company is based on the actual volatility of similar entities. In evaluating similarity, factors such as industry, stage of life cycle, size, and financial leverage are taken into consideration. The term over which volatility was measured was commensurate with the expected term.

*Risk-free interest rate.* The risk-free rate that the Company uses in the Black-Scholes option valuation model is based on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term.

*Expected dividends.* The Company has never declared or paid any cash dividends and does not plan to pay cash dividends in the foreseeable future, and, therefore, used an expected dividend yield of zero in the valuation model.

**Restricted stock units**

The Company began granting restricted stock units in August 2011. The following table summarizes the stock-based compensation expense recognized for restricted stock units for the three and nine months ended September 30, 2011 (in thousands):

Restricted stock units	Three and Nine months ended September 30, 2011	
Cost of goods sold	\$	25
Research and development		50
Sales and marketing		46
General and administrative		43
	\$	164

The weighted-average fair value of restricted stock units granted was \$6.98 per share for the nine months ended September 30, 2011. At September 30, 2011, the Company has \$2.9 million of unrecognized stock-based compensation expense that will be recognized over the remaining weighted-average period of 2.8 years.

**Note 11. Income taxes**

The Company's income tax expense for the three and nine months ended September 30, 2011 is primarily related to income taxes of the Company's non-U.S. operations. The Company recorded an income tax provision of \$0.3 million and \$1.2 million for the three and nine months ended September 30, 2011, as compared to an income tax provision of \$0.4 million and \$1.7 million during the three and nine months ended September 30, 2010.

The Company conducts its business globally. However, operating income is subject to varying rates of tax in the United States and China. Consequently, the Company's effective tax rate is dependent upon the geographic distribution of earnings or losses and the tax laws and regulations in each geographical region. The Company expects that its income taxes will vary in relation to the Company's profitability and the

## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

geographic distribution of its profits. Historically, the Company has experienced net losses in the United States and in the short term, the Company expects this trend to continue. One of the Company's subsidiaries in China generates a cash tax liability. The subsidiary has qualified for a preferential 15% tax rate available for high technology enterprises as opposed to the statutory 25% tax rate.

**Table of Contents**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the carrying amounts of existing assets and liabilities in the financial statements and their respective tax bases using tax rates expected to be in effect during the years in which the basis differences reverse.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of a deferred tax asset will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. A valuation allowance is recorded for loss carryforwards and other deferred tax assets where it is more likely than not that such deferred tax assets will not be realized. Due to historic losses in the U.S., the Company has a full valuation allowance on the U.S. deferred tax assets.

As of September 30, 2011, there were no material changes to either the nature or the amounts of the uncertain tax positions previously determined as of December 31, 2010.

**Note 12. Other comprehensive income**

The components of comprehensive income (loss), net of tax, were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Net income (loss) attributable to NeoPhotonics Corporation	\$ (4,089)	\$ 78	\$ 7,556	\$ 2,841
Foreign currency translation adjustments	1,309	1,301	2,569	1,588
Unrealized gains (losses) on securities:	(393)	0	(528)	0
Unrealized gains on equity investments (1)	0	0	(4,411)	0
Comprehensive income (loss) attributable to NeoPhotonics Corporation	(3,173)	1,379	5,186	4,429
Comprehensive income (loss) attributable to noncontrolling interests	0	0	0	80
Comprehensive income (loss)	\$ (3,173)	\$ 1,379	\$ 5,186	\$ 4,509

- (1) Unrealized gains on equity investments represents the reclassification adjustment for gains realized upon the sale of equity shares in an unconsolidated investee. See Note 6 for further details.

**Note 13. Subsequent events***Draw down of loan*

On October 7, 2011, the Company drew down a four-year acquisition advance and a three-year revolving line advance under the Third Amendment to Loan and Security Agreement and Waiver and Consent with a bank for an aggregate principal amount of \$28,000,000. Of this amount, \$20,000,000 is repayable in equal monthly installments through September 29, 2015, and interest is payable monthly on the revolving line advance until maturity on September 30, 2014 at which time the principal is due and payable. The proceeds of the advances were used by the Company for the Santur acquisition. See Note 7 for more information as to the detailed terms of these credit facilities.

*Acquisition of Santur Corporation*

On October 12, 2011, the Company acquired Santur Corporation ( Santur ) for a total purchase price of approximately \$44.4 million which includes the repayment of Santur's debt and excludes cash acquired from Santur. An aggregate amount of \$6.0 million was withheld and placed into escrow to cover certain indemnity obligations from the closing date through October 11, 2013. In addition, such holders are also entitled to receive up to an additional \$7.5 million, in the aggregate, contingent on the financial performance of Santur products during calendar year 2012. In connection with the acquisition, the Company granted stock options under the NeoPhotonics 2011 Inducement Award Plan to retain certain Santur employees. See Note 9 for more information as to the plan details.





---

## **Table of Contents**

Santur is a designer and manufacturer of Indium Phosphide (InP) based PIC products, and is now a wholly owned subsidiary of the Company. The acquisition of Santur is intended to enhance the Company's position in PIC-based modules and subsystems for high speed networks.

To fund the acquisition of Santur, the Company also sold a portion of its security investments in the three months ended September 30, 2011. The Company expects to sell more of its security investments in the future and the proceeds of the sale are expected to be used to fund future operating needs.

The financial results of Santur will be included in the results of the Company beginning from the fourth quarter of 2011. Given that the acquisition closed in early October, the Company is in the process of completing the purchase price allocation and determination of opening balance sheet. As a result, the Company is not yet in a position to provide further disclosures relating to the acquisition, and expects to do so in its Form 10-K for the year ending December 31, 2011.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q for the period ended September 30, 2011 and the audited consolidated financial statements and notes thereto and management's discussion and analysis of financial condition and results of operations for the fiscal year ended December 31, 2010 included in our Annual Report on Form 10-K. References to NeoPhotonics, we, our and us are to NeoPhotonics Corporation unless otherwise specified or the context otherwise requires.*

*This Quarterly Report on Form 10-Q for the period ended September 30, 2011 contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q for the period ended September 30, 2011 that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Terminology such as believe, may, might, objective, estimate, continue, anticipate, intend, should, plan, expect, predict, potential, or the negative of these terms or other similar expressions is intended to identify forward-looking statements.*

*We have based these forward-looking statements largely on our current expectations and projections about future events and industry and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified in Part II Item 1A. Risk Factors below, and those discussed in the sections titled Special Note Regarding Forward-Looking Statements and Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, as filed with the SEC on March 28, 2011. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.*

### **Business overview**

We are a leading designer and manufacturer of photonic integrated circuit, or PIC,-based modules and subsystems for bandwidth-intensive, high-speed communications networks.

Our products are designed to enable high-speed transmission rates and efficient allocation of bandwidth over optical networks with high quality and low costs. Our PIC technology utilizes proprietary design elements that provide optical functionality on a silicon chip. PIC devices can integrate many more functional elements than discretely packaged components, enabling increased functionality in a small form factor while reducing packaging and interconnection costs. In addition, the cost advantages of PIC-based components are similar to the economics of semiconductor wafer mass manufacturing, where the marginal cost of producing an incremental chip is much less than that of a discrete component.

---

## **Table of Contents**

We have research and development and wafer fabrication facilities in San Jose, California which coordinate with our research and development and manufacturing facilities in Shenzhen, China. We also maintain research facilities in Wuhan, China and Hachioji, Japan. We utilize proprietary design tools and design-for-manufacturing techniques to align our design process with our precision nanoscale, vertically integrated manufacturing and testing capabilities. We sell our products to the leading network equipment vendors globally, including ADVA AG Optical Networking Ltd., Alcatel-Lucent SA, Ciena Corporation, Cisco Systems, Inc., FiberHome Technologies Group, ECI Telecom Ltd., Telefonaktiebolaget LM Ericsson, Fujitsu Limited, Harmonic, Inc., Huawei Technologies Co., Ltd., Mitsubishi Electric Corporation, NEC Corporation, Nokia Siemens Networks B.V. and ZTE Corporation. We refer to these companies as our Tier 1 customers.

We operate a sales model that focuses on direct alignment with our customers through coordination of our sales, product engineering and manufacturing teams. Our sales and marketing organizations support our strategy of increasing product penetration with our Tier 1 customers while also serving our broader customer base. We use a direct sales force covering the United States, China, Canada, India, Israel, Japan, Russia and the European Union. These individuals work with our product engineers, and product marketing and sales operations teams, in an integrated approach to address our customers' current and future needs. We also engage independent commissioned representatives and distributors in these and other countries to extend our global reach.

In February 2011, we completed our initial public offering of 8,625,000 shares of common stock, including the full underwriters' over-allotment option, at a public offering price of \$11.00 per share. Our initial public offering generated net proceeds of \$84.1 million, after deducting offering expenses and underwriter discounts. In connection with the closing of the initial public offering, all of the shares of our Series 1, Series 2 and Series 3 preferred stock then outstanding automatically converted into 6,639,513 shares of common stock on a 1-for-1 basis and all of the shares of our Series X preferred stock then outstanding automatically converted into 7,398,976 shares of common stock on a 400-for-1 basis.

For the first nine months of fiscal 2011 compared to the same period in fiscal 2010, we experienced an increase in demand for our access products as carriers continued to deploy fiber-to-the-home solutions, particularly in China. Additionally, we experienced increases in demand for our 40Gbps and 100Gbps speed products. In the third quarter of 2011, however, we experienced lower demand for our access products in particular, and lower demand for many of our other products. We expect similar levels of demand for our products in the fourth quarter as we experienced in the third quarter of 2011. The market for optical communications products remains highly competitive. We expect to continue to experience competition from companies that range from large international companies offering a wide range of products to smaller companies specializing in narrow markets. We anticipate macroeconomic conditions, including the slow recovery in the U.S., European sovereign debt issues, and concerns relating to inflation in China and flooding in Thailand, could impact the Company's results.

In September 2011, we announced the acquisition of Santur Corporation. Founded in 2000, Santur is located in Fremont, California. Santur is a designer and manufacturer of Indium Phosphide (InP) based PIC products, and is now a wholly owned subsidiary of the Company. The acquisition of Santur is intended to enhance the Company's position in PIC-based modules and subsystems for high speed networks.

### **Critical accounting policies and estimates**

There have been no material changes to our significant accounting policies during the nine months ended September 30, 2011 from those disclosed in our 2010 Form 10-K, with the exception of our accounting policies for stock-based compensation and financial instruments, as described in Note 2 of the Notes to the Condensed Consolidated Financial Statements.

**Table of Contents***Stock-based compensation*

Our stock-based compensation expense (credit) was recorded as follows:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Cost of goods sold	\$ (121)	\$ 32	\$ 404	\$ 78
Research and development	218	93	791	283
Sales and marketing	173	92	517	292
General and administrative	224	180	708	587
	\$ 494	\$ 397	\$ 2,420	\$ 1,240

We grant stock options, stock purchase rights, stock appreciation units and restricted stock units to employees and directors. The stock-based awards are accounted for at fair value as of the measurement date. For stock options and restricted stock units, the measurement date is the grant date and for stock purchase rights the measurement date is the first day of the offering period. Stock appreciation units are subject to remeasurement each reporting period.

Restricted stock units are measured based on the value of our common stock on the date of grant. Our determination of the fair value of all of our other stock-based payment awards on the measurement date utilizes the Black-Scholes option pricing model, and is impacted by our common stock price as well as changes in assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, expected common stock price volatility over the term of the option awards, projected employee option exercise behaviors (expected period between stock option vesting date and stock option exercise date), risk-free interest rates and expected dividends.

The fair value is recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period) on a straight-line basis. Stock-based compensation expense includes the impact of estimated forfeitures. We estimate future forfeitures at the date of grant and revise the estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Black-Scholes pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants. Existing valuation models, including the Black-Scholes model, may not provide reliable measures of the fair value of our stock-based awards. Consequently, there is a risk that our estimates of the fair value of our stock-based awards on the measurement dates may bear little resemblance to the actual values realized upon exercise. Stock options may expire or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our consolidated financial statements. Further, the value of share purchase rights recognized on the grant date may differ from the value realized by the employee on the purchase dates. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our consolidated financial statements. With regard to stock appreciation units, the value remeasured each period, may not be representative of the value realized upon exercise.

We calculated the fair value of stock options granted to employees using the Black-Scholes pricing model with the following assumptions:

Stock options	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Weighted-average expected term (years)	6.69	6.56	6.69	6.56
Weighted-average volatility	71%	75%	71%	75%
Risk-free interest rate	1.83%-2.13%	2.96%-3.19%	1.83%-2.92%	2.96%-3.19%
Expected dividends	0%	0%	0%	0%

**Table of Contents**

We calculated the fair value of all employee stock appreciation units using the Black-Scholes valuation model with the following assumptions:

<b>Stock appreciation units</b>	<b>Three months ended September 30,</b>	<b>Nine months ended September 30,</b>
Weighted-average expected term (years)	3.78	3.98
Weighted-average volatility	75%	74%
Risk-free interest rate	0.43%-1.23%	0.43%-2.42%
Expected dividends	0%	0%

The first share purchase rights were granted February 2, 2011, the first day our common stock was listed on the New York Stock Exchange. The offering period, which extends through November 2011, contains two purchase dates, one in May 2011 and one in November 2011. We account for the stock purchase rights at the grant date (first day of the offering period) by valuing the two purchase periods separately. The value of the stock purchase right consists of: (1) the 15% discount on the purchase of the stock, (2) 85% of the call option and (3) 15% of the put option. The call option and put option were valued using the Black-Scholes option pricing model with the following assumptions:

<b>2010 ESPP</b>	<b>Purchase Period Ending May 15, 2011</b>	<b>November 15, 2011</b>
Weighted-average expected term (years)	0.28	0.77
Weighted-average volatility	58%	58%
Risk-free interest rate	0.15%	0.22%
Expected dividends	0%	0%

In addition to the assumptions used to calculate the fair value of our options, we are required to estimate the expected forfeiture rate of all stock-based awards and only recognize expense for those awards we expect to vest. Accordingly, the stock-based compensation expense recognized in our consolidated statement of operations for the nine months ended September 30, 2011 and 2010 has been reduced for estimated forfeitures. If we were to change our estimate of forfeiture rates, the amount of stock-based compensation expense could differ, materially under certain circumstances, from the amount recognized in our consolidated financial statements. For example, if we had decreased our estimate of expected forfeitures by 50%, the increase in our stock-based compensation expense for the three and nine months ended September 30, 2011, net of expected forfeitures, would have been immaterial. This decrease in our estimate of expected forfeitures would increase the amount of expense for all unvested awards that have not yet been recognized by \$530,000 as of September 30, 2011, which would be amortized over a weighted-average period of 2.5 years. In addition, if our stock-based compensation expense increases in the future, the impact of a change in the estimated forfeiture rate could be more significant.

*Financial Instruments*

The following methods were used to estimate the fair value of each class of financial instruments:

*Cash and cash equivalents.* Cash and cash equivalents consist of bank deposits and money market funds used for operational purposes. Cash equivalents are recognized at fair value.

*Short-term and long-term investments.* Short-term investments consist of debt securities and money market funds with maturities of 12 months or less. Long-term investments consist of debt securities with maturities greater than 12 months. Short-term and long-term investments are classified as available-for-sale investments and are recognized at fair value. As of September 30, 2011, all of our security investments were short-term investments based on our intent to sell the investments to fund our future operations activity.

We review our investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is other-than-temporary include: the length of time and extent to which the fair market value has been lower than the cost basis, the financial condition and near-term prospects of the investee, credit quality, likelihood of recovery, and our ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair market value.

**Table of Contents**

Unrealized gains and losses, net of tax, are included in accumulated other comprehensive income (loss) as a separate component of stockholders equity (deficit) on the condensed consolidated balance sheets. The amortization of premiums and discounts on the investments, and realized gains and losses on available-for-sale securities are included in other income, net in the condensed consolidated statements of operations. We use the specific-identification method to determine cost in calculating realized gains and losses upon sale of our debt securities.

*Equity investments.* Equity securities are classified as available-for-sale and are reported at fair market value and unrealized gains and losses are included in accumulated other comprehensive income (loss) as a separate component of stockholders deficit in the condensed consolidated balance sheets. As of December 31, 2010, our investment in equity securities was classified as long-term based on our intent and ability to hold the investment for more than 12 months from the balance sheet date. During the second quarter of 2011, the investee was purchased by another company and, as a result, we sold our investment in equity securities.

**Results of operations***Revenue*

We sell substantially all of our products to original equipment manufacturers, or OEMs. Revenue is recognized upon delivery of our product to the OEM. We price our products based on market and competitive conditions and may periodically reduce the price of our products as market and competitive conditions change and as manufacturing costs are reduced. Our sales transactions to customers are denominated primarily in Chinese Renminbi ( RMB ) or U.S. dollars. Revenue is driven by the volume of shipments and may be impacted by pricing pressures. For the three and nine months ended September 30, 2011, 62% and 65% of our sales were derived from our China-based subsidiaries, respectively, the majority of which were denominated in RMB. In addition, we have generated most of our revenue from a limited number of customers. Given the high concentration of network equipment vendors in our industry, our top ten customers represented 88% and 91% of our revenue in the three months ended September 30, 2011 and 2010, respectively, and 90% and 87% of our revenue in the nine months ended September 30, 2011 and 2010, respectively.

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Total revenue	\$ 43,961	\$ 47,126	\$ 146,965	\$ 132,888

Total revenue decreased by \$3.2 million in the three months ended September 30, 2011 compared to the three months ended September 30, 2010, representing a 7% decrease. The decrease in revenue was primarily due to a decrease in demand for access and transport products from our largest customer, Huawei Technologies. The decrease was partially offset by an increase in revenue for our 100Gbps products from other customers introduced in 2011.

Total revenue increased by \$14.1 million in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, representing an 11% increase. The increase in revenue was primarily attributable to increases in demand for our products as carriers continued to deploy fiber-to-the-home solutions and deploy 40Gbps, 100Gbps and other telecom networks. Sales increased on a global basis, primarily in China.

We expect that a significant portion of our revenue will continue to be derived from a limited number of customers. Our largest customer, Huawei Technologies, represented 42% and 51% of our total revenue in the three and nine months ended September 30, 2011, respectively. As a result, the loss of, or a significant reduction in orders from, Huawei Technologies or any of our other key customers would materially and adversely affect our revenue and results of operations. We expect a significant portion of our sales to be denominated in foreign currencies in the future, and therefore may continue to be affected by changes in foreign exchange rates.

*Cost of goods sold and gross margin*

Our cost of goods sold consists primarily of the cost to produce wafers and to manufacture and test our products. We have a global set of suppliers to help balance considerations related to product availability, quality and cost. Components of our cost of goods sold are denominated primarily in RMB. Our manufacturing process extends from wafer fabrication through final module and subsystem assembly and test. The cost of our manufacturing,



**Table of Contents**

assembly and test processes includes the cost of personnel and the cost of our manufacturing equipment and facilities. Our cost of goods sold is impacted by manufacturing variances such as assembly and test yields and production volume. We typically experience lower yields and higher associated costs on new products. In general, our cost of goods sold associated with a particular product declines over time as a result of decreases in wafer costs associated with the increase in the volume of wafers produced, as well as yield improvements and assembly and test enhancements. Additionally, our cost of goods sold includes stock-based compensation, reserves for excess and obsolete inventory, royalty payments, amortization of certain purchased intangible assets, warranty, shipping and allocated facilities costs.

Gross profit as a percentage of total revenue, or gross margin, has been and is expected to continue to be affected by a variety of factors, including the introduction of new products, production volume, production volume compared to sales over time, the mix of products sold, inventories, changes in the average selling prices of our products, changes in the cost and volumes of materials purchased from our suppliers, changes in labor costs, changes in overhead costs or requirements, revaluation of stock appreciation unit awards that are impacted by our stock price, and any reserves for excess and obsolete inventory. Our newer and more advanced products typically have higher average selling prices and higher gross margins. Average selling prices by product typically decline as a result of periodic negotiations with our customers and competitive pressures. We strive to increase our gross margin as we seek to manage the costs of our supply chain and increase productivity in our manufacturing processes.

(in thousands, except percentages)	Three months ended September 30, 2011		2010		Nine months ended September 30, 2011		2010	
	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue
Cost of goods sold	\$ 31,765	72%	\$ 32,913	70%	\$ 108,570	74%	\$ 91,079	69%
Gross margin					28%	30%	26%	31%

Cost of goods sold decreased by \$1.1 million in the three months ended September 30, 2011 compared to the three months ended September 30, 2010, representing a 3% decrease. Cost of goods sold decreased primarily due to lower sales volume of high speed and agility products, improved manufacturing utilization as a result of higher retention and more skillful direct labor in manufacturing and overall continuous price reduction efforts in material purchases. The decrease in cost of goods sold was partially offset by additional direct labor and overhead costs, as a result of increased headcount and increased employee benefit cost from the new housing fund and minimum wage as required by the Shenzhen government effective as of late 2010 and early 2011, respectively. Gross margin was 28% for the three months ended September 30, 2011, compared to 30% for the three months ended September 30, 2010. The decrease in gross margin primarily resulted from the increase in sales of our lower-margin access products and higher headcount, partially offset by overall continuous pricing reduction efforts in material purchases and higher efficiencies in manufacturing.

Cost of goods sold increased by \$17.5 million in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, representing a 19% increase. Cost of goods sold increased primarily from higher sales volumes, additional direct labor and overhead costs as a result of increased headcount and increased employee benefit cost from the new housing fund and minimum wage as required by the Shenzhen government effective as of late 2010 and early 2011, respectively, and equipment purchases as a result of capacity expansion in 2011. The increase in cost of goods sold was partially offset by overall continuous price reduction efforts in material purchases, improved manufacturing utilization and a decrease in amortization of purchased intangible assets as certain assets became fully amortized. Gross margin was 26% for the nine months ended September 30, 2011, compared to 31% for the nine months ended September 30, 2010. The decrease in gross margin primarily resulted from the increase in sales of our lower-margin access products, additional payroll and employee-related costs, and

**Table of Contents**

the impact of lower pricing contracts entered into with customers at the end of the 2010 and effective during first half of 2011, partially offset by overall continuous pricing reduction in material purchases and higher efficiencies in manufacturing.

We expect to continue to experience increased demand for certain of our products that can have lower than average margins, which can cause our gross margin to be lower than the comparable year-ago periods. In addition, we may experience higher China manufacturing labor cost due to future laws and regulations in China, and our gross margins and results of operations may be adversely affected.

*Operating expenses*

Our operating expenses consist of research and development, sales and marketing, general and administrative and amortization of purchased intangible assets. Personnel costs are the most significant component of operating expenses and consist of costs such as salaries, benefits, bonuses, stock-based compensation and, with regard to sales and marketing expense, sales commissions. Although our operating expenses are denominated primarily in RMB and U.S. dollars, most are denominated in U.S. dollars.

(in thousands, except percentages)	Three months ended September 30, 2011		2010		Nine months ended September 30, 2011		2010	
	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue
Research and development	\$ 7,162	16%	\$ 6,091	13%	\$ 20,204	14%	\$ 16,049	12%
Sales and marketing	2,988	7	2,677	6	8,166	6	7,502	6
General and administrative	5,957	14	4,440	9	14,812	10	12,397	9
Amortization of purchased intangible assets	104		286	1	668		855	1
<b>Total operating expenses</b>	<b>\$ 16,211</b>	<b>37%</b>	<b>\$ 13,494</b>	<b>29%</b>	<b>\$ 43,850</b>	<b>30%</b>	<b>\$ 36,803</b>	<b>28%</b>

*Research and development*

Research and development expense consists of personnel costs, including stock-based compensation, for our research and development personnel, and product development costs, including engineering services, development software and hardware tools, depreciation of capital equipment and facility costs. We record all research and development expense as incurred.

Research and development expense increased by \$1.1 million in the three months ended September 30, 2011 compared to the three months ended September 30, 2010, representing an 18% increase. This increase was primarily due to a \$0.7 million increase in additional payroll and employee-related costs as a result of increased headcount and a \$0.4 million increase in material consumption, facility costs and equipment usage to support higher research and development projects.

Research and development expense increased by \$4.2 million in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, representing a 26% increase. This increase was primarily due to a \$2.9 million increase in additional payroll and employee-related costs as a result of increased headcount, and a \$1.6 million increase in material consumption, facility costs and equipment usage to support more research and development projects.

We intend to continue to invest in research and development and expect this expense to increase as we grow our business. We have invested a portion of the realized profit from our investment in an unconsolidated investee in the second quarter of 2011 and plan to continue to invest a portion of the profit over the coming quarters in research and development relating to switching and high speed devices.

*Sales and marketing*

Sales and marketing expense consists primarily of personnel costs, including stock-based compensation and sales commissions, costs related to sales and marketing programs and services and facility costs.



## **Table of Contents**

Sales and marketing expense increased by \$0.3 million in the three months ended September 30, 2011 compared to the three months ended September 30, 2010, representing a 12% increase, and was primarily due to additional payroll and employee-related costs.

Sales and marketing expense increased by \$0.7 million in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, representing a 9% increase, and was primarily due to additional payroll and employee-related costs, partially offset by decrease in administrative overhead expense.

We expect our sales and marketing expense to increase as we grow our business.

### *General and administrative*

General and administrative expense consists primarily of personnel costs, including stock-based compensation, for our finance, human resources and information technology personnel and certain executive officers, as well as professional services costs related to accounting, tax, banking, legal and information technology services, depreciation of capital equipment and facility costs.

General and administrative expense increased by \$1.5 million in the three months ended September 30, 2011 compared to the three months ended September 30, 2010, representing a 34% increase. The increase was primarily due to a \$0.8 million increase related to public company compliance expenses and legal fees, a \$0.3 million increase in payroll and employee-related costs, and a \$0.3 million increase in business tax mainly related to city construction tax and educational surtax as required by the Chinese government.

General and administrative expense increased by \$2.4 million in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, representing a 19% increase. The increase was primarily due to a \$1.1 million increase in professional services expense related to public company compliance expenses and legal fees, a \$0.7 million increase in business tax mainly related to city construction tax and educational surtax as required by the Chinese government, and a \$0.6 million increase in additional payroll and employee-related costs as a result of higher headcount.

We expect our general and administrative expense to increase as we incur costs associated with being a public company and as we expand and grow our operations and business.

### *Amortization of purchased intangible assets*

We completed a series of business acquisitions in 2005 and 2006, which included the acquisition of intangible assets. These intangible assets are being amortized over their estimated useful lives.

Amortization of purchased intangible assets decreased by \$0.2 million in the three and nine months ended September 30, 2011 compared to the three and nine months ended September 30, 2010, representing a 64% and 22% decrease, respectively. The decreases were primarily due to some of these assets becoming fully amortized in the second half of 2010.

We expect our amortization of purchased intangible assets to increase due to the Santur acquisition in October 2011.

### *Interest and other income (expense), net*

Interest income consists of income earned on our cash, cash equivalents and short-term investments. Interest expense consists of amounts paid for interest on our short-term and long-term debt borrowings. Other income (expense), net is primarily made up of gains from the sale of equity shares of an unconsolidated investee, government subsidies and foreign currency transaction gains and losses. The functional currency of our subsidiaries in China is the RMB and the foreign currency transaction gains and losses of our subsidiaries in China primarily result from their transactions in U.S. dollars.

**Table of Contents**

(in thousands)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Interest income	\$ 77	\$ 44	\$ 159	\$ 163
Interest expense	(52)	(175)	(230)	(565)
Other income (expense), net	159	(105)	14,259	42
Total interest and other income (expense), net	\$ 184	\$ (236)	\$ 14,188	\$ (360)

Total interest and other income (expense), net increased by \$0.4 million in the three months ended September 30, 2011 compared to the three months ended September 30, 2010, primarily due to increases in government subsidies received by our China subsidiaries and interest collected from receivables.

Total interest and other income (expense), net increased by \$14.5 million in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, primarily related to a gain of \$13.8 million from the sale of an unconsolidated investee, a \$0.4 million increase in government subsidies received by our China subsidiaries, and a \$0.3 million decrease in interest expense as a result of our lower loan balances outstanding.

We expect our interest income to remain relatively modest given the low yields available in the marketplace and lower investable balances, we also expect our interest expense to increase as we have borrowed \$28.0 million in October 2011 to fund the Santur acquisition.

*Income taxes*

We conduct our business globally. However, our operating income is subject to varying rates of tax in the United States and China. Consequently, our effective tax rate is dependent upon the geographic distribution of our earnings or losses and the tax laws and regulations in each geographical region. We expect that our income taxes will vary in relation to our profitability and the geographic distribution of our profits. Historically, we have experienced net losses in the United States and we expect this trend to continue. One of our subsidiaries in China generates a cash tax liability. The subsidiary has qualified for a preferential 15% tax rate available for high technology enterprises as opposed to the statutory 25% tax rate. The preferential rate applies to 2011 and 2010 and we have reapplied for the preferential rate for 2012. If approved, the rate will remain at 15% for 2012 and 2013.

(in thousands, except percentages)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Provision for income taxes	\$ (258)	\$ (405)	\$ (1,177)	\$ (1,725)
Effective tax rate	(7)%	84%	13%	37%

Our income tax expense for the three and nine months ended September 30, 2011 is primarily related to income taxes of our non-U.S. operations. We had an effective tax rate of negative 7% for the three months ended September 30, 2011 primarily due to our operating profit realized in our non-U.S. operations, despite a consolidated loss before income taxes. We had an effective tax rate of 13% in the nine months ended September 30, 2011 primarily due to the gain on sale of a unconsolidated investee, which was offset by previously incurred net operating losses and research and development credits in the U.S.

**Liquidity and capital resources**

Until the consummation of our initial public offering in February 2011, we financed our operations through private sales of equity securities and cash generated from operations and from various lending arrangements. We believe that our existing cash and cash equivalents, and cash flows from our operating activities, will be sufficient to meet our anticipated cash needs for at least the next 12 months. As of September 30, 2011, our cash and cash equivalents totaled \$31.5 million, and our short-term investments totaled \$71.9 million. Our future capital

---

**Table of Contents**

requirements will depend on many factors including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products, the costs to increase our manufacturing capacity, the continuing market acceptance of our products and acquisitions of businesses and technology. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

A customary business practice in China is for customers to exchange our accounts receivable with notes receivable issued by their bank. From time to time we accept notes receivable from certain of our customers in China. These notes receivable are non-interest bearing and are generally due within six months, and such notes receivable may be redeemed with the issuing bank prior to maturity at a discount. Historically, we have collected on the notes receivable in full at the time of maturity.

Frequently, we also direct our banking partners to issue notes payable to our suppliers in China in exchange for accounts payable. Our Chinese subsidiaries banks issue the notes to vendors and issue payment to the vendors upon redemption. We owe the payable balance to the issuing bank. The notes payable are non-interest bearing and are generally due within six months of issuance. As a condition of the notes payable lending arrangements, we are required to keep a compensating balance at the issuing banks that is a percentage of the total notes payable balance until the notes payable are paid by our subsidiaries in China. These balances are classified as restricted cash on our condensed consolidated balance sheets. As of September 30, 2011, our restricted cash totaled \$2.9 million.

We have lending arrangements with several financial institutions, including a loan and security agreement with Comerica Bank in the United States, which was amended in September 2011, and several line of credit arrangements for our subsidiaries in China.

As of September 30, 2011, our loan and security agreement in the United States included the following:

an \$8.0 million revolving line of credit, which was extended by the September 2011 amendment to the loan and security agreement through September 2014. In September 2011, the stand-by letters of credit issued by the bank to guarantee a loan for the Company's subsidiaries in China was terminated. As of September 30, 2011, no amounts were outstanding under the revolving line of credit and \$8.0 was available for borrowing.

a \$9.5 million credit facility based on capital expenditures under the original loan and security agreement was terminated under the September 2011 amendment.

a \$20.0 million acquisition advance, expiring in September 2015. Proceeds of the acquisition advance may be used to make permitted business acquisitions. Advances may be drawn in two tranches and are due and payable in equal monthly installments of principal and interest such that all amounts will be repaid by the acquisition line maturity date. The advances will bear interest at a rate of LIBOR plus 2%. As of September 30, 2011, \$0 million was outstanding under the acquisition advance and the total available borrowing capacity under this facility was \$20.0 million.

a \$7.0 million equipment line advance for capital expenditures in the United States. Advances may be drawn in four tranches and are due and payable in equal monthly installments of principal and interest such that all amounts will be repaid by September 2015. Borrowings under this facility will bear interest at a rate of LIBOR plus 2%. As of September 30, 2011, \$0 million was outstanding under the equipment line advance and the total available borrowing capacity under this facility was \$7.0 million.

Our loan and security agreement requires us to maintain specified financial covenants, including a liquidity ratio, and restricts our ability to incur additional debt or to engage in specified transactions and is secured by substantially all of our U.S. assets, other than intellectual property assets. As of September 30, 2011, we were in compliance with all covenants contained in this agreement.

In October 2011, we drew down the full amount of the \$20.0 million under the acquisition advance and \$8.0 million under a revolving line of credit in connection with an acquisition of a company. As a result, we expect less capacity available under our credit facilities in the fourth quarter of 2011 as compared to the third quarter of 2011.



**Table of Contents**

Our primary subsidiary in China had a \$5.0 million line of credit facility with a Hong Kong bank. This line of credit agreement was supported by letters of credit issued pursuant to our U.S. loan and security agreement, as referenced above. As of September 30, 2011, we eliminated the \$5.0 million letter of credit and there was no capacity available under the line of credit.

Our subsidiaries in China have short-term line of credit facilities with several banking institutions. These short-term loans have an original maturity date of one year or less as of September 30, 2011 and bear interest at a rate of 5.84%. Amounts requested by us are not guaranteed and are subject to the banks' funds and currency availability. The short-term loan agreements do not contain financial covenants and one such loan agreement is secured by our main manufacturing facility in China. As of September 30, 2011, we had an aggregate of \$1.5 million of short-term loans outstanding.

The table below sets forth selected cash flow data for the periods presented:

(in thousands)	Nine months ended September 30,	
	2011	2010 (As Revised)
Net cash provided by (used in) operating activities	\$ (9,552)	\$ 6,130
Net cash used in investing activities	(59,329)	(18,832)
Net cash provided by (used in) financing activities	74,684	(5,665)
Effect of exchange rates on cash and cash equivalents	234	300
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>\$ 6,037</b>	<b>\$ (18,067)</b>

In February 2011, we completed an initial public offering of common stock, raising proceeds of \$87.7 million, net of offering expenses paid during the nine months ended September 30, 2011. We used a portion of our net proceeds to repay a portion of our outstanding indebtedness and make investments in available-for-sale securities. We intend to use our remaining net proceeds from the offering for working capital, to continue to expand our existing business, acquire complementary businesses, and general corporate purposes. Accordingly, our management will have broad discretion in the application of our net proceeds from the offering, and investors will be relying on management's judgment regarding the application of these net proceeds. We also may use a portion of our net proceeds from the offering to acquire complementary businesses, products, services or technologies, but we currently have no agreements or commitments relating to any material acquisitions (other than the Santur acquisition).

*Operating activities*

During the nine months ended September 30, 2011, net cash used in operating activities was \$9.5 million. Cash used in operating activities was primarily related to cash payments to our employees and suppliers in excess of cash receipts from customers. During the nine months ended September 30, 2011, we recognized net income of \$7.6 million, which incorporated non-cash charges, including gain on sale of an unconsolidated investee, net of direct cost, of \$13.8 million, depreciation and amortization of \$8.2 million and stock-based compensation expenses of \$2.4 million. These amounts were partially offset by the purchase of inventory of \$15.7 million to replenish our inventories in preparation for higher customer demands in future periods and extended payment terms with certain suppliers, as evidenced by the net increase in accounts payable and accrued liabilities of \$1.2 million during the period.

During the nine months ended September 30, 2010, net cash provided by operating activities was \$6.1 million. Cash provided by operating activities primarily related to cash receipts from customers in excess of cash payments to our employees and suppliers. During the nine months ended September 30, 2010, we recognized net income of \$2.9 million. However, that net income incorporated non-cash charges, including depreciation and amortization of \$9.1 million, stock-based compensation expenses of \$1.2 million and non-cash increases to our asset reserve accounts of \$0.9 million. In addition, we spent an additional \$11.5 million to replenish our inventories in anticipation of seasonally higher sales volumes in the second and third quarters and extended payment terms with certain suppliers, as evidenced by our net increase in accounts payable and accrued liabilities of \$0.9 million during the period.

**Table of Contents**

During the nine months ended September 30, 2011, we determined cash payments in 2010 for initial public offering related expenses had been incorrectly classified as operating cash flow activities on the statements of cash flows, and that such payments should be classified as financing cash flow activities. We revised the 2010 statement of cash flows to correct for the classification. The correction resulted in an increase to Net Cash Provided by Operating Activities of \$2,190,000, with a corresponding increase to Net Cash Used in Financing Activities for the nine months ended September 30, 2010.

During the nine months ended September 30, 2011, we determined that certain cash generated from operating and investing cash flow activities in 2010 had been misclassified as Effect of exchange rates on cash and cash equivalents. We revised the 2010 statement of cash flows to correct the classification. The correction resulted in an increase in Net Cash Provided by Operating Activities of \$977,000, with a corresponding reduction to Effect of exchange rates on cash and cash equivalents for the nine months ended September 30, 2010.

*Investing activities*

Our investing activities consisted primarily of investments in debt and equity securities and capital expenditures and in the nine months ended September 30, 2011, and included purchases and sales of debt securities and the sale of equity shares of Ignis ASA ( Ignis ).

During the nine months ended September 30, 2011, net cash used in investing activities was \$59.4 million, mainly due to the purchase of available-for-sale securities of \$148.9 million and the purchase of capital equipment of \$8.4 million, partially offset by proceeds from sale and maturity of securities of \$76.4 million and proceeds from sale of Ignis of \$21.3 million.

During the nine months ended September 30, 2010, net cash used in investing activities was \$18.8 million. We purchased \$10.1 million of capital equipment, invested \$8.0 million in shares of Ignis and decreased our restricted cash associated with our notes payable in China by \$0.3 million. In addition, we completed the sale of our ownership interest in Shenzhen Archcom Technology Co., Ltd. ( Archcom ) and, as a result, received the remaining \$0.6 million in cash proceeds, offset by the transfer of the cash of Archcom of \$1.7 million to the buyer.

During the nine months ended September 30, 2011, we determined that cash generated from operating and investing cash flow activities in 2010 had been misclassified as Effect of exchange rates on cash and cash equivalents. We revised the 2010 statement of cash flows to correct the classification. The correction resulted in an increase in Net Cash Used in Investing Activities of \$302,000, with a corresponding reduction to Effect of exchange rates on cash and cash equivalents for the nine months ended September 30, 2010.

*Financing activities*

Our financing activities consisted primarily of proceeds from the issuance of stock and activity associated with our various lending arrangements and in the nine months ended September 30, 2011, and included proceeds from our initial public offering.

During the nine months ended September 30, 2011, net cash provided by financing activities was \$74.7 million. Our initial public offering generated proceeds of \$86.5 million, net of offering expenses paid during the nine months ended September 30, 2011, partially offset by \$11.9 million of net payments on our outstanding bank loans.

During the nine months ended September 30, 2010, net cash used in financing activities was \$5.7 million. We paid \$8.8 million, net of our bank loans, repaid \$0.7 million, net of our notes payable, and received \$6.0 million in cash from the issuance of preferred stock.

During the nine months ended September 30, 2011, we revised the 2010 statement of cash flows, which resulted in an increase to Net Cash Provided by Operating Activities of \$2,190,000, and a corresponding increase to Net Cash Used in Financing Activities for the nine months ended September 30, 2010 as discussed in Operating activities above.

**Table of Contents****Contractual obligations and commitments**

Our contractual obligations and commitments decreased from \$60.3 million at December 31, 2010, to \$44.0 million at September 30, 2011, primarily due to the repayment of our debt obligations following our initial public offering, and a \$5.5 million decrease in purchase commitments. The following summarizes our contractual obligations as of September 30, 2011:

(in thousands)	Payments due by period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Short-term loans and notes payable (1)	\$ 14,510	\$ 14,510	\$ 0	\$ 0	\$ 0
Operating leases (2)	7,041	1,991	2,193	1,265	1,592
Purchase commitments (3)	19,627	19,627	0	0	0
Asset retirement obligations (4)	1,000	0	0	0	1,000
	42,178	36,128	2,193	1,265	2,592
Expected interest payments (5)	1,792	1,041	645	106	0
<b>Total commitments</b>	<b>\$ 43,970</b>	<b>\$ 37,169</b>	<b>\$ 2,838</b>	<b>\$ 1,371</b>	<b>\$ 2,592</b>

- (1) In China, we have several lending arrangements that provide short-term loans with a maturity date of one year or less and frequently we issue notes payable to our suppliers. The notes payable are generally due within six months of issuance. The amount presented in the table represents the principal portion of the obligations. The short-term loans outstanding as of September 30, 2011 bear interest at a rate of 5.84%, which interest rate was fixed at the time of drawdown. The notes payable are non-interest bearing.
- (2) We have entered into various non-cancelable operating lease agreements for our offices in China, Japan and the United States.
- (3) We are obligated to make payments under various arrangements with suppliers for the procurement of goods and services.
- (4) We have an asset retirement obligation of approximately \$1.0 million associated with our facility lease in California, which expires in October 2019. This obligation is included in other noncurrent liabilities in our condensed consolidated balance sheet as of September 30, 2011.
- (5) We calculate the expected interest payments based on our outstanding short-term loans and future loan drawn downs subsequent to September 30, 2011 at prevailing interest rates as of September 30, 2011.

**Off-balance sheet arrangements**

During the nine months ended September 30, 2011, we did not have any off-balance sheet arrangements.

**Recent accounting pronouncements**

In September 2009, the Financial Accounting Standards Board, or FASB, reached final consensus on a new revenue recognition guidance regarding revenue arrangements with multiple deliverables. The new accounting guidance addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and how the arrangement consideration should be allocated among the separate units of accounting. The new accounting guidance became effective beginning January 1, 2011. The adoption of this guidance did not have a material impact on our financial position, results of operations or cash flows.

In January 2010, the FASB issued amended guidance on fair value measurements and disclosures. The new guidance requires additional disclosures regarding fair value measurements, amends disclosures about postretirement benefit plan assets, and provides clarification regarding the level of disaggregation of fair value disclosures by investment class. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for certain Level 3 activity disclosure requirements that will be effective for reporting periods beginning after December 15, 2010. Level 3 assets and liabilities are those whose fair market value inputs are unobservable and reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Accordingly, we adopted this amendment for the year ended December 31, 2010, except for the additional Level 3 requirements which were adopted on January 1, 2011. The adoption of this guidance did not have a material impact on our financial position, results of operations or cash flows.





---

**Table of Contents**

In April 2010, the FASB issued an accounting standard update which provides guidance on the criteria to be followed in recognizing revenue under the milestone method. The milestone method of recognition allows a vendor who is involved with the provision of deliverables to recognize the full amount of a milestone payment upon achievement, if, at the inception of the revenue arrangement, the milestone is determined to be substantive as defined in the standard. The guidance is effective on a prospective basis for milestones achieved beginning January 1, 2011. The adoption of this guidance did not have a material impact on our financial position, results of operations or cash flows.

In May 2011, the FASB issued amendments to the FASB Accounting Standard Codification relating to fair value measurements. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards ( IFRS ). The amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. We will apply these amendments prospectively beginning in fiscal 2012. We are currently evaluating the impact the application of these amendments will have on our consolidated financial statements.

In June 2011, the FASB issued amendments to the FASB Accounting Standard Codification relating to presentation of comprehensive income. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments should be applied retrospectively, and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We are currently evaluating the impact the application of these amendments will have on the consolidated financial statements.

In August 2011, the FASB approved a revised accounting standard update intended to simplify how an entity tests goodwill for impairment. The amendments permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 and early adoption is permitted. We are currently evaluating the impact of these amendments on our consolidated financial statements and have not yet determined whether we will early adopt.

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

*Interest rate fluctuation risk*

As of September 30, 2011, our cash equivalents consisted primarily of money market funds and interest and non-interest bearing bank deposits. The main objective of these instruments was safety of principal and liquidity while maximizing return, without significantly increasing risk. Given the short-term nature of our cash equivalents, we do not anticipate any material effect on our cash equivalents portfolio due to fluctuations in interest rates.

We invest our excess cash in short-term and long-term security investments to take advantage of higher yields generated by these investments. As of September 30, 2011, the gross unrealized gains or losses on our investments classified as available-for-sale which were primarily due to increases or decreases in the fair value of the marketable securities as a result of changes in market interest rates. We have determined that the gross unrealized gains or losses on the available-for-sale securities at September 30, 2011 are temporary in nature. We may sell these securities investments in the future to fund future operations needs. As a result, we recorded all our marketable securities in short-term investments as of September 30, 2011, regardless of the contractual maturity date of the securities.

We are exposed to market risk due to the possibility of changing interest rates associated with certain outstanding balances under our debt instruments. As of September 30, 2011, the interest rates on all of our outstanding debt in China were fixed at the time of drawdown, and were not subject to fluctuations. As of September 30, 2011, we paid off all of our U.S. debt, and therefore, were not subject to interest rate fluctuations. In October 2011, we drew down \$28.0 million from our available credit facilities, which are subject to interest rate fluctuations and therefore, we may be further exposed to market risk beginning in the fourth quarter of 2011.

**Table of Contents***Foreign currency exchange risk*

Foreign currency exchange rates are subject to fluctuation and may cause us to recognize transaction gains and losses in our statements of operations. A substantial portion of our business is conducted through our subsidiaries in China whose functional currency is the RMB. To the extent that transactions by our subsidiaries in China are denominated in currencies other than RMB, we bear the risk that fluctuations in the exchange rates of the RMB in relation to other currencies could decrease our revenue and increase our costs and expenses. During the three months ended September 30, 2011 and 2010, we recognized foreign currency transaction gains of \$8,000 and \$6,000, respectively. During the nine months ended September 30, 2011 and 2010, we recognized foreign currency transaction losses of \$35,000 and \$2,000, respectively. We use the U.S. dollar as the reporting currency for our consolidated financial statements. Any significant revaluation of the RMB may materially and adversely affect our results of operations upon translation of our Chinese subsidiaries' financial statements into U.S. dollars. While we generate a majority of our revenue in RMB, a majority of our operating expenses are in U.S. dollars. Therefore a depreciation in RMB against the U.S. dollar would negatively impact our revenue upon translation to the U.S. dollars but the impact on operating expenses would be less. For example, for the three and nine months ended September 30, 2011, a 10% depreciation in RMB against the U.S. dollar would have resulted in a \$2.5 million and \$8.7 million decrease in our revenue, respectively, and a \$0.1 million and \$0.6 million decrease in our net income, respectively. Comparatively, for the three and nine months ended September 30, 2010, a 10% depreciation in RMB against the U.S. dollar would have resulted in an \$2.6 million and \$7.9 million decrease in our revenue, respectively, and a \$0.2 million and \$1.1 million decrease in our net income, respectively.

To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedging transactions may be limited and we may not be able to successfully hedge our exposure. In addition, our currency exchange variations may be magnified by any Chinese exchange control regulations that restrict our ability to convert RMB into foreign currency.

*Inflation risk*

Inflationary factors, such as increases in our cost of goods sold and operating expenses, may adversely affect our results of operations. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, an increase in the rate of inflation in the future, particularly in China, may have an adverse effect on our levels of gross profit and operating expenses as a percentage of revenue if the sales prices for our products do not proportionately increase with these increased expenses.

**ITEM 4. CONTROLS AND PROCEDURES*****Evaluation of Disclosure Controls and Procedures***

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2011. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of September 30, 2011, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

**Table of Contents**

***Changes in Internal Control***

There were no changes in our internal control over financial reporting identified in management's evaluation pursuant to Rules 13a-15(d) or 15d-15(d) of the Exchange Act during the period covered by this Quarterly Report on Form 10-Q that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

From time to time, we are involved in litigation that we believe is of the type common to companies engaged in our line of business, including commercial disputes and employment issues. As of the date of this Quarterly Report on Form 10-Q, other than as described below, we are not involved in any pending legal proceedings that we believe could have a material adverse effect on our financial condition, results of operations or cash flows. Intellectual property rights disputes generally involve the demand by a third party that we cease the manufacture, use or sale of the allegedly infringing products, processes or technologies and/or pay substantial damages or royalties for past, present and future use of the allegedly infringing intellectual property. Claims that our products or processes infringe or misappropriate any third-party intellectual property rights (including claims arising through our contractual indemnification of our customers) often involve highly complex, technical issues, the outcome of which is inherently uncertain. Moreover, from time to time, we may pursue litigation to assert our intellectual property rights. Regardless of the merit or resolution of any such litigation, complex intellectual property litigation is generally costly and diverts the efforts and attention of our management and technical personnel which could adversely affect our business.

**ITEM 1A. RISK FACTORS**

*The risk factors facing our company have not changed materially from those set forth in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the SEC on March 28, 2011, which risk factors are set forth below, except for those risk factors denoted by an asterisk (\*).*

*\*Natural disasters, terrorist attacks or other catastrophic events could harm our operations.*

Our worldwide operations could be subject to natural disasters and other business disruptions, which could harm our future revenue and financial condition and increase our costs and expenses. For example, the recent floods in Thailand and the earthquakes and tsunami in Japan, and the subsequent crisis relating to nuclear power plants in the affected regions, may adversely impact our revenues from customers located in Thailand and Japan and/or our ability to source parts from companies located in Thailand and Japan. Reliable information about the extent of this crisis on our suppliers and customers, including those with substantial operations in Thailand and Japan, has been limited to date. In addition, the combined effects of these natural disasters have created significant uncertainty, and it is possible that the crisis could result in reduced end user demand due to the economic impact to Thailand and Japan and potentially the global economy; a slowdown of business or inability to manufacture products by our customers or others in the industry that are located in Thailand and Japan; a disruption to the global supply chain for products manufactured in Thailand and Japan that are included in the products either by us or by our customers; a disruption to manufacturing resulting from power shortages or other rationing of inputs to production; an increase in the cost of products that we purchase due to reduced supply; and other unforeseen impacts as a result of the uncertainty in Thailand and Japan.

Similarly our worldwide operations could be subject to secondary effects of natural disasters and other business disruptions, which could harm our future revenue and financial condition and increase our costs and expenses. For example, the current flooding in Thailand may adversely impact our revenues. While we do not have contract manufacturing in Thailand and we do not source materials or components from Thailand, our customers do. Therefore the combined effect of the flooding on other suppliers and potential for resulting shortage of such materials to our customers could adversely impact our customers' ability to assemble and ship their products, thereby reducing near term need for products that they buy from us. The combined effects of the flooding increases uncertainty about demand and could result in reduced customer demand in the near and intermediate term.

In addition, our corporate headquarters and wafer fabrication facility in San Jose, California are located near major earthquake fault lines, and our manufacturing facilities are located in Shenzhen, China, an area that is susceptible to typhoons. Further, a terrorist attack, including one aimed at energy or communications infrastructure suppliers, could hinder or delay the development and sale of our products. In the event that an earthquake, tsunami, typhoon, terrorist attack or other natural or man-made catastrophe were to destroy any part of our facilities, destroy or disrupt vital infrastructure systems or interrupt our operations or the facilities or operations of our suppliers or customers for any extended period of time, our business, financial condition and results of operations would be materially and adversely affected. We are not insured against many natural disasters, including earthquakes.

---

**Table of Contents**

***\*We have a history of losses which may continue in the future.***

We have a history of losses and we may incur additional losses in future periods. As of September 30, 2011, our accumulated deficit was \$208.2 million. We also expect to continue to make significant expenditures related to the development of our business. These include expenditures to hire additional personnel related to the sales, marketing and development of our products and to maintain and expand our manufacturing facilities and research and development operations.

***\*Customer demand is difficult to accurately forecast and, as a result, we may be unable to optimally match production with customer demand.***

We make planning and spending decisions, including determining the levels of business that we will seek and accept, production schedules, and inventory levels, component procurement commitments, personnel needs and other resource requirements, based on our estimates of customer requirements. The short-term nature of commitments by many of our customers and the possibility of unexpected changes in demand for their products reduce our ability to accurately estimate future customer requirements. On occasion, customers may require rapid increases in production, which can strain our resources, cause our manufacturing to be negatively impacted by materials shortages, necessitate higher or more restrictive procurement commitments and reduce our gross margin. We may not have sufficient capacity at any given time to meet the volume demands of our customers, or one or more of our suppliers may not have sufficient capacity at any given time to meet our volume demands. Conversely, a downturn in the markets in which our customers compete can cause, and in the past have caused, our customers to significantly reduce or delay the amount of products ordered from us or to cancel existing orders, leading to lower utilization of our facilities. Because many of our costs and operating expenses are relatively fixed, reduction in customer demand would have a material adverse effect on our gross margin, operating income and cash flow. During an industry downturn, there is also a higher risk that our trade receivables would be uncollectible.

Our products are typically sold pursuant to individual purchase orders or by use of a vendor-managed inventory, or VMI, model, which is a process by which we ship agreed quantities of products to a customer-designated location and those products remain our inventory and we retain the title and risk of loss for those products until the customer takes possession of the products. While our customers generally provide us with their demand forecasts and may give us a promised market share award, they are typically not contractually committed to buy any quantity of products beyond firm purchase orders. Many of our customers may increase, decrease, cancel or delay purchase orders already in place. We have experienced and expect to continue to experience wide fluctuations in demand from customers using VMI, particularly Huawei Technologies, even in instances where we have built and shipped products to the customer-designated locations as VMI. If any of our major customers decrease, stop or delay purchasing our products for any reason, our business and results of operations would be harmed. Cancellation or delays of such orders may cause us to fail to achieve our short and long-term financial and operating goals.

***\*We are dependent on Huawei Technologies and our key customers for a significant portion of our revenue and the loss of, or a significant reduction in orders from, Huawei Technologies or any of our other key customers may reduce our revenue and adversely impact our results of operations.***

Historically, we have generated most of our revenue from a limited number of customers. In 2010, our largest customer, Huawei Technologies, represented 48.3% of our total revenue and our top ten customers represented 88.6% of our total revenue. In the three months ended September 30, 2011, Huawei Technologies represented 42.4% of our total revenue and our top ten customers represented 88.3% of our total revenue. Additionally, it has been reported publicly that the growth rate of Huawei Technologies has declined in 2011. As a result, the loss of, or a significant reduction in orders from, Huawei Technologies or any of our other key customers would materially and adversely affect our revenue and results of operations. For instance, in the three months ended September 30, 2011, demand from Huawei Technologies was lower than expected, which adversely affected our revenue for such period. Adverse events affecting our customers could also adversely affect our revenue and results of operations (for instance, in 2009, the filing of a voluntary petition for bankruptcy protection by one of our customers, Nortel Networks Limited, has prevented us from timely collection of our accounts receivable from that customer). In addition, network equipment vendors serving the communications networks industry may continue to consolidate, and we may not be able to offset any potential decline in revenue arising from consolidation of our existing customers with revenue from new customers.

## **Table of Contents**

### ***We are under continuous pressure to reduce the prices of our products.***

The communications networks industry has been characterized by declining product prices over time. We have reduced the prices of many of our products in the past and we expect to experience pricing pressure for our products in the future. When seeking to maintain or increase their market share, our competitors may also reduce the prices of their products. In addition, our customers may have the ability or seek to internally develop and manufacture competing products at a lower cost than we would otherwise charge, which would add additional pressure on us to lower our selling prices. If we are unable to offset any future reductions in our average selling prices by increasing our sales volume, reducing our costs and expenses or introducing new products, our gross margin would suffer.

### ***Increasing costs may impact our gross margins.***

The rate of increase in our costs and expenses, including as a result of rising labor costs in China, may exceed the rate of increase in our revenue, either of which would materially and adversely affect our business, our results of operations and our financial condition.

### ***We are subject to the cyclical nature of the markets in which we compete and any future downturn may reduce demand for our products and revenue.***

The markets in which we compete are tied to the aggregate capital expenditures of service providers as they build out and upgrade their network infrastructure. These markets are highly cyclical and characterized by constant and rapid technological change, price erosion, evolving standards and wide fluctuations in product supply and demand. In the past, including recently to varying degrees in China, the U.S. and Europe, these markets have experienced significant downturns, often connected with, or in anticipation of, the maturation of product cycles for both manufacturers and their customers' products or in response to over or under purchasing of inventory by our customers relative to ultimate carrier demand, and with declining general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices.

Our historical results of operations have been subject to substantial fluctuations, and we may experience substantial period-to-period fluctuations in future results of operations. Any future downturn in the markets in which we compete could significantly reduce the demand for our products and therefore may result in a significant reduction in revenue. It may also increase the volatility of the price of our common stock. Our revenue and results of operations may be materially and adversely affected in the future due to changes in demand from individual customers or cyclical changes in the markets utilizing our products.

In addition, the communications networks industry from time to time has experienced and may again experience a pronounced downturn. To respond to a downturn, many service providers may slow their capital expenditures, cancel or delay new developments, reduce their workforces and inventories and take a cautious approach to acquiring new equipment and technologies from original equipment manufacturers, which would have a negative impact on our business. Weakness in the global economy or a future downturn in the communications networks industry may cause our results of operations to fluctuate from quarter-to-quarter and year-to-year, harm our business, and may increase the volatility of the price of our common stock.

### ***If spending for communications networks does not continue to grow as expected, our business may suffer.***

Our future success as a provider of modules and subsystems to leading network equipment vendors depends on their continued capital spending on global communications networks. Network traffic has experienced rapid growth driven primarily by bandwidth-intensive content, including HD and 3D video, music, social networking, video conferencing and other multimedia. This growth is intensified by the proliferation of fixed and wireless network-attached devices, including smartphones, laptops, netbooks, tablet computers, PCs, e-readers, televisions and gaming devices, that are enabling consumers to access content at increasing data rates anytime and anywhere. Our future success depends on continued demand for high-bandwidth, high-speed communications networks and the ability of network equipment vendors to meet this demand. Growth in demand for communications networks is

---

## **Table of Contents**

limited by several factors, including an evolving regulatory environment and uncertainty regarding long-term sustainable business models. We cannot be certain that demand for bandwidth-intensive content will continue to grow in the future. If expectations for growth of communications networks and bandwidth consumption are not realized and investment in communications networks does not grow as anticipated, our business could be harmed.

*It could be discovered that our products contain defects that may cause us to incur significant costs, divert our attention, result in a loss of customers and result in product liability claims.*

Our products are complex and undergo quality testing as well as formal qualification, both by our customers and by us. However, defects may occur from time to time. Our customers' testing procedures are limited to evaluating our products under likely and foreseeable failure scenarios and over varying amounts of time. For various reasons, such as the occurrence of performance problems that are unforeseeable in testing or that are detected only when products age or are operated under peak stress conditions, our products may fail to perform as expected long after customer acceptance. Failures could result from faulty components or design, problems in manufacturing or other unforeseen reasons. As a result, we could incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. We have experienced such failures in the past and will continue to face this risk going forward, as our products are widely deployed throughout the world in multiple demanding environments and applications. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty in order to maintain customer relationships. Any significant product failure could result in lost future sales of the affected product and other products, as well as customer relations problems, litigation and damage to our reputation.

In addition, our products are typically embedded in, or deployed in conjunction with, our customers' products, which incorporate a variety of components, modules and subsystems and may be expected to interoperate with modules produced by third parties. As a result, not all defects are immediately detectable and when problems occur, it may be difficult to identify the source of the problem. These problems may cause us to incur significant damages or warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems or loss of customers, all of which would harm our business.

The occurrence of any defects in our products could give rise to liability for damages caused by such defects. They could, moreover, impair our customers' acceptance of our products. Both could have a material adverse effect on our business and financial condition. Although we carry product liability insurance which covers this risk, this insurance may not adequately cover our costs arising from defects in our products or otherwise.

*Manufacturing problems could result in delays in product shipments to customers and could adversely affect our revenue, competitive position and reputation.*

We may experience delays, disruptions or quality control problems in our manufacturing operations. For instance, we could experience a disruption in our fabrication facility for our PIC products due to any number of reasons, such as equipment failure, contaminated materials or process deviations, which could adversely impact manufacturing yields or delay product shipments. As a result, we could incur additional costs that would adversely affect our gross margin, and product shipments to our customers could be delayed beyond the shipment schedules requested by our customers, which would negatively affect our revenue, competitive position and reputation.

Additionally, manufacturing yields depend on a number of factors, including the stability and manufacturability of the product design, manufacturing improvements gained over cumulative production volumes, the quality and consistency of component parts and the nature and extent of customization requirements by customers. Capacity constraints, raw materials shortages, logistics issues, labor shortages, the introduction of new product lines and changes in customer requirements, manufacturing facilities or processes, or those of some third party contract manufacturers and suppliers of raw materials and components have historically caused, and may in the future cause, reduced manufacturing yields, negatively impacting the gross margin on, and our production capacity for, those products. Moreover, an increase in the rejection and rework rate of products during the quality control process before, during or after manufacture would result in our experiencing lower yields, gross margin and production capacity.

Our ability to maintain sufficient manufacturing yields is particularly challenging with respect to PICs due to the complexity and required precision of a large number of unique manufacturing process steps. Manufacturing yields for PICs can also suffer if contaminated materials or materials that do not meet highly precise composition

---

## **Table of Contents**

requirements are inadvertently utilized. Because a large portion of our PIC manufacturing costs are fixed, PIC manufacturing yields have a substantial effect on our gross margin. Lower than expected manufacturing yields could also delay product shipments and decrease our revenue.

***We have a limited history operating on a global basis, making it difficult to predict our future results of operations.***

We have a limited history operating on a global basis, which makes it difficult to evaluate our business and financial prospects. While our operations began in 1996, we did not begin commercial shipments of our PIC products until the second quarter of 2003 and we did not acquire our subsidiaries in China until 2005. Since then, our revenue, gross margin and results of operations have varied significantly and are likely to continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. For instance, changes in gross margin may result from various factors, such as changes in pricing, changes in our fixed costs, changes in the cost of labor, changes in the mix of our products sold, changes in the amount of product manufactured versus the amount of product sold over time, and charges for excess and obsolete inventory. In making an investment decision relating to our common stock, you should evaluate our business in light of the risks, expenses and difficulties frequently encountered by companies operating on a global platform, particularly companies in the rapidly changing communications networks industry. It is difficult for us to accurately forecast our future revenue and gross margin and plan expenses accordingly and, therefore, it is difficult for us to predict our future results of operations.

***We must continually achieve new design wins and enhance existing products or our business may be harmed.***

The markets for our products are characterized by frequent new product introductions, changes in customer requirements and evolving industry standards, all with an underlying pressure to reduce cost and meet stringent reliability and qualification requirements. Our future performance will depend on our successful development, introduction and market acceptance of new and enhanced products that address these challenges. The anticipated or actual introduction of new and enhanced products by us and by our competitors may cause our customers to defer or cancel orders for our existing products. In addition, the introduction of new products by us or our competitors could result, and in the past, has resulted, in a slowdown in demand for our existing products and could result, and in the past, has resulted, in a write-down in the value of inventory. We have both recently and in the past experienced a slowdown in demand for existing products and delays in new product development, and such delays may occur in the future. To the extent customers defer or cancel orders for our products for any reason or we fail to achieve new design wins, our competitive position would be adversely affected and our ability to grow revenue would be impaired.

Product development delays may result from numerous factors, including:

changing product specifications and customer requirements;

unanticipated engineering complexities;

difficulties in reallocating engineering resources and overcoming resource limitations; and

changing market or competitive product requirements.

Furthermore, fast time-to-market with new products can be critical to success in our markets. It is difficult to displace an existing supplier for a particular type of product once a network equipment vendor has chosen a supplier, even if a later-to-market product provides superior performance or cost efficiency. If we are unable to make our new or enhanced products commercially available on a timely basis, we may lose existing and potential customers and our financial results would suffer.

The development of new, technologically-advanced products is a complex and uncertain process requiring frequent innovation, highly-skilled engineering and development personnel and significant capital, as well as the accurate anticipation of technological and market trends. We cannot assure you that we will be able to identify, develop, manufacture, market or support new or enhanced products successfully, if at all, or on a timely basis. Further, we cannot assure you that our new products will gain market acceptance or that we will be able to respond effectively to product introductions by competitors, technological changes or emerging industry standards. We also may not be able to develop the underlying core technologies necessary to create new products and enhancements, license these technologies from third parties, or remain competitive in our markets.





---

**Table of Contents**

***Our success will depend on our ability to anticipate and quickly respond to evolving technologies and customer requirements.***

The communications networks industry is characterized by substantial investment in new technology and the development of diverse and changing technologies and industry standards. For example, new technologies are required to satisfy the emerging standards for 40Gbps and 100Gbps data transmission in communications networks.

Our ability to anticipate and respond to evolving technology, industry standards, customer requirements and product offerings, and to develop and introduce new and enhanced products and technologies, will be critical factors in our ability to succeed. If we are unable to anticipate and respond to such changes in the future, our competitive position could be adversely affected. In addition, the introduction of new products by other companies embodying new technologies, or the emergence of new industry standards, could render our existing products uncompetitive from a pricing standpoint, obsolete or otherwise unmarketable.

***If our customers do not qualify our products for use, then our results of operations may suffer.***

Prior to placing volume purchase orders with us, most of our customers require us to obtain their approval called qualification in our industry of our new and existing products, and our customers often audit our manufacturing facilities and perform other vendor evaluations during this process. The qualification process involves product sampling and reliability testing and collaboration with our product management and engineering teams in the design and manufacturing stages. If we are unable to qualify our products with customers, then our revenue would be lower than expected and we may not be able to recover the costs associated with the qualification process which would have an adverse effect on our results of operations.

In addition, due to evolving technological changes in our markets, a customer may cancel or modify a design project before we have qualified our product or begun volume manufacturing of a qualified product. It is unlikely that we would be able to recover the expenses for cancelled or unutilized custom design projects. It is difficult to predict with any certainty whether our customers will delay or terminate product qualification or the frequency with which customers will cancel or modify their projects, but any such delay, cancellation or modification would have a negative effect on our results of operations.

In particular, we have developed new technologies and products that we believe are key components in our customers' systems for 40Gbps and 100Gbps data transmission. There are multiple modulation approaches for these systems and not all are likely to be equally successful. While we are shipping certain products for 40Gbps and 100Gbps system designs today, many of our products for these systems are currently being qualified for use by our customers. Our ability to successfully qualify and scale capacity for these new technologies and products is important to our ability to grow our business and market presence. If we are unable to qualify and sell any of these products in volume on time, or at all, our results of operations may be adversely affected.

***We face intense competition which could negatively impact our results of operations and market share.***

The communications networks industry is highly competitive. Our competitors range from large, international companies offering a wide range of products to smaller companies specializing in niche markets. In addition, we believe that a number of companies have developed or are developing planar lightwave, indium phosphide, or MEMS-based, PIC devices and other products that compete directly with our products. Current and potential competitors may have substantially greater financial, marketing, research and manufacturing resources than we possess, and there can be no assurance that our current and future competitors will not be more successful than us in specific product lines or as a whole.

Some of our competitors have substantially greater name recognition, technical, financial, and marketing resources, and greater manufacturing capacity, as well as better-established relationships with customers, than we do. Some of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for these products and technologies. Some of our competitors may be able to develop new products more quickly than us and may be able to develop products that are more reliable or which provide more functionality than ours. In addition, some of our competitors have the financial resources on business strategy to offer competitive products at below-market pricing levels that could prevent us from competing effectively and result in a loss of sales or market share or cause us to lower prices for our products.

---

## **Table of Contents**

We also face competition from some of our customers who evaluate our capabilities against the merits of manufacturing products internally. Due to the fact that such customers are not seeking to make a profit directly from the manufacture of these products, they may have the ability to manufacture competitive products at a lower cost than we would charge such customers. As a result, these customers may purchase less of our products and there would be additional pressure to lower our selling prices which, accordingly, would negatively impact our revenue and gross margin.

In particular we have developed new technologies and products that we believe are key components in our customers' systems for 40Gbps and 100Gbps data transmission. The emergence of technologies and products from our competitors and their success in competing against our technologies and products for 40Gbps and 100Gbps data transmission could render our existing products uncompetitive from a pricing standpoint, obsolete or otherwise unmarketable.

Intense competition in our markets could result in aggressive business tactics by our competitors, including aggressively pricing their products or selling older inventory at a discount. If our current or future competitors utilize aggressive business tactics, including those described above, demand for our products could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our sales prices.

***If we fail to retain our key personnel or if we fail to attract additional qualified personnel, we may not be able to achieve our anticipated level of growth and our business could suffer.***

Our success and ability to implement our business strategy depends upon the continued contributions of our senior management team and others, including our technical and operations employees. Our future success depends, in part, on our ability to attract and retain key personnel, including our senior management and others, and on the continued contributions of members of our senior management team and key technical and operations personnel, each of whom would be difficult to replace. The loss of services of members of our senior management team or key personnel or the inability to continue to attract and retain qualified personnel could have a material adverse effect on our business. Competition for highly skilled technical and operations people, both in the United States, China, Japan, Malaysia, Canada and other areas in which we operate is extremely intense, and we continue to face challenges identifying, hiring and retaining qualified personnel in many areas of our business. If we fail to retain our senior management and other key personnel or if we fail to attract additional qualified personnel, our business could suffer.

***The communications networks industry has long product development cycles requiring us to incur product development costs without assurances of an acceptable investment return.***

The communications networks industry is highly capital-intensive. Large volumes of equipment and support structures are installed with considerable expenditures of funds and other resources, and long investment return period expectations. At the component supplier level, these cycles create considerable, typically multi-year, gaps between the commencement of new product development and volume purchases. Accordingly, we and our competitors often incur significant research and development and sales and marketing costs for products that, at the earliest, will be purchased by our customers long after much of the cost is incurred and, in some cases, may never be purchased due to changes in industry or customer requirements in the interim.

Due to changing industry and customer requirements, we are constantly developing new products, including seeking to further integrate functions on PICs and developing and using new technologies in our products. These development activities can and are expected to necessitate significant investment of capital. Our new products often require a long time to develop because of their complexity and rigorous testing and qualification requirements. Additionally, developing a manufacturing approach with an acceptable cost structure and yield for new products can be expensive and time-consuming. Due to the costs and length of research and development and manufacturing process cycles, we may not recognize revenue from new products until long after such expenditures are incurred, if at all, and our gross margin may decrease if our costs are higher than expected.

***While we rely on many suppliers, there are a few which, if they stopped, decreased or delayed shipments to us, it could have an adverse effect on our business.***

We depend on a limited number of suppliers for certain components and materials we have qualified to use in the manufacture of certain of our products. Some of these suppliers could disrupt our business if they stop, decrease or delay shipments or if the components they ship have quality, consistency, or business continuity issues; such as a



---

**Table of Contents**

disruption relating to the earthquake and tsunami in Japan. Some of these components and materials are available only from a sole source, or have been qualified only from a single source, although other sources may exist. For example, we use various types of adhesives that are sourced from various manufacturers, which presently are sole sources for these particular adhesives. Furthermore, there are a limited number of entities from which we could obtain certain other components and materials. We may also face component shortages if we experience increased demand for components beyond what our qualified suppliers can deliver. We have experienced component shortages from certain key suppliers, which has resulted and, if this occurs in the future, may result in an inability to meet customer demand, higher purchasing costs, or both. Although we engage in various actions to mitigate the impact of these shortages, any inability on our part to obtain sufficient quantities of critical components at reasonable costs could adversely affect our ability to meet demand for our products, which could cause our revenue, results of operations, or both to suffer.

Our customers generally restrict our ability to change the component parts in our modules without their approval. For more critical components, such as PICs, lasers and photodetectors, any changes may require repeating the entire qualification process. We typically have not entered into long-term or written agreements with our suppliers to guarantee the supply of the key components used in our products, and, therefore, our suppliers could stop supplying materials and equipment at any time or fail to supply adequate quantities of component parts on a timely basis. It is difficult, costly, time consuming and, on short notice, sometimes impossible for us to identify and qualify new component suppliers. The reliance on a sole supplier, single qualified vendor or limited number of suppliers could result in delivery and quality problems, reduced control over product pricing, reliability and performance and an inability to identify and qualify another supplier in a timely manner. We have in the past had to change suppliers, which has, in some instances, resulted in delays in product development and manufacturing and loss of revenue. Any such delays in the future may limit our ability to respond to changes in customer and market demands. Any supply deficiencies relating to the quality, quantities or timeliness of delivery of components that we use to manufacture our products could adversely affect our ability to fulfill our customer orders and our results of operations.

***If we fail to protect, or incur significant costs in defending, our intellectual property and other proprietary rights, our business and results of operations could be materially harmed.***

Our success depends to a significant degree on our ability to protect our intellectual property and other proprietary rights. We rely on a combination of patent, trademark, copyright, trade secret and unfair competition laws, as well as license agreements and other contractual provisions, to establish and protect our intellectual property and other proprietary rights. We have applied for patent registrations in the United States and in other foreign countries, some of which have been issued. In addition, we have registered the trademark NeoPhotonics in the United States. We cannot guarantee that our pending applications will be approved by the applicable governmental authorities. Moreover, our existing and future patents and trademarks may not be sufficiently broad to protect our proprietary rights or may be held invalid or unenforceable in court. A failure to obtain patents or trademark registrations or a successful challenge to our registrations in the United States or other foreign countries may limit our ability to protect the intellectual property rights that these applications and registrations intended to cover.

Policing unauthorized use of our technology is difficult and we cannot be certain that the steps we have taken will prevent the misappropriation, unauthorized use or other infringement of our intellectual property rights. Further, we may not be able to effectively protect our intellectual property rights from misappropriation or other infringement in foreign countries where we have not applied for patent protections, and where effective patent, trademark, trade secret and other intellectual property laws may be unavailable, or may not protect our proprietary rights as fully as U.S. law. Particularly, our U.S. patents do not afford any intellectual property protection in China, Japan, Canada or Malaysia, where we have company operations. We seek to secure, to the extent possible, comparable intellectual property protections in China and other areas in which we operate. However, while we have issued patents and pending patent applications in China, portions of our intellectual property portfolio are not yet protected by patents in China. Moreover, the level of protection afforded by patent and other laws in China may not be comparable to that afforded in the United States.

We attempt to protect our intellectual property, including our trade secrets and know-how, through the use of trade secret and other intellectual property laws, and contractual provisions. We enter into confidentiality and invention assignment agreements with our employees and independent consultants. We also use non-disclosure

---

## Table of Contents

agreements with other third parties who may have access to our proprietary technologies and information. Such measures, however, provide only limited protection, and there can be no assurance that our confidentiality and non-disclosure agreements will not be breached, especially after our employees or those of our third-party contract manufacturers end their employment or engagement, and that our trade secrets will not otherwise become known by competitors or that we will have adequate remedies in the event of unauthorized use or disclosure of proprietary information. Unauthorized third parties may try to copy or reverse engineer our products or portions of our products, otherwise obtain and use our intellectual property, or may independently develop similar or equivalent trade secrets or know-how. If we fail to protect our intellectual property and other proprietary rights, or if such intellectual property and proprietary rights are infringed or misappropriated, our business, results of operations or financial condition could be materially harmed.

In the future, we may need to take legal actions to prevent third parties from infringing upon or misappropriating our intellectual property or from otherwise gaining access to our technology. Protecting and enforcing our intellectual property rights and determining their validity and scope could result in significant litigation costs and require significant time and attention from our technical and management personnel, which could significantly harm our business. In addition, we may not prevail in such proceedings. An adverse outcome of such proceedings may reduce our competitive advantage or otherwise harm our financial condition and our business.

***\*We may be involved in intellectual property disputes in the future, which could divert management's attention, cause us to incur significant costs and prevent us from selling or using the challenged technology.***

Participants in the markets in which we sell our products have experienced frequent litigation regarding patent and other intellectual property rights. Numerous patents in these industries are held by others, including our competitors. In addition, from time to time, we have been notified that we may be infringing certain patents or other intellectual property rights of others. Regardless of their merit, responding to such claims can be time consuming, divert management's attention and resources and may cause us to incur significant expenses. In addition, there can be no assurance that third parties will not assert infringement claims against us. While we believe that our products do not infringe in any material respect upon intellectual property rights of other parties and/or meritorious defense would exist with respect to any assertions to the contrary, we cannot be certain that our products would not be found infringing the intellectual property rights of others. Intellectual property claims against us could invalidate our proprietary rights and force us to do one or more of the following:

obtain from a third party claiming infringement a license to sell or use the relevant technology, which may not be available on reasonable terms, or at all;

stop manufacturing, selling, incorporating or using our products that use the challenged intellectual property;

pay substantial monetary damages; or

expend significant resources to redesign the products that use the technology and to develop non-infringing technology.

Any of these actions could result in a substantial reduction in our revenue and could result in losses over an extended period of time.

On January 5, 2010, Finisar Corporation, or Finisar, filed a complaint in the United States District Court for the Northern District of California against Source Photonics, Inc., MRV Communications, Inc., Oplink Communications, Inc. and us, or collectively, the co-defendants. In the complaint, Finisar alleged infringement of certain of its U.S. patents arising from the co-defendants' respective manufacture, importation, use, sale of or offer to sell certain optical transceiver products in the United States. Finisar sought to recover unspecified damages, up to treble the amount of actual damages, together with attorneys' fees, interest and costs. Finisar alleged that at least some of the patents asserted are a part of certain digital diagnostic standards for optoelectronics transceivers and, therefore, are being utilized in such digital diagnostic standards. On March 23, 2010, we filed an answer to the complaint and counterclaims, asserting two claims of patent infringement and additional claims asserting that Finisar has violated state and federal competition laws and violated its obligations to license on reasonable and non-discriminatory terms. On May 5, 2010, the court dismissed without prejudice all co-defendants (including us) except Source Photonics, Inc., on grounds that such claims should have been asserted in four separate lawsuits, one against each co-defendant. This dismissal without prejudice does not prevent Finisar from bringing a new similar lawsuit against us. We and Finisar had agreed to a 90 day tolling of our respective claims and not to refile any claims against each other until one or more specified events occur resulting in the partial or complete resolution of the litigation between Source Photonics and Finisar. On September 10, 2010, Source Photonics and Finisar settled their lawsuit, commencing the tolling period, which expired in early December 2010.



---

**Table of Contents**

Additionally, past intellectual property disputes that were not finally resolved or settled may arise again in the future. On January 18, 2011, we and Finisar agreed to toll our respective claims based on the January 5, 2010 patent infringement complaint filed by Finisar Corporation in the United States District Court for the Northern District of California against Source Photonics, Inc., MRV Communications, Inc., Oplink Communications, Inc. and us, or collectively, the co-defendants, but from which we were dismissed without prejudice by the court on May 5, 2010, and not to refile the originally asserted claims against each other until at least 90 days after one or more specified events occur resulting in the partial or complete resolution of litigation involving the same Finisar patents between Oplink Communications, Inc. and Finisar. At that time, Finisar will be permitted to bring a new lawsuit against us if they choose to do so. If we are unsuccessful in our defense of the Finisar patent infringement claims, a license to use the allegedly infringing technology may not be available to us at all, and if it is, it may not be available on commercially reasonable terms and therefore may limit or preclude us from competing in the market for optical transceivers in the United States, which may have a material adverse effect on our results of operations and financial condition, and otherwise materially harm our business.

Although we believe that we would have meritorious defenses to the infringement allegations and intend to defend any new similar lawsuit vigorously, there can be no assurance that we will be successful in our defense. Even if we are successful, we may incur substantial legal fees and other costs in defending the lawsuit. Further, a new lawsuit, if brought, would be likely to divert the efforts and attention of our management and technical personnel, which could harm our business.

***If we fail to obtain the right to use the intellectual property rights of others which are necessary to operate our business, and to protect their intellectual property, our ability to succeed will be adversely affected.***

From time to time we may choose to or be required to license technology or intellectual property from third parties in connection with the development of our products. We cannot assure you that third-party licenses will be available to us on commercially reasonable terms, if at all. Generally, a license, if granted, would include payments of up-front fees, ongoing royalties or both. These payments or other terms could have a significant adverse impact on our results of operations. The inability to obtain a necessary third-party license required for our product offerings or to develop new products and product enhancements could require us to substitute technology of lower quality or performance standards, or of greater cost, either of which could adversely affect our business. If we are not able to obtain licenses from third parties, if necessary, then we may also be subject to litigation to defend against infringement claims from these third parties. Our competitors may be able to obtain licenses or cross-license their technology on better terms than we can, which could put us at a competitive disadvantage. Also, we typically enter into confidentiality agreements with such third parties in which we agree to protect and maintain their proprietary and confidential information, including requiring our employees to enter into agreements protecting such information. There can be no assurance that the confidentiality agreements will not be breached by any of our employees or that such third parties will not make claims that their proprietary information has been disclosed.

***Any potential dispute involving our patents or other intellectual property could also include our customers using our products, which could trigger our indemnification obligations to them and result in substantial expenses to us.***

In any potential dispute involving our patents or other intellectual property, our customers could also become the target of litigation. Because we often indemnify our customers for intellectual property claims made against them for products incorporating our technology, any claims against our customers could trigger indemnification obligations in some of our supply agreements, which could result in substantial expenses such as increased legal expenses, damages for past infringement or royalties for future use. While we have not incurred any indemnification expenses to date, any future indemnity claim could adversely affect our relationships with our customers and result in substantial costs to us. Our insurance does not cover intellectual property infringement.

***If we fail to adequately manage our long-term growth and expansion requirements, our business will suffer.***

In recent years, we have experienced significant growth through, among other things, internal expansion programs, product development and acquisitions of other companies. We expect to continue to grow, which could require us to expand our manufacturing operations, including hiring new personnel, purchasing additional



## **Table of Contents**

equipment, leasing or purchasing additional facilities, developing the management infrastructure and developing our suppliers to manage any such expansion. If we fail to secure these expansion requirements or manage our future growth effectively, our business could suffer.

***Rapidly changing standards and regulations could make our products obsolete, which would cause our revenue and results of operations to suffer.***

We design our products to conform to regulations established by governments and to standards set by industry standards bodies worldwide, such as The American National Standards Institute, the European Telecommunications Standards Institute, the International Telecommunications Union and the Institute of Electrical and Electronics Engineers, Inc. Various industry organizations are currently considering whether and to what extent to create standards for elements used in 100Gbps systems. Because certain of our products are designed to conform to current specific industry standards, if competing or new standards emerge that are preferred by our customers, we would have to make significant expenditures to develop new products. If our customers adopt new or competing industry standards with which our products are not compatible, or the industry groups adopt standards or governments issue regulations with which our products are not compatible, our existing products would become less desirable to our customers and our revenue and results of operations would suffer.

***\*Potential future acquisitions could be difficult to integrate, divert the attention of key personnel, disrupt our business, dilute stockholder value and impair our financial results.***

As part of our business strategy, we have pursued and intend to continue to pursue acquisitions of complementary businesses, products, services or technologies that we believe could accelerate our ability to compete in our existing markets or allow us to enter new markets. For instance, in October 2011, we completed the acquisition of Santur Corporation, a designer and manufacturer of Indium Phosphide (InP) based PIC products.

Acquisitions involve numerous risks, any of which could harm our business, including:

difficulties in integrating the operations, technologies, products, existing contracts, accounting and personnel of the target company and realizing the anticipated synergies of the combined businesses;

difficulties in realizing our expectations for the financial performance of the target company;

difficulties in supporting and transitioning customers, if any, of the target company;

diversion of financial and management resources from existing operations;

the price we pay or other resources that we devote may exceed the value we realize, or the value we could have realized if we had allocated the purchase price or other resources to another opportunity;

risks of entering new markets in which we have limited or no experience;

potential loss of key employees, customers and strategic alliances from either our current business or the target company's business;

assumption of unanticipated problems or latent liabilities, such as problems with the quality of the target company's products;

inability to generate sufficient revenue to offset acquisition costs;

dilutive effect on our stock as a result of any equity-based acquisitions; and

in the event of international acquisitions, risks associated with accounting and business practices that are different from applicable U.S. practices and requirements.

Acquisitions also frequently result in the recording of goodwill and other intangible assets which are subject to potential impairments which have occurred in the past and which, were they to occur in the future, could harm our financial results. As a result, if we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of any such acquisitions, and we may incur costs in excess of what we anticipate. The failure to successfully evaluate and execute acquisitions or investments or otherwise adequately address these risks could materially harm our business and financial results.

## **Table of Contents**

### ***Potential changes in our effective tax rate could harm our future results.***

We are subject to income taxes in China and the United States and various foreign jurisdictions, and our domestic and international tax liabilities are subject to the allocation of expenses in differing jurisdictions. Our tax rate is affected by changes in the mix of earnings and losses in countries with differing statutory tax rates, certain non-deductible expenses arising from the requirement to expense stock options and the valuation of deferred tax assets and liabilities, including our ability to utilize our net operating losses. Increases in our effective tax rate could harm our results of operations.

### ***Our future results of operations may be subject to volatility as a result of exposure to fluctuations in foreign exchange rates, primarily the RMB/U.S. dollar exchange rate.***

We are exposed to foreign exchange risks. Foreign currency fluctuations may adversely affect our revenue and our costs and expenses, and hence our results of operations. A substantial portion of our business is conducted through our subsidiaries based in China, whose functional currency is the RMB. The value of the RMB against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in political and economic conditions. Since July 21, 2005, the RMB has no longer been pegged solely to the value of the U.S. dollar. Instead, the RMB is now pegged against a basket of currencies, determined by the People's Bank of China, against which it can rise or fall by as much as 0.5% each day. This change in policy has resulted in approximately 20% appreciation of the RMB against the U.S. dollar between July 21, 2005 and December 31, 2010. While the international reaction to the RMB revaluation has generally been positive, there remains significant international pressure on the Chinese government to adopt an even more flexible currency policy, which may result in a further and more significant appreciation of the RMB against the U.S. dollar. In the long term, the RMB may appreciate or depreciate significantly in value against the U.S. dollar, depending upon the fluctuation of the basket of currencies against which it is currently valued, or it may be permitted to enter into a full float, which may also result in a significant appreciation or depreciation of the RMB against the U.S. dollar.

Foreign currency exchange rates are subject to fluctuation and may cause us to recognize transaction gains and losses in our statements of operations. To the extent that transactions by our subsidiaries in China are denominated in currencies other than the RMB, we bear the risk that fluctuations in the exchange rates of the RMB in relation to other currencies could decrease our revenue or increase our costs and expenses, therefore having an adverse effect on our future results of operations.

While we generate the majority of our revenue in RMB, conversely, a majority of our operating expenses are in U.S. dollars. Therefore, depreciation in the RMB against the U.S. dollar would adversely impact our revenue upon translation to U.S. dollars, but the positive impact on operating expenses would be less. This would result in an overall adverse effect on our results of operations and financial position. For example, for the year ended December 31, 2010, a 10% appreciation in RMB against the U.S. dollar would have resulted in a \$13.0 million increase in our revenue and a \$1.5 million increase in our net income for the period.

To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedging transactions may be limited and we may not be able to successfully hedge our exposure. In addition, our currency exchange variations may be magnified by Chinese exchange control regulations that restrict our ability to convert RMB into foreign currency.

### ***We face a variety of risks associated with international sales and operations.***

We currently derive, and expect to continue to derive, a significant portion of our revenue from international sales in various markets. In addition, a major portion of our operations is based in Shenzhen, China as well as our having additional operations in Malaysia, Canada and Japan. Our international revenue and operations are subject to a number of material risks, including, but not limited to:

difficulties in staffing, managing and supporting operations in more than one country;

difficulties in enforcing agreements and collecting receivables through foreign legal systems;

fewer legal protections for intellectual property in foreign jurisdictions;

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

foreign and U.S. taxation issues and international trade barriers;

general economic and political conditions in the markets in which we operate;

**Table of Contents**

difficulties in obtaining any necessary governmental authorizations for the export of our products to certain foreign jurisdictions;

fluctuations in foreign economies;

fluctuations in the value of foreign currencies and interest rates;

trade and travel restrictions;

outbreaks of avian flu, Severe Acute Respiratory Syndrome, or SARS, H1N1 swine flu or other contagious disease;

domestic and international economic or political changes, hostilities and other disruptions in regions where we currently operate or may operate in the future;

difficulties and increased expenses in complying with a variety of U.S. and foreign laws, regulations and trade standards, including the Foreign Corrupt Practices Act; and

different and changing legal and regulatory requirements in the jurisdictions in which we currently operate or may operate in the future.

Negative developments in any of these areas in China or other countries could result in a reduction in demand for our products, the cancellation or delay of orders already placed, difficulties in producing and delivering our products, threats to our intellectual property, difficulty in collecting receivables, and a higher cost of doing business. In addition, although we maintain an anti-corruption compliance program throughout our company, violations of our compliance program may result in criminal or civil sanctions, including material monetary fines, penalties and other costs against us or our employees, and may have a material adverse effect on our business.

***We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets.***

We are subject to export and import control laws, trade regulations and other trade requirements that limit which products we sell and where and to whom we sell our products, especially laser-dependent products. In some cases, it is possible that export licenses would be required from U.S. government agencies for some of our products in accordance with various statutory authorities, including but not limited to the International Traffic in Arms Regulations, the Export Administration Act of 1979, the International Emergency Economic Powers Act of 1977, the Trading with the Enemy Act of 1917 and the Arms Export Control Act of 1976 and various country-specific trade sanctions legislation. In addition, various countries regulate the import of certain technologies and have enacted laws that could limit our ability to distribute our products. We may not be successful in obtaining the necessary export and import licenses. Failure to comply with these and similar laws on a timely basis, or at all, or any limitation on our ability to export or sell our products would adversely affect our business, financial condition and results of operations.

Changes in our products or changes in export and import laws and implementing regulations may create delays in the introduction of new products in international markets, prevent our customers from deploying our products internationally or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. In such event, our business and results of operations could be adversely affected.

***If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.***

## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Preparing our consolidated financial statements involves a number of complex manual and automated processes, which are dependent upon individual data input or review and require significant management judgment. One or more of these elements may result in errors that may not be detected and could result in a material misstatement of our consolidated financial statements. In 2007, we implemented Oracle eBusiness suite software to automate certain business operations and internal reporting activities. While automation is intended to decrease the likelihood for error and enhance our ability to detect errors that could arise, we expect that for the foreseeable future

---

**Table of Contents**

we will have procedures that are manually intensive. In addition, we may experience difficulties in implementing effective internal controls over financial reporting as part of our integration of Santur. Santur has historically been a private company and not subject to the internal control requirements of a public company.

If a material misstatement occurs in the future, we may fail to meet our future reporting obligations, we may need to restate our financial results and the price of our common stock may decline. Our internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. Even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. If we fail to maintain the adequacy of our internal controls, including any failure to implement required new or improved controls, or if we experience difficulties in the implementation, our business and operating results may be harmed and we may fail to meet our financial reporting obligations. Any failure of our internal controls could also adversely affect the results of the periodic management evaluations and annual independent registered public accounting firm attestation reports regarding the effectiveness of our internal control over financial reporting that will be required when the rules of the Securities and Exchange Commission, or the SEC, under Section 404 of the Sarbanes-Oxley Act, become applicable to us beginning with the filing of our Annual Report on Form 10-K for the year ended December 31, 2011. Effective internal controls are necessary for us to produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and results of operations could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.

***Covenants in our credit facilities may limit our flexibility in responding to business opportunities and competitive developments and increase our vulnerability to adverse economic or industry conditions.***

We have lending arrangements with several financial institutions, including a loan and security agreement with Comerica Bank in the United States, and our subsidiaries in China have line of credit arrangements. Our U.S. loan and security agreement requires us to maintain certain financial covenants, including a liquidity ratio, and restricts our ability to take certain actions such as incurring additional debt, paying dividends, or engaging in certain transactions like mergers and acquisitions, investments and asset sales. These restrictions may limit our flexibility in responding to business opportunities, competitive developments and adverse economic or industry conditions. In addition, our obligations under our U.S. loan and security agreement with Comerica Bank are secured by substantially all of our U.S. assets other than intellectual property assets, which limits our ability to provide collateral for additional financing. A breach of any of these covenants, or a failure to pay interest or indebtedness when due under any of our credit facilities, could result in a variety of adverse consequences, including the acceleration of our indebtedness.

***We may be unable to utilize our net operating loss carryforwards to reduce our income taxes.***

As of December 31, 2010, we had net operating loss, or NOL, carryforwards for U.S. federal and state tax purposes of \$138.4 million and \$47.3 million, respectively. If not utilized, these NOL carryforwards expire, beginning in 2011. The utilization of the NOL and tax credit carryforwards are subject to a substantial limitation imposed by Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, and similar state provisions. We recorded deferred tax assets, net of valuation allowance, for the NOL carryforwards currently available after considering the existing Section 382 limitation. If we incur an additional limitation under Section 382, then the NOL carryforwards, as disclosed, could be reduced by the impact of any future limitation that would result in existing NOL carryforwards and tax credit carryforwards expiring unutilized.

***We incur increased costs as a result of operating as a public company, and our management is required to devote substantial time to new compliance initiatives.***

We became a public reporting company in February 2011. As a public company, we incur legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act, as well as rules subsequently implemented by the SEC and the New York Stock Exchange, imposes additional requirements on public companies, including specific corporate governance practices. For example, the listing requirements of the New York Stock Exchange require that we satisfy certain corporate governance requirements relating to independent directors, audit and compensation committees, distribution of annual and interim reports, stockholder meetings, stockholder approvals, solicitation of proxies, conflicts of interest, stockholder voting rights and codes of conduct. Our management and other personnel need to devote a substantial amount of time to these compliance

## **Table of Contents**

initiatives. Moreover, these rules and regulations increase our legal and financial compliance costs and make some activities more time-consuming and costly. For example, these rules and regulations may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantial additional costs to maintain the same or similar coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers.

### ***We are subject to government regulations that could adversely impact our business.***

The Federal Communications Commission, or FCC, has jurisdiction over the entire U.S. telecommunications industry and, as a result, our products and our U.S. customers are subject to FCC rules and regulations. Current and future FCC regulations affecting communications services, our products or our customers' businesses could negatively affect our business. In addition, international regulatory standards could impair our ability to develop products for international customers in the future. Delays caused by our compliance with regulatory requirements could result in postponements or cancellations of product orders. Further, we may not be successful in obtaining or maintaining any regulatory approvals that may, in the future, be required to operate our business. Any failure to obtain such approvals could harm our business and results of operations.

### ***In some instances, we rely on third-party sales representatives and distributors to assist in selling our products, and the failure of these representatives and distributors to perform as expected could reduce our future revenue.***

Although we primarily sell our products through direct sales to systems vendors, we also sell our products to some of our customers through third-party sales representatives and distributors. Many of our third-party sales representatives and distributors also market and sell competing products from our competitors. Our third-party sales representatives and distributors may terminate their relationships with us at any time, or with short notice. Our future performance will also depend, in part, on our ability to attract additional third-party sales representatives and distributors that will be able to market and support our products effectively, especially in markets in which we have not previously distributed our products. If our current third-party sales representatives and distributors fail to perform as expected, our revenue and results of operations could be harmed.

### ***We are subject to environmental, health and safety laws and regulations, which could subject us to liabilities, increase our costs, or restrict our business or operations in the future.***

Our manufacturing operations and our products are subject to a variety of federal, state, local and international environmental, health and safety laws and regulations in each of the jurisdictions in which we operate or sell our products. These laws and regulations govern, among other things, air emissions, wastewater discharges, the handling and disposal of hazardous substances and wastes, soil and groundwater contamination, employee health and safety, and the use of hazardous materials in, and the recycling of, our products. Our failure to comply with present and future environmental, health or safety requirements, or the identification of contamination, could cause us to incur substantial costs, including cleanup costs, monetary fines, civil or criminal penalties, or curtailment of operations. In addition, these laws and regulations have increasingly become more stringent over time. The identification of presently unidentified environmental conditions, more vigorous enforcement of current environmental, health and safety requirements by regulatory agencies, the enactment of more stringent laws and regulations, or other unanticipated events could restrict our ability to expand our facilities, require us to install costly pollution control equipment or incur other additional expenses, or require us to modify our manufacturing processes or the contents of our products, which could have a material adverse effect on our business, financial condition and results of operations.

Our manufacturing facilities use, store and dispose of hazardous substances in connection with their processes. In addition, our operations have grown through acquisitions, and it is possible that businesses that we have acquired may expose us to environmental liabilities that have not yet been discovered associated with historical site conditions or offsite locations. Some environmental laws impose liability for contamination on current and former owners and operators of affected sites, or on parties that generated wastes disposed of at off-site locations, regardless of fault. In the event we are found liable for any such contamination in the future, there can be no assurance that remediation costs, or potential claims for personal injury or property or natural resource damages resulting from contamination, will not be material.



---

## **Table of Contents**

Additionally, increasing efforts to control emissions of greenhouse gases, or GHG, may also impact us. For example California's recently enacted Global Warming Solutions Act will require us to design and install additional pollution control equipment at our San Jose, California, manufacturing plant. Additional climate change or GHG control requirements are under consideration at the federal level in the United States and in China. Additional restrictions, limits, taxes, or other controls on GHG emissions could increase our operating costs and, while it is not possible to estimate the specific impact any final GHG regulations will have on our operations, there can be no assurance that these measures will not have significant additional impact on us.

*We may not be able to obtain capital when desired on favorable terms, if at all, or without dilution to our stockholders.*

We believe that our existing cash and cash equivalents, and cash flows from our operating activities, will be sufficient to meet our anticipated cash needs for at least the next 12 months. We operate in an industry, however, that makes our prospects difficult to evaluate. It is possible that we may not generate sufficient cash flow from operations or otherwise have the capital resources to meet our future capital needs. If this occurs, we may need additional financing to execute on our current or future business strategies, including to:

invest in our research and development efforts, including by hiring additional technical and other personnel;

expand our operating or manufacturing infrastructure;

acquire complementary businesses, products, services or technologies; or

otherwise pursue our strategic plans and respond to competitive pressures.

If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders could be significantly diluted, and these newly-issued securities may have rights, preferences or privileges senior to those of existing stockholders, including those acquiring shares in our initial public offering. We cannot assure you that additional financing will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, if and when needed, our ability to fund our operations, take advantage of unanticipated opportunities, develop or enhance our products, or otherwise respond to competitive pressures could be significantly limited.

### **Risks related to our operations in China**

Our business operations conducted in China are critical to our success. A total of \$107.3 million, or 58%, of our revenue in 2010 was recognized from customers located in China. Additionally, a substantial portion of our property, plant and equipment, 74% as of December 31, 2010, is located in China. We expect to make further investments in China in the foreseeable future. Therefore, our business, financial condition, results of operations and prospects are to a significant degree subject to economic, political, legal, and social events and developments in China.

*Adverse changes in economic and political policies in China, or Chinese laws or regulations could have a material adverse effect on business conditions and the overall economic growth of China, which could adversely affect our business.*

The Chinese economy differs from the economies of most developed countries in many respects, including the level of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. The Chinese economy has been transitioning from a planned economy to a more market-oriented economy. Despite reforms, the government continues to exercise significant control over China's economic growth by way of the allocation of resources, control over foreign currency-denominated obligations and monetary policy and provision of preferential treatment to particular industries or companies. Moreover, the laws, regulations and legal requirements in China, including the laws that apply to foreign-invested enterprises are relatively new and are subject to frequent changes. The interpretation and enforcement of such laws is uncertain. Any adverse changes to these laws, regulations and legal requirements, including tax laws, or their interpretation or enforcement could have a material adverse effect on our business.

Furthermore, while China's economy has experienced rapid growth in the past 20 years, growth has been uneven across different regions, among various economic sectors and over time. China has also in the past and may



---

**Table of Contents**

in the future experience economic downturns due to, for example, government austerity measures, changes in government policies relating to capital spending, limitations placed on the ability of commercial banks to make loans, reduced levels of exports and international trade, inflation, lack of financial liquidity, restrictions on the flow of capital and foreign exchange, stock market volatility and global economic conditions. Any of these developments could contribute to a decline in business and consumer spending in addition to other adverse market conditions, which could adversely affect our business.

***Our cost advantage from having our manufacturing and part of our research and development in China may diminish over time due to increasing labor costs, which could materially and adversely affect our operating results.***

The labor market in China, particularly in the manufacturing-heavy Southeast region of China where our manufacturing facilities are located, has experienced higher costs due to increased wages. We were required to pay additional employee benefits taxes beginning in late 2010 and were subject to an increase in the minimum range for hourly workers beginning in the quarter ended September 30, 2011. We expect that we will be required to increase wages or be subject to further increase in personnel costs on taxes in the future due to market conditions and/or government mandates. If labor costs in China continue to increase, our gross margins and profit margins and results of operations may be adversely affected. In addition, our competitive advantage against competitors with manufacturing in traditionally higher cost countries would be diminished.

***The termination, expiration or unavailability of our preferential income tax treatment in China may have a material adverse effect on our operating results.***

Prior to January 1, 2008, entities established in China were generally subject to a 30% state and 3% local enterprise income tax rate. In accordance with the China Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, effective through December 31, 2007, our subsidiaries in China enjoyed preferential income tax rates. Effective January 1, 2008, the China Enterprise Income Tax Law, or the EIT law, imposes a single uniform income tax rate of 25% on all Chinese enterprises, including foreign-invested enterprises, and eliminates or modifies most of the tax exemptions, reductions and preferential treatment available under the previous tax laws and regulations. As a result, our subsidiaries in China may be subject to the uniform income tax rate of 25% unless we are able to qualify for preferential status. Currently, we have qualified for a preferential 15% tax rate that is available for new and high technology enterprises. The preferential rate applied to 2010, 2009 and 2008 and expires in December 2011. We realized benefits from this 10% reduction in tax rate of \$1.7 million, \$1.0 million and \$0.2 million for 2010, 2009, and 2008, respectively. Our 15% preferential tax rate expires in December 2011, and as a result, we continue to make estimated tax payments for 2011 using the 15% preferential rate. We have reapplied for the preferential rate for 2011 and our application is currently under review. If approved, the income tax rate will remain at 15%, otherwise, we anticipate that our income tax rate in China will be approximately 24% for 2011 and 25% thereafter.

***Our subsidiaries in China are subject to restrictions on dividend payments, on making other payments to us or any other affiliated company, and on borrowing or allocating tax losses among our subsidiaries.***

Current Chinese regulations permit our subsidiaries in China to pay dividends only out of their accumulated profits, if any, determined in accordance with Chinese accounting standards and regulations, which are different than U.S. accounting standards and regulations. In addition, our subsidiaries in China are required to set aside at least 10% of their respective accumulated profits each year, if any, to fund their statutory common reserves until such reserves have reached at least 50% of their respective registered capital. As of December 31, 2010, our Chinese subsidiaries' common reserves had not reached this threshold and, accordingly, these entities are required to continue funding such reserves with accumulated net profits. The statutory common reserves are not distributable as cash dividends except in the event of liquidation. In addition, current Chinese regulations prohibit inter-company borrowings or allocation of tax losses among subsidiaries in China. Further, if our subsidiaries in China incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends or make other payments to us. Accordingly, we may not be able to move our capital easily, which could harm our business.

---

**Table of Contents*****Restrictions on currency exchange may limit our ability to receive and use our revenue and cash effectively.***

Because a substantial portion of our revenue is denominated in RMB, any restrictions on currency exchange may limit our ability to use revenue generated in RMB to fund any business activities we may have outside China or to make dividend payments in U.S. dollars. Under relevant Chinese rules and regulations, the RMB is currently convertible under the current account, which includes dividends, trade and service-related foreign exchange transactions, but not under the capital account, which includes foreign direct investment and loans, without the prior approval of the State Administration of Foreign Exchange, or SAFE. Currently, our subsidiaries in China may purchase foreign exchange for settlement of current account transactions, including the payment of dividends to us, without the approval of SAFE. Although Chinese government regulations now allow greater convertibility of the RMB for current account transactions, significant restrictions remain. For example, foreign exchange transactions under our primary Chinese subsidiary's capital account, including principal payments in respect of foreign currency-denominated obligations, remain subject to significant foreign exchange controls and the approval of SAFE. These limitations could affect the ability of our subsidiaries in China to obtain foreign exchange for capital expenditures through debt or equity financing, including by means of loans or capital contributions from us. We cannot be certain that Chinese regulatory authorities will not impose more stringent restrictions on the convertibility of the RMB, especially with respect to foreign exchange transactions. If such restrictions are imposed, our ability to adjust our capital structure or engage in foreign exchange transactions may be limited.

In August 2008, SAFE promulgated the *Circular on the Relevant Operating Issues Concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign-invested Enterprises*, or Circular 142, a notice regulating the conversion by foreign-invested enterprises ( FIE ) of foreign currency into RMB by restricting how the converted RMB may be used. Circular 142 requires that RMB converted from the foreign currency-dominated capital of a FIE may only be used for purposes within the business scope approved by the applicable government authority and may not be used for equity investments within China unless specifically provided for otherwise. In addition, SAFE strengthened its oversight over the flow and use of RMB funds converted from the foreign currency-dominated capital of a FIE. The use of such RMB may not be changed without approval from SAFE. As a result of Circular 142, our subsidiaries in China that are considered foreign-invested enterprises may not be able to convert our capital contributions to them into RMB for equity investments or acquisitions in China.

***Uncertainties with respect to China's legal system could adversely affect the legal protection available to us.***

Our operations in China are governed by Chinese laws and regulations. Our subsidiaries in China are generally subject to laws and regulations applicable to foreign investments in China and, in particular, laws applicable to wholly foreign-owned enterprises. China's legal system is a civil law system based on written statutes. Unlike common law systems, it is a legal system where decided legal cases have limited value as precedents. Since 1979, Chinese legislation and regulations have significantly enhanced the protections afforded to various forms of foreign investments in China. However, China has not developed a fully-integrated legal system, and recently-enacted laws and regulations may not sufficiently cover all aspects of economic activities in China. In particular, because these laws and regulations are relatively new, the interpretation and enforcement of these laws and regulations involve uncertainties. For example, we may have to resort to administrative and court proceedings to enforce the legal protection under contracts or law. However, since Chinese administrative and court authorities have significant discretion in interpreting and implementing statutory and contract terms, it may be more difficult to evaluate the outcome of administrative and court proceedings and the level of legal protection we would receive compared to more developed legal systems. In addition, protections of intellectual property rights and confidentiality in China may not be as effective as in the United States or other countries or regions with more developed legal systems. Furthermore, the legal system in China is based in part on government policies and internal rules (some of which are not published on a timely basis or at all) that may have a retroactive effect. As a result, we may not be aware of our violation of these policies and rules until sometime after the violation. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention. All the uncertainties described above could limit the legal protections available to us.

---

**Table of Contents**

***Chinese regulations relating to offshore investment activities by Chinese residents and employee stock options granted by overseas-listed companies may increase our administrative burden, restrict our overseas and cross-border investment activity or otherwise adversely affect the implementation of our acquisition strategy. If our stockholders who are Chinese residents, or our Chinese employees who are granted or exercise stock options, fail to make any required registrations or filings under such regulations, we may be unable to distribute profits and may become subject to liability under Chinese laws.***

Chinese foreign exchange regulations require Chinese residents and corporate entities to register with local branches of SAFE in connection with their direct or indirect offshore investment activities. These regulations apply to our stockholders who are Chinese residents and may apply to any offshore acquisitions that we make in the future. Pursuant to these foreign exchange regulations, Chinese residents who make, or have previously made, direct or indirect investments in offshore companies, will be required to register those investments. In addition, any Chinese resident who is a direct or indirect stockholder of an offshore company is required to file or update the registration with the local branch of SAFE, with respect to that offshore company, any material change involving its round-trip investment, capital variation, such as an increase or decrease in capital, transfer or swap of shares, merger, division, long-term equity or debt investment or creation of any security interest. If any Chinese stockholder fails to make the required SAFE registration or file or update the registration, subsidiaries in China of that offshore parent company may be prohibited from distributing their profits and the proceeds from any reduction in capital, share transfer or liquidation, to their offshore parent company, and the offshore parent company may also be prohibited from injecting additional capital into their subsidiaries in China. Moreover, failure to comply with the various foreign exchange registration requirements described above could result in liability under Chinese laws for evasion of applicable foreign exchange restrictions. We cannot provide any assurances that all of our stockholders who are Chinese residents have made or obtained, or will make or obtain, any applicable registrations or approvals required by these foreign exchange regulations. The failure or inability of our stockholders in China to comply with the required registration procedures may subject us to fines and legal sanctions, restrict our cross-border investment activities, or limit our Chinese subsidiaries' ability to distribute dividends or obtain foreign-exchange-dominated loans. Moreover, because of the uncertainties in the interpretation and implementation of these foreign exchange regulations, we cannot predict how they will affect our business operations or future strategy. For example, we may be subject to a more stringent review and approval process with respect to our foreign exchange activities, such as remittance of dividends and foreign-currency-denominated borrowings, which may adversely affect our results of operations and financial condition. In addition, if we decide to acquire a domestic company in China, we cannot assure you that we or the owners of such company, as the case may be, will be able to obtain the necessary approvals or complete the necessary filings and registrations required by these foreign exchange regulations. This may restrict our ability to implement our acquisition strategy and could adversely affect our business and prospects.

On March 28, 2007, SAFE promulgated the *Application Procedure of Foreign Exchange Administration for Domestic Individuals Participating in Employee Stock Holding Plan or Stock Option Plan of Overseas-Listed Company*, or the Stock Option Rule. Under the Stock Option Rule, Chinese residents who are granted stock options by an overseas publicly-listed company are required, through a Chinese agent or Chinese subsidiary of such overseas publicly-listed company, to register with SAFE and complete certain other procedures. We and our Chinese employees who have been granted stock options are subject to the Stock Option Rule. We are currently in the process of registering our stock option and appreciation plans with SAFE. If we or our optionees in China fail to comply with these regulations, we or our optionees in China may be subject to fines and legal sanctions. Several of our employees in China have exercised their stock options prior to our becoming an overseas publicly-listed company. Since there is not yet a clear regulation on how and whether Chinese employees can exercise their stock options granted by overseas private companies, it is unclear whether such exercises are permissible by Chinese laws and it is uncertain how SAFE or other government authorities will interpret or administer such regulations. Therefore, we cannot predict how such exercises will affect our business or operations. For example, we may be subject to more stringent review and approval processes with respect to our foreign exchange activities, such as remittance of dividends and foreign-currency-denominated borrowings, which may affect our results of operations and financial condition.

***We may be obligated to withhold and pay individual income tax in China on behalf of our employees who are subject to individual income tax in China arising from the exercise of stock options. If we fail to withhold or pay such individual income tax in accordance with applicable Chinese regulations, we may be subject to certain sanctions and other penalties and may become subject to liability under Chinese laws.***

The State Administration of Taxation has issued several circulars concerning employee stock options. Under these circulars, our Chinese employees (which could include both employees in China and expatriate employees subject to individual income tax in China) who exercise stock options will be subject to individual income tax in China. Our subsidiaries in China have obligations to file documents related to employee stock options with relevant

---

**Table of Contents**

tax authorities and withhold and pay individual income taxes for those employees who exercise their stock options. However, since there is not yet a clear regulation on how and whether Chinese employees can exercise stock options granted by overseas private companies and how Chinese employers shall withhold and pay individual taxes, the relevant tax authority has verbally advised us that due to the difficulty in determining the fair market value of our shares as a private company, we did not withhold and pay the individual income tax for the exercises until after we completed our initial public offering in February 2011. Thus, we have not withheld and paid the individual income tax for the option exercises through the date of our initial public offering. However, we cannot assure you that the Chinese tax authorities will not act otherwise and request us to withhold and pay the individual income tax immediately and impose sanctions on us.

***If the Chinese government determines that we failed to obtain approvals of, or registrations with, the requisite Chinese regulatory authority with respect to our current and past import and export of technologies, we could be subject to sanctions.***

China imposes controls on technology import and export. The term "technology import and export" is broadly defined to include, without limitation, the transfer or license of patents, software and know-how, and the provision of services in relation to technology. Depending on the nature of the relevant technology, the import and export of technology to or from China requires either approval by, or registration with, the relevant Chinese governmental authorities.

If we are found to be, or to have been, in violation of Chinese laws or regulations, the relevant regulatory authorities have broad discretion in dealing with such violation, including, but not limited to, issuing a warning, levying fines, restricting us from benefiting from these technologies inside or outside of China, confiscating our earnings generated from the import or export of such technology or even restricting our future export and import of any technology. If the Chinese government determines that our past import and export of technology were inconsistent with, or insufficient for, the proper operation of our business, we could be subject to similar sanctions. Any of these or similar sanctions could cause significant disruption to our business operations or render us unable to conduct a substantial portion of our business operations and may adversely affect our business and result of operations.

***China regulation of loans and direct investment by offshore holding companies to China entities may delay or prevent us from using the proceeds we received from our initial public offering to make loans or additional capital contributions to our China subsidiaries.***

In utilizing the proceeds we received from our initial public offering, we may make loans or additional capital contributions to our China subsidiaries. Any loans to our China subsidiaries are subject to China regulations and approvals. For example, any loans to our China subsidiaries to finance their activities cannot exceed statutory limits, must be registered with SAFE, or its local counterpart, and must be approved by the relevant government authorities. Any capital contributions to our China subsidiaries must be approved by the Ministry of Commerce or its local counterpart. In addition, under Circular 142, our China subsidiaries, as foreign-invested enterprises, may not be able to convert our capital contributions to them into RMB for equity investments or acquisitions in China.

We cannot assure you that we will be able to obtain these government registrations or approvals on a timely basis, if at all, with respect to our future loans or capital contributions to our China subsidiaries. If we fail to receive such registrations or approvals, our ability to use the proceeds of our initial public offering and to capitalize our China subsidiaries may be negatively affected, which could materially and adversely affect our liquidity and ability to fund and expand our business.

***Dividends paid to us by our Chinese subsidiaries may be subject to Chinese withholding tax.***

The EIT Law and the implementation regulations provide that a 10% withholding tax may apply to dividends payable to investors that are non-resident enterprises, to the extent such dividends are derived from sources within China. The comprehensive Double Taxation Arrangement between China and Hong Kong generally reduces the withholding tax on dividends paid from a Chinese company to a Hong Kong company to 5%. Dividends paid to us by our Chinese subsidiaries will be subject to Chinese withholding tax if, as expected, we are considered a non-resident enterprise under the EIT Law. If dividends from our Chinese subsidiaries are subject to Chinese withholding tax, our financial condition may be adversely impacted to the extent of such tax.

---

**Table of Contents**

***Our worldwide income may be subject to Chinese tax under the EIT Law.***

The EIT Law provides that enterprises established outside of China whose de facto management bodies are located in China are considered resident enterprises and are generally subject to the uniform 25% enterprise income tax on their worldwide income. Under the implementation regulations for the EIT Law issued by the State Council, a de facto management body is defined as a body that has material and overall management and control over the manufacturing and business operations, personnel and human resources, finances and treasury, and acquisition and disposition of properties and other assets of an enterprise. If we are deemed to be a resident enterprise for Chinese tax purposes, we will be subject to Chinese tax on our worldwide income at the 25% uniform tax rate, which could have an impact on our effective tax rate and an adverse effect on our net income (loss), however, dividends paid to us by our Chinese subsidiaries may not be subject to withholding if we are deemed to be a resident enterprise.

***Dividends payable by us to our investors and gains on the sale of our common stock by our foreign investors may be subject to tax under Chinese law.***

Under the EIT Law and implementation regulations issued by the State Council, a 10% withholding tax is applicable to dividends payable to investors that are non-resident enterprises. Similarly, any gain realized on the transfer of common stock by such investors is also subject to a 10% withholding tax if such gain is regarded as income derived from sources within China. If we are determined to be a resident enterprise, dividends we pay on our common stock, or the gain you may realize from the transfer of our common stock, would be treated as income derived from sources within China. If we are required under the EIT Law to withhold tax from dividends payable to investors that are non-resident enterprises, or if a gain realized on the transfer of our common stock is subject to withholding, the value of your investment in our common stock may be materially and adversely affected.

***Because a substantial portion of our business is located in China, we may have difficulty establishing adequate management, legal and financial controls, which we are required to do in order to comply with Section 404 of the Sarbanes-Oxley Act and securities laws, and which could cause a material adverse impact on our consolidated financial statements, the trading price of our common stock and our business.***

Chinese companies have historically not adopted a western style of management and financial reporting concepts and practices, which includes strong corporate governance, internal controls and computer, financial and other control systems. Most of our middle and top management staff in China are not educated and trained in the western system, and we may have difficulty hiring new employees in China with experience and expertise relating to accounting principles generally accepted in the United States and U.S. public-company reporting requirements. As a result of these factors, we may experience difficulty in establishing management, legal and financial controls, collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet U.S. public-company reporting requirements. We may, in turn, experience difficulties in implementing and maintaining adequate internal controls as required under Section 404 of the Sarbanes-Oxley Act. This may result in material weaknesses in our internal controls which could impact the reliability of our consolidated financial statements and prevent us from complying with SEC rules and regulations and the requirements of the Sarbanes-Oxley Act. Any such material weaknesses or lack of compliance with SEC rules and regulations could result in restatements of our historical consolidated financial statements, cause investors to lose confidence in our reported financial information, have an adverse impact on the trading price of our common stock, adversely affect our ability to access the capital markets and our ability to recruit personnel, lead to the delisting of our securities from the stock exchange on which they are traded. This could lead to litigation claims, thereby diverting management's attention and resources, and which may lead to the payment of damages to the extent such claims are not resolved in our favor, lead to regulatory proceedings, which may result in sanctions, monetary or otherwise, and have a material adverse effect on our reputation and business.

See also the risk factor If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.

***Our subsidiaries in China are subject to Chinese labor laws and regulations. Recently enacted Chinese labor laws may increase our operation costs in China.***

China Labor Contract Law, effective January 1, 2008, together with its implementing rules, effective September 18, 2008, provides more protection to Chinese employees. Previously, an employer had discretionary

**Table of Contents**

power in deciding the probation period, not to exceed six months. Additionally, the employment contract could only be terminated for cause. Under the new rules, the probation period varies depending on contract terms and the employment contract can only be terminated during the probation period for cause upon three days notice. Additionally, an employer may not be able to terminate a contract during the probation period on the grounds of a material change of circumstances or a mass layoff. The new law also has specific provisions on conditions when an employer has to sign an employment contract with open-ended terms. If an employer fails to enter into an open-ended contract in certain circumstances, the employer must pay the employee twice their monthly wage beginning from the time the employer should have executed an open-ended contract. Additionally an employer must pay severance for nearly all terminations, including when an employer decides not to renew a fixed-term contract.

On January 1, 2008, the Regulations on Paid Annual Leaves of Staff and Workers also took effect, followed by its implementing measures effective September 18, 2008. These regulations provide that employees who have worked consecutively for one year or more are entitled to paid annual leave. An employer must guarantee that employees receive the same wage income during the annual leave period as that for the normal working period. Where an employer cannot arrange annual leave for an employee due to production needs, upon agreement with the employee, the employer must pay daily wages equal to 300% of the employee's daily salary for each day of annual leave forfeited by such employee.

The Shenzhen municipal government, effective December 2010, issued a measure to require all government agencies, public institutions, and enterprises in Shenzhen to pay a monthly housing fund. The housing fund is designed to enhance the welfare and increase the funds available to Shenzhen employees when buying, building, renovating, or overhauling owner-occupied houses. Employee and employers are required to make equal contributions to the housing fund, which can range between 5% and 20% and we commenced making these contributions in the fourth quarter of 2010.

From time to time, the Chinese government has implemented requirements to increase the minimum wage for employees in China. These requirements have resulted in the past, and may result in the future, in higher employee costs for our personnel in China. For example, the minimum wage in Shenzhen, China increased by 20% in April 2011. We were required to increase wages to comply with these requirements and it may be necessary for us to increase wages more than the minimum wage adjustment requires due to market conditions or additional government mandates. If labor costs in China continue to increase, our gross margins and results of operations may be adversely affected. In addition, our competitive advantage against competitors with personnel costs or manufacturing in traditionally higher cost countries may be diminished. These newly introduced laws and regulations may materially increase the costs of our operations in China.

***The turnover of direct labor in manufacturing industries in China is high, which could adversely affect our production, shipments, and results of operations.***

Employee turnover of direct labor in the manufacturing sector in China is high and retention of such personnel is a challenge to companies located in or with operations in China. Although direct labor cost does not represent a high proportion of our overall manufacturing costs, direct labor is required for the manufacture of our products. If our direct labor turnover rates are higher than we expect, or we otherwise fail to adequately manage our direct labor turnover rates, then our results of operations could be adversely affected.

***Adoption of international labor standards may increase our direct labor costs.***

International standards of corporate social responsibility include strict requirements on labor work practices and overtime. As global service providers and their network equipment vendors adopt these standards, we have in the past incurred and may be required in the future to incur additional direct labor costs associated with our compliance with these standards.

***If any of our subsidiaries in China becomes the subject of a bankruptcy or liquidation procedures, we may lose the ability to use its assets.***

Because a substantial portion of our business and revenue are derived from China, if any of our subsidiaries in China goes bankrupt and all or part of its assets become subject to liens or rights of third-party creditors, we may be unable to continue some or all of our operations in China. Any delay, interruption or cessation of all or a part of our operations in China would negatively impact our ability to generate revenue and otherwise adversely affect our business.



## **Table of Contents**

### ***We face risks related to health epidemics and outbreaks of contagious diseases.***

Over the past several years, there have been recent reports of outbreaks of avian flu, SARS and H1N1 swine flu in Asia. Since a large portion of our operations and our customers' and suppliers' operations are currently based in Asia (mainly China), an outbreak of avian flu, SARS, H1N1 swine flu or other contagious diseases in Asia or elsewhere, or the perception that such outbreak could occur, and the measures taken by the governments of countries affected, including China, may result in material disruptions in our operations.

### **Risks related to ownership of our common stock**

#### ***Our financial results may vary significantly from quarter-to-quarter due to a number of factors, which may lead to volatility in our stock price.***

Our quarterly revenue and results of operations have varied in the past and may continue to vary significantly from quarter to quarter. This variability may lead to volatility in our stock price as research analysts and investors respond to these quarterly fluctuations. These fluctuations are due to numerous factors, including:

fluctuations in demand for our products;

the timing, size and product mix of sales of our products;

changes in our pricing and sales policies or the pricing and sales policies of our competitors;

our ability to design, manufacture and deliver products to our customers in a timely and cost-effective manner and that meet customer requirements;

quality control or yield problems in our manufacturing operations;

our ability to timely obtain adequate quantities of the components used in our products;

length and variability of the sales cycles of our products;

unanticipated increases in costs or expenses; and

fluctuations in foreign currency exchange rates.

The foregoing factors are difficult to forecast, and these, as well as other factors, could materially adversely affect our quarterly and annual results of operations. In addition, a significant amount of our operating expenses is relatively fixed in nature due to our internal manufacturing, research and development, sales and general administrative efforts. Any failure to adjust spending quickly enough to compensate for a revenue shortfall could magnify the adverse impact of such revenue shortfall on our results of operations. Moreover, our results of operations may not meet our announced guidance or the expectations of research analysts or investors, in which case the price of our common stock could decrease significantly. There can be no assurance that we will be able to successfully address these risks.

#### ***Our stock price may be volatile.***

## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

The market price of our common stock could be subject to wide fluctuations in response to, among other things, the risk factors described in this section of our Quarterly Report on Form 10-Q, and other factors beyond our control, such as fluctuations in the valuation of companies perceived by investors to be comparable to us.

The stock markets have experienced price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political and market conditions, such as recessions, sovereign debt or liquidity issues, interest rate changes or international currency fluctuations, may negatively affect the market price of our common stock.

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may become the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

---

**Table of Contents**

*If research analysts do not publish research about our business or if they issue unfavorable commentary or downgrade our common stock, our stock price and trading volume could decline.*

The trading market for our common stock depends in part on the research and reports that research analysts publish about us and our business. The price of our common stock could decline if one or more research analysts downgrade our stock or if those analysts issue other unfavorable commentary or cease publishing reports about us or our business. If one or more of the research analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our common stock could decrease, which could cause our stock price or trading volume to decline.

*The concentration of our capital stock ownership with our principal stockholders, executive officers and directors and their affiliates will limit other stockholders' ability to influence corporate matters.*

As of May 2, 2011, our executive officers and directors, and entities that are affiliated with them, beneficially own an aggregate of approximately 35% of our outstanding common stock. This significant concentration of share ownership may adversely affect the trading price for our common stock because investors often perceive disadvantages in owning stock in companies with controlling stockholders. Also, as a result, these stockholders, acting together, may be able to control our management and affairs and matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. Consequently, this concentration of ownership may have the effect of delaying or preventing a change in control, including a merger, consolidation or other business combination involving us, or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control, even if such a change in control would benefit our other stockholders.

*\*Future sales of shares of our common stock by stockholders could depress the price of our common stock.*

As of May 2, 2011, we had an aggregate of 24,655,078 shares of common stock outstanding. Of this amount, 8,625,000 shares sold pursuant to the initial public offering completed in February 2011 are currently tradable without restriction. Of the remaining shares:

800,938 shares were eligible for sale in May 2011;

15,193,398 shares became eligible for sale in August 2011 upon the expiration of lock-up agreements entered into with substantially all of our stockholders in connection with our initial public offering, subject in some cases to volume and other restrictions of Rule 144 and Rule 701 under the Securities Act of 1933, as amended, or the Securities Act; and

6,665 shares will be eligible for sale in the public market from time to time thereafter upon the lapse of our right of repurchase with respect to any unvested shares.

The lock-up agreements originally were set to expire after 180 days, on July 31, 2011; however, automatic extension of the lock-up was triggered when we announced the date of the earnings release results for the second quarter which occurred on August 4, 2011. Therefore, the lock-up expired on August 21, 2011.

In addition, we have registered 3,211,778 shares of our common stock that have been issued or reserved for future issuance under our stock incentive plans.

Sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur, could cause the market price of our common stock to decline. These sales could also make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate.

*We currently do not intend to pay dividends on our common stock and, consequently, your only opportunity to achieve a return on your investment is if the price of our common stock appreciates.*

We currently do not plan to declare dividends on shares of our common stock in the foreseeable future. In addition, the terms of our loan and security agreement with Comerica Bank restrict our ability to pay dividends. Consequently, your only opportunity to achieve a return on your investment in our company will be if the market



## **Table of Contents**

price of our common stock appreciates and you sell your shares at a profit. There is no guarantee that the price of our common stock that will prevail in the market after our initial public offering will ever exceed the price that you pay.

***Our charter documents and Delaware law could prevent a takeover that stockholders consider favorable and could also reduce the market price of our stock.***

Our amended and restated certificate of incorporation and our amended and restated bylaws contain provisions that could delay or prevent a change in control of our company. These provisions could also make it more difficult for stockholders to elect directors and take other corporate actions. These provisions include:

providing for a classified board of directors with staggered, three-year terms;

not providing for cumulative voting in the election of directors;

authorizing our board of directors to issue, without stockholder approval, preferred stock rights senior to those of common stock;

prohibiting stockholder action by written consent;

limiting the persons who may call special meetings of stockholders; and

requiring advance notification of stockholder nominations and proposals.

In addition, we have been governed by the provisions of Section 203 of the Delaware General Corporate Law since the completion of our initial public offering. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding common stock, from engaging in certain business combinations without approval of substantially all of our stockholders for a certain period of time.

These and other provisions in our amended and restated certificate of incorporation, our amended and restated bylaws and under Delaware law could discourage potential takeover attempts, reduce the price that investors might be willing to pay for shares of our common stock in the future and result in the market price being lower than it would be without these provisions.

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

### ***Unregistered Sales of Equity Securities***

None.

### ***Use of proceeds***

On February 2, 2011, our registration statement on Form S-1 (File No. 333-166096) was declared effective for our initial public offering, pursuant to which we registered the offering and sale of 8,625,000 shares of common stock, including the full underwriters' over-allotment option, at a public offering price of \$11.00 per share. Merrill Lynch, Pierce, Fenner & Smith Incorporated and Deutsche Bank Securities Inc. acted as the managing underwriters for our initial public offering. The offering was completed February 7, 2011. We paid to the underwriters underwriting discounts and commissions totaling approximately \$6.6 million in connection with the offering. In addition, we incurred additional costs of approximately \$4.2 million in connection with the offering, which when added to the underwriting discounts and commissions paid by us, amounts to total fees and costs of approximately \$10.8 million. Thus, the net offering proceeds to us, after deducting underwriting discounts and offering costs, were approximately \$84.1 million. None of such payments were a direct or indirect payment to any of our directors or officers or their associates, to persons owning ten percent or more of our common stock or any of our other affiliates.

## Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

There has been no material change in the planned use of proceeds from our initial public offering as described in our final prospectus filed with the SEC pursuant to Rule 424(b), except that we are investing a portion of the proceeds from our initial public offering in marketable securities, including long-term investments, until such time pending their use as described in our final prospectus.

**Table of Contents**

From the effective date of the registration statement through September 30, 2011, we have used approximately \$11.9 million to repay a portion of our outstanding indebtedness, \$2.1 for general corporate and working capital purposes, and the remainder to invest in available-for-sale securities.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. (REMOVED AND RESERVED)**

**ITEM 5. OTHER INFORMATION**

None.

**Table of Contents**

**ITEM 6. EXHIBITS**

See the Exhibit Index which follows the signature page of this Quarterly Report on Form 10-Q, which is incorporated herein by reference.



**Table of Contents**

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized.

**NeoPhotonics Corporation**

Date: November 10, 2011

By:

*/s/ JAMES D. FAY*  
**James D. Fay**  
**Chief Financial Officer**  
**(Principal Financial and Accounting Officer)**

**Table of Contents****EXHIBIT INDEX**

<b>Exhibit no.</b>	<b>Description of exhibit</b>
2.1(1)	Agreement and Plan of Merger, dated as of September 29, 2011, by and among NeoPhotonics Corporation, Dulcimer Acquisition Corp., Santur Corporation and Shareholder Representative Services LLC, solely in its capacity as the Stockholder Representative.
3.1(2)	Amended and Restated Certificate of Incorporation of NeoPhotonics Corporation.
3.2(3)	Amended and Restated Bylaws of NeoPhotonics Corporation.
4.1	Specimen Common Stock Certificate of NeoPhotonics Corporation.
4.2	2008 Investors Rights Agreement by and between NeoPhotonics Corporation and the investors listed on Exhibit A thereto, dated May 14, 2008.
4.3	Warrant to Purchase Common Stock by and between NeoPhotonics Corporation and Comerica Bank, dated December 20, 2007.
10.1(4)	NeoPhotonics Corporation 2011 Inducement Award Plan and related documents.
10.2(5)	2011 Executive Officer Cash Compensation Arrangements.
10.3	Property Lease Contract between NeoPhotonics (China) Co., Ltd. and Dongguan Conrad Hi-Tech Park Ltd., dated May 13, 2011.
10.4	Building Lease Agreement between NeoPhotonics Japan Godo Kaisha and Jones Lang Lasalle K.K., dated September 8, 2011.
10.5	Third Amendment To Loan And Security Agreement And Waiver And Consent by and between NeoPhotonics Corporation and Comerica Bank, dated September 29, 2011.
10.6	Libor/Prime Referenced Rate Addendum To Loan And Security Agreement by and between NeoPhotonics Corporation and Comerica Bank, dated September 29, 2011.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
32.1(6)	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

Filed as the like-numbered exhibit to our Registration Statement on Form S-1, as amended (Reg. No. 333-166096), and incorporated herein by reference.

- (1) Filed as Exhibit 2.1 to the Current Report on Form 8-K (File No. 001-35061), filed with the SEC on October 18, 2011, and incorporated herein by reference.

**Table of Contents**

- (2) Filed as Exhibit 3.1 to the Current Report on Form 8-K (File No. 001-35061), filed with the SEC on February 10, 2011, and incorporated herein by reference.
- (3) Filed as Exhibit 3.4 to our Registration Statement on Form S-1, as amended (File No. 333-166096), filed with the SEC on November 22, 2010, and incorporated herein by reference.
- (4) Filed as Exhibit 99.1 to our Registration Statement on Form S-8 (File No. 333-177306), filed with the SEC on October 13, 2011, and incorporated herein by reference.
- (5) Filed as Exhibit 10.2 to the Quarterly Report on Form 10-Q (File No. 001-35061), filed with the SEC on August 11, 2011, and incorporated herein by reference.
- (6) The certifications attached as Exhibit 32.1 accompany this Quarterly Report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of NeoPhotonics Corporation, under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.