

NEOPHOTONICS CORP  
Form 10-Q  
November 09, 2012  
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**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, 2012

OR

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

Commission File Number: 001-35061

**NeoPhotonics Corporation**

(Exact name of registrant as specified in its charter)

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**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)

**+1 (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 October 31, 2012, there were 30,277,831 shares of the registrant's Common Stock outstanding.

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**NEOPHOTONICS CORPORATION**

**For the Nine Months Ended September 30, 2012**

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		September 30,	As of December 31,
		2012	2011
<b>(In thousands, except share and per share data)</b>			
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$	38,579	\$ 32,321
Short-term investments		67,296	54,063
Restricted cash		2,739	3,227
Accounts receivable, net of allowance for doubtful accounts of \$825 and \$506 at September 30, 2012 and December 31, 2011, respectively		68,816	68,877
Inventories		44,092	35,341
Prepaid expenses and other current assets		7,927	5,882
Current assets held-for-sale		0	1,687
Total current assets		229,449	201,398
Long-term investments		162	92
Property, plant and equipment, net		54,016	56,344
Other intangible assets, net		15,148	17,999
Other long-term assets		1,043	1,049
Long-term assets held-for-sale		0	167
Total assets	\$	299,818	\$ 277,049
<b>LIABILITIES, REDEEMABLE COMMON STOCK AND STOCKHOLDERS' EQUITY</b>			
Current liabilities:			
Accounts payable	\$	37,683	\$ 37,599
Notes payable		11,098	14,620
Current portion of long-term debt		5,000	5,000
Accrued and other current liabilities		22,323	18,299
Current liabilities held-for-sale		0	1,681
Total current liabilities		76,104	77,199
Long-term debt, net of current portion		18,417	22,166
Deferred income tax liabilities		650	927
Other noncurrent liabilities		1,720	3,103
Total liabilities		96,891	103,395
Commitments and contingencies (Note 8)			
Redeemable common stock		5,000	0
Stockholders' equity:			
Preferred stock, \$0.0025 par value			
At September 30, 2012: 10,000,000 shares authorized, no shares issued or outstanding;			
At December 31, 2011: 10,000,000 shares authorized, no shares issued or outstanding		0	0

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Common stock, \$0.0025 par value		
At September 30, 2012: 100,000,000 shares authorized, 30,277,831 shares issued and outstanding;		
At December 31, 2011: 100,000,000 shares authorized, 24,862,585 shares issued and outstanding	76	62
Additional paid-in capital	431,730	392,792
Accumulated other comprehensive income	11,215	11,353
Accumulated deficit	(245,094)	(230,553)
 Total stockholders' equity	 197,927	 173,654
 Total liabilities, redeemable common stock and stockholders' equity	 \$ 299,818	 \$ 277,049

*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,	
	2012	2011	2012	2011
Revenue	\$ 66,152	\$ 42,848	\$ 183,400	\$ 143,845
Cost of goods sold	45,536	30,827	135,773	106,034
Gross profit	20,616	12,021	47,627	37,811
Operating expenses:				
Research and development	9,893	7,059	29,753	19,816
Sales and marketing	3,354	3,103	9,783	8,318
General and administrative	6,770	5,877	20,616	14,613
Amortization of purchased intangible assets	321	104	996	668
Adjustment to fair value of contingent consideration	(850)	0	(246)	0
Total operating expenses	19,488	16,143	60,902	43,415
Income (loss) from operations	1,128	(4,122)	(13,275)	(5,604)
Interest income	147	76	424	155
Interest expense	(135)	(52)	(434)	(230)
Other income (expense), net	154	191	(538)	14,299
Total interest and other income (expense), net	166	215	(548)	14,224
Income (loss) before income taxes	1,294	(3,907)	(13,823)	8,620
Provision for income taxes	(571)	(258)	(888)	(1,177)
Income (loss) from continuing operations	723	(4,165)	(14,711)	7,443
Income from discontinued operations, net of tax (including gain on disposal of \$636, net of tax, for the nine months ended September 30, 2012)	0	75	170	112
Net income (loss)	723	(4,090)	(14,541)	7,555
Deemed dividend on beneficial conversion of Series X redeemable convertible preferred stock	0	0	0	(17,049)
Accretion of redeemable convertible preferred stock	0	0	0	(7)
Net income (loss) attributable to NeoPhotonics Corporation common stockholders	\$ 723	\$ (4,090)	\$ (14,541)	\$ (9,501)
Basic net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:				
Continuing operations	\$ 0.02	\$ (0.17)	\$ (0.53)	\$ (0.45)
Discontinued operations	\$ 0.00	\$ 0.00	\$ 0.01	\$ 0.01

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Net income (loss)	\$	0.02	\$	(0.17)	\$	(0.52)	\$	(0.44)
Diluted net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:								
Continuing operations	\$	0.02	\$	(0.17)	\$	(0.53)	\$	(0.45)
Discontinued operations	\$	0.00	\$	0.00	\$	0.01	\$	0.01
Net income (loss)	\$	0.02	\$	(0.17)	\$	(0.52)	\$	(0.44)
Weighted average shares used to compute net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:								
Basic		30,215,144		24,744,417		27,838,292		21,534,927
Diluted		30,611,304		24,744,417		27,838,292		21,534,927

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****NEOPHOTONICS CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(UNAUDITED)**

<b>(In thousands)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Net income (loss)	\$ 723	\$ (4,090)	\$ (14,541)	\$ 7,555
Other comprehensive income (loss), before tax				
Foreign currency translation adjustments	(190)	1,309	(537)	2,568
Unrealized gains (losses) on available-for-sale securities	163	(393)	399	(527)
Unrealized gain on equity investment	0	0	0	8,291
Less: reclassification adjustment for gain on sale of equity investment included in net income	0	0	0	(12,703)
Other comprehensive income (loss), before tax	(27)	916	(138)	(2,371)
Income tax related to items of other comprehensive income (loss)	0	0	0	0
Other comprehensive income (loss), net of tax	(27)	916	(138)	(2,371)
Comprehensive income (loss)	\$ 696	\$ (3,174)	\$ (14,679)	\$ 5,184

*See accompanying Notes to Condensed Consolidated Financial Statements.*



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<b>(In thousands)</b>		<b>Nine Months Ended September 30,</b>	
		<b>2012</b>	<b>2011</b>
<b>Cash flows from operating activities</b>			
Net income (loss)	\$	(14,541)	\$ 7,555
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation and amortization		14,302	8,159
Stock-based compensation expense		3,435	2,420
Deferred taxes		387	0
Loss on disposal of fixed assets		57	140
Gain on sale of unconsolidated investee, net of direct cost		0	(13,867)
Gain on sale of discontinued operations		(750)	0
Allowance for doubtful accounts		178	93
Provision for inventories		3,456	449
Change in assets and liabilities:			
Accounts receivable		(481)	(1,549)
Inventories		(12,686)	(15,739)
Prepaid expenses and other current assets		(1,887)	1,715
Accounts payable		141	5,012
Accrued and other liabilities		1,012	(4,298)
Net cash used in operating activities		(7,377)	(9,910)
<b>Cash flows from investing activities</b>			
Purchase of property, plant and equipment		(8,963)	(8,590)
Purchase of marketable securities		(151,871)	(148,860)
Proceeds from sale of marketable securities		103,839	72,760
Proceeds from maturity of securities		34,584	3,623
Proceeds from sale of unconsolidated investee		0	21,363
Decrease in restricted cash		471	225
Proceeds received on sale of discontinued operations, net of tax		1,825	0
Net cash used in investing activities		(20,115)	(59,479)
<b>Cash flows from financing activities</b>			
Proceeds from issuance of common stock, net of issuance costs		39,636	86,528
Proceeds from exercise of stock options and warrants		228	291
Proceeds from issuance of stock under ESPP		923	508
Repayment of bank loans		(3,750)	(11,881)
Proceeds from issuance of notes payable		19,651	21,438
Repayment of notes payable		(23,098)	(21,692)
Net cash provided by financing activities		33,590	75,192
Effect of exchange rates on cash and cash equivalents		(4)	234
Net increase in cash and cash equivalents		6,094	6,037
Cash and cash equivalents at the beginning of the period		32,485	25,465
Cash and cash equivalents at the end of the period	\$	38,579	\$ 31,502

**Supplemental disclosure of noncash investing and financing activities:**

Conversion of redeemable convertible preferred stock to common stock	0	228,597
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*See accompanying Notes to Condensed Consolidated Financial Statements.*

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**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, 2012 and December 31, 2011 and for the three and nine months ended September 30, 2012 and 2011, 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, 2011. 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. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by U.S. generally accepted accounting principles ( U.S. GAAP ). 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, 2011. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated.

*Consolidation*

The condensed consolidated financial statements are prepared in accordance with U.S. GAAP and include the consolidated accounts of the Company and its majority owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

*Discontinued operations*

In the fourth quarter of 2011, the Company initiated a plan to sell a component of its business, Shenzhen Photon Broadband Technology Co., Ltd. ( Broadband ), a subsidiary in China. As such, the net assets of Broadband are classified as held-for-sale in its consolidated balance sheets as of December 31, 2011, and the results of operations associated with Broadband are presented as discontinued operations in its consolidated statements of operations for all periods presented. The sale was completed on March 13, 2012. Unless otherwise indicated, all discussions relate to the Company's continuing operations. For further details, see Note 3 to the Condensed Consolidated Financial Statements.

The Condensed Consolidated Statements of Cash Flows for NeoPhotonics Corporation include the cash flow from both continuing and discontinued operations. Therefore, the beginning and ending cash balances represent the cash and cash equivalents of the Company's continuing operations, as presented on the condensed consolidated balance sheets, plus cash and cash equivalents associated with discontinued operations, included within current assets held-for-sale on the condensed consolidated balance sheets. For further details, see Note 3 to the Condensed Consolidated Financial Statements.

*Corrections in classification of Condensed Consolidated Statements of Cash Flows*

The Company identified errors in the classification of the Condensed Consolidated Statements of Cash Flows for the three months ended June 30, 2011 relating to issuance of common stock under ESPP and the purchase of patents, both of which were incorrectly classified within operating activities. The corrections would result in an increase to Net Cash Used in Operating Activities of \$358,000, an increase to Net Cash Used in Investing Activities of \$150,000 and an increase to Net Cash Provided by Financing Activities of \$508,000 for the six months ended June 30, 2011 and the nine months ended September 30, 2011.

Management assessed the impact of these corrections on the 2011 interim consolidated statements of cash flows and concluded that the corrections were not material, either individually, or in the aggregate, to the previously reported cash flows. As a result, the comparative statements of cash flows were revised to correct for the classification in the Company's Forms 10-Q for the periods ended June 30, 2012 and September 30, 2012.



**Table of Contents***Reclassifications*

Certain prior-year amounts in the consolidated financial statements and the notes thereto have been reclassified where necessary to conform to the current presentation. These reclassifications did not affect the prior period deficit, net cash provided by (used in) operating activities or net income (loss).

**Note 2. Significant accounting policies**

There have been no changes in the Company's significant accounting policies for the nine months ended September 30, 2012, as compared to the significant accounting policies described in its Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

*Recent accounting pronouncements*

In July 2012, the Financial Accounting Standard Board (FASB) issued amendments to the FASB Accounting Standard Codification relating to indefinite-lived intangible assets for impairments. The amendments permit an entity first to assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued. The adoption of this guidance did not have a material impact on our results of operations, cash flows or financial condition.

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. The new guidance became effective for the Company beginning January 1, 2012. The adoption of this guidance did not have a material impact to the Company's 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 adopted this guidance on January 1, 2012 and the application of this guidance resulted in financial statement presentation changes only.

**Note 3. Discontinued operations**

In the fourth quarter of 2011, the Company initiated a plan to sell a component of its business, Broadband, a subsidiary in China. The Company decided to sell Broadband because the nature of its operations was different than the core technology and strategy of the Company. On January 11, 2012, the Company entered into a purchase agreement with Guangdong Rainbow Electronic Ltd. (Rainbow) to dispose of its 100% equity interest in Broadband for a total cash consideration of RMB 13.0 million (\$2.1 million). The transaction closed on March 13, 2012. The Company recognized a gain of \$0.6 million on the sale of Broadband, representing the difference between the consideration received and the net assets transferred to Rainbow, net of tax. The gain was included in income from discontinued operations, net of tax in the statement of operations for the nine months ended September 30, 2012.

The results of operations associated with Broadband are presented as discontinued operations in the Company's consolidated statements of operations for the three and nine months ended September 30, 2012 and 2011. Revenue and the components of net income related to the discontinued operations for all periods were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue	\$ 0	\$ 1,112	\$ 590	\$ 3,119
Income from discontinued operations before income taxes	0	75	284	112

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Provision for income taxes	0	0	(114)	0
Income from discontinued operations	\$ 0	\$ 75	\$ 170	\$ 112
Basic and diluted net income per share on discontinued operations	\$ 0.00	\$ 0.00	\$ 0.01	\$ 0.01

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As of December 31, 2011, the net assets of Broadband were classified as held-for-sale in the Company's consolidated balance sheet. Details of the net assets held-for-sale is as follows (in thousands):

	December 31, 2011
Cash and cash equivalents	\$ 164
Accounts receivable, net	873
Inventories	484
Prepaid expenses and other current assets	166
<b>Current assets held-for-sale</b>	<b>\$ 1,687</b>
Property, plant and equipment, net	\$ 167
<b>Long-term assets held-for-sale</b>	<b>\$ 167</b>
Accounts payable	\$ 1,225
Accrued an other current liabilities	456
<b>Current liabilities held-for-sale</b>	<b>\$ 1,681</b>

## Note 4. Cash and investments

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, 2012				As of December 31, 2011			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Money market funds	\$ 3,251	\$ 0	\$ 0	\$ 3,251	\$ 2,216	\$ 0	\$ 0	\$ 2,216
Time deposit	15,532	0	0	15,532	17,759	0	0	17,759
Marketable securities:								
Corporate bonds	0	24,808	0	24,808	0	17,198	0	17,198
Commercial paper	0	0	0	0	0	7,467	0	7,467
U.S. federal agencies	0	28,339	0	28,339	0	11,450	0	11,450
Foreign bonds and notes	0	5,702	0	5,702	0	4,052	0	4,052
Municipal obligations	0	2,151	0	2,151	0	2,651	0	2,651
	\$ 18,783	\$ 61,000	\$ 0	\$ 79,783	\$ 19,975	\$ 42,818	\$ 0	\$ 62,793

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):

	As of September 30, 2012				As of December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash and cash equivalents								
Money market funds	\$ 11	\$ 0	\$ 0	\$ 11	\$ 11	\$ 0	\$ 0	\$ 11

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Time deposit	12,476	0	0	12,476	8,719	0	0	8,719
Total investments in cash and cash equivalents	12,487	0	0	12,487	8,730	0	0	8,730
Short-term investments								
Money market funds	3,240	0	0	3,240	2,205	0	0	2,205
Time deposit	3,056	0	0	3,056	9,040	0	0	9,040
Corporate bonds	24,740	68	0	24,808	17,403	19	(224)	17,198
Commercial paper	0	0	0	0	7,497	0	(30)	7,467
U.S. federal agencies	28,333	8	(2)	28,339	11,447	3	0	11,450
Foreign bonds and notes	5,685	17	0	5,702	4,128	4	(80)	4,052
Municipal obligations	2,151	0	0	2,151	2,651	0	0	2,651
Total investments in short-term investments	67,205	93	(2)	67,296	54,371	26	(334)	54,063
Total investments	\$ 79,692	\$ 93	\$ (2)	\$ 79,783	\$ 63,101	\$ 26	\$ (334)	\$ 62,793



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As of September 30, 2012 and December 31, 2011, maturities of financial assets are as follows (in thousands):

	September 30, 2012	December 31, 2011
Less than 1 year	\$ 65,644	\$ 46,264
Due in 1 to 5 years	12,238	14,126
Due after 5 years	1,901	2,403
Total	\$ 79,783	\$ 62,793

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, 2012 and December 31, 2011, regardless of the contractual maturity date of the securities.

Realized gains and losses on the sale of marketable securities during the three and nine months ended September 30, 2012 and 2011 were immaterial. The Company did not recognize any impairment losses on its marketable securities during the three and nine months ended September 30, 2012 and 2011. As of September 30, 2012, 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.

**Note 5. Net income (loss) per share attributable to NeoPhotonics Corporation common stockholders**

The following table sets forth the computation of the basic and diluted net 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,	
	2012	2011	2012	2011
<b>Numerator:</b>				
Income (loss) from continuing operations	\$ 723	\$ (4,165)	\$ (14,711)	\$ 7,443
Less: deemed dividend on beneficial conversion of Series X redeemable convertible preferred stock	0	0	0	(17,049)
Less: accretion of redeemable convertible preferred stock	0	0	0	(7)
Income (loss) from continuing operations attributable to NeoPhotonics Corporation common stockholders	\$ 723	\$ (4,165)	\$ (14,711)	\$ (9,613)
Income (loss) from discontinued operations	\$ 0	\$ 75	\$ 170	\$ 112
Net income (loss) attributable to NeoPhotonics Corporation common stockholders	\$ 723	\$ (4,090)	\$ (14,541)	\$ (9,501)
<b>Denominator:</b>				
Weighted average shares used to compute basic net income (loss) per share attributable to NeoPhotonics Corporation common stockholders	30,215,144	24,744,417	27,838,292	21,534,927
Effect of dilutive equity incentive plan	396,160	0	0	0
Weighted average shares used to compute diluted net income (loss) per share attributable to NeoPhotonics Corporation common stockholders	30,611,304	24,744,417	27,838,292	21,534,927
Basic net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:				

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Continuing operations	\$	0.02	\$	(0.17)	\$	(0.53)	\$	(0.45)
Discontinued operations	\$	0.00	\$	0.00	\$	0.01	\$	0.01
Net income (loss)	\$	0.02	\$	(0.17)	\$	(0.52)	\$	(0.44)
Diluted net income (loss) per share attributable to Neophotonics Corporation common stockholders:								
Continuing operations	\$	0.02	\$	(0.17)	\$	(0.53)	\$	(0.45)
Discontinued operations	\$	0.00	\$	0.00	\$	0.01	\$	0.01
Net income (loss)	\$	0.02	\$	(0.17)	\$	(0.52)	\$	(0.44)

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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.

For the nine months ended September 30, 2011, all components of net loss were attributed to common stockholders as the stockholders of the redeemable preferred stock did not have a contractual obligation to share in the Company's net losses.

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 conversion amount of \$6.25 per share. At the closing of the initial public offering, 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 nine months ended September 30, 2011, pro forma net income per share, 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):

	<b>Nine Months Ended September 30, 2011</b>
Income from continuing operations	\$ 7,443
Income from discontinued operations	\$ 112
Net income	\$ 7,555
Basic pro forma net income per share attributable to NeoPhotonics Corporation common stockholders	
Continuing operations	\$ 0.32
Discontinued operations	\$ 0.00
Net income	\$ 0.32
Diluted pro forma net income per share attributable to NeoPhotonics Corporation common stockholders	
Continuing operations	\$ 0.32
Discontinued operations	\$ 0.00
Net income	\$ 0.32
Weighted average shares used to compute pro forma net income per share attributable to NeoPhotonics Corporation common stockholders - Basic	23,489,002
Weighted average shares used to compute pro forma net income per share attributable to NeoPhotonics Corporation common stockholders - Diluted	23,767,718

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The following potentially dilutive securities were excluded from the computation of diluted net income (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,	
	2012	2011	2012	2011
Employee stock options	1,454,417	738,768	1,497,693	855,740
Common stock warrants	4,482	4,482	4,482	4,482
Employee stock purchase plan	0	33,149	26,690	76,323
Restricted stock units	37	1,003	411,728	334
Redeemable convertible preferred stock, on an if-converted basis <sup>(1)</sup>	0	0	0	1,975,787
	1,458,936	777,402	1,940,593	2,912,666

(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 6. Balance sheet components

#### Accounts receivable, net

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

	September 30, 2012	December 31, 2011
Accounts receivable	\$ 65,686	\$ 60,655
Trade notes receivable	3,955	8,728
Allowance for doubtful accounts	(825)	(506)
	\$ 68,816	\$ 68,877

**Table of Contents***Inventories*

Inventories consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Raw materials	\$ 17,225	\$ 16,892
Work in process	11,609	4,991
Finished goods	15,258	13,458
	\$ 44,092	\$ 35,341

*Other Purchased intangible assets, net*

Other intangible assets, net, consist of the following (in thousands):

	September 30, 2012			December 31, 2011		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Technology and patents	\$ 32,065	\$ (22,143)	\$ 9,922	\$ 32,145	\$ (20,489)	\$ 11,656
Customer relationships	11,752	(7,706)	4,046	11,788	(6,746)	5,042
Leasehold interest	1,343	(231)	1,112	1,352	(195)	1,157
Noncompete agreements	950	(882)	68	950	(806)	144
	\$ 46,110	\$ (30,962)	\$ 15,148	\$ 46,235	\$ (28,236)	\$ 17,999

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,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of goods sold	\$ 616	\$ 7	\$ 1,830	\$ 66
Operating expenses	321	104	996	668
Total	\$ 937	\$ 111	\$ 2,826	\$ 734

The estimated future amortization expense of purchased intangible assets as of September 30, 2012, is as follows (in thousands):

2012 (remaining 3 months)	\$ 942
2013	3,619
2014	3,502
2015	3,483
2016	2,750
Thereafter	852



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

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

	September 30, 2012	December 31, 2011
Employee-related	\$ 12,242	\$ 9,523
Other	10,081	8,776
	<b>\$ 22,323</b>	<b>\$ 18,299</b>

*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,	
	2012	2011	2012	2011
Beginning balance	\$ 1,298	\$ 372	\$ 1,443	\$ 299
Warranty accruals	98	71	251	235
Settlements and adjustments	(65)	(63)	(363)	(154)
Ending balance	\$ 1,331 <sup>(1)</sup>	\$ 380	\$ 1,331 <sup>(1)</sup>	\$ 380

- (1) Included within the ending balance is an accrual of \$0.3 million relating to a specific part, for which the liability was assumed as part of the acquisition of Santur. The amount recorded represents the Company's estimate of the liability to be incurred, and management believes that the amount recorded in the consolidated financial statements will be adequate to resolve any warranty obligations related to this issue, although this assessment is subject to change based on the ultimate resolution of this matter with customers.

**Note 7. Debt**

The Company records debt at its carrying amount. The Company uses a market approach to determine fair value using rate of LIBOR plus 2%, which results in a Level 2 fair-value measurement. 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, 2012			December 31, 2011		
	Carrying Amount	Fair Value	Weighted Average Interest Rate	Carrying Amount	Fair Value	Weighted Average Interest Rate
Notes payable	\$ 11,098	\$ 11,098		\$ 14,620	\$ 14,620	

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Total long-term debt	23,417	22,291	2.24%	27,166	25,455	2.24%
Less: current portion of long-term debt	(5,000)	(4,890)		(5,000)	(4,890)	
Total long-term debt, net of current portion	\$ 18,417	\$ 17,401		\$ 22,166	\$ 20,565	



**Table of Contents***Notes payable*

The Company's subsidiaries in China have trade notes payable from various banking institutions. The trade notes are unsecured, noninterest bearing and are due approximately nine months after issuance.

*Long-term debt*

The Company has a loan and security agreement with a bank for an available credit facility. The components of the available credit facilities as of September 30, 2012 and December 31, 2011 are as follows:

As of September 30, 2012 and December 31, 2011, \$8.0 million was outstanding under the revolving line of credit agreement and \$0.0 million was available for borrowing. Amounts are due on or before September 2014 and borrowings under this facility bear interest at a rate of LIBOR plus 2%.

As of September 30, 2012 and December 31, 2011, no amounts were outstanding under the equipment advance line and all \$7.0 million was available for borrowing. Borrowings under this facility bear interest at a rate of LIBOR plus 2%.

As of September 30, 2012 and December 31, 2011, \$15.4 million and \$19.2 million was outstanding under the acquisition advance. And \$4.6 million and \$0.8 million was available for borrowing, respectively. Advances are due and payable in equal monthly installments of principal and interest through September 2015. The advances bear interest at a rate of LIBOR plus 2%. During the nine months ended September 30, 2012, the Company made principal payments toward the acquisition advance of \$3.8 million.

Our U.S. 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, 2012, the Company was in compliance with all covenants contained in this agreement.

Our subsidiaries in China have short-term line of credit facilities with several banking institutions. These short-term loans had an original maturity date of one year or less as of September 30, 2012. 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, 2012, the Company had no short-term loans outstanding.

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

The Company leases various facilities under noncancelable operating leases. As of September 30, 2012, the future minimum commitments under all operating leases are as follows (in thousands):

2012 (remaining 3 months)	\$ 562
2013	1,650
2014	1,213
2015	1,062
2016	666
Thereafter	1,468
	<b>\$ 6,621</b>



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Rent expense under the Company's operating leases was \$0.6 million and \$0.5 million for the three months ended September 30, 2012 and 2011, respectively, and \$1.7 million and \$1.4 million for the nine months ended September 30, 2012 and 2011, 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 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, 2012. 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.

On January 5, 2010, Finisar Corporation, or Finisar, filed a complaint in the U.S. District Court for the Northern District of California against Source Photonics, Inc., MRV Communications, Inc., Oplink Communications, Inc. and the Company, or collectively, the co-defendants. In the complaint, Finisar alleged infringement of certain of its U.S. patents arising from the codefendants' respective manufacture, importation, use, sale of or offer to sell certain optical transceiver products. 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, the Company 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 the Company) except Source Photonics, Inc., on grounds that such claims should have been asserted in four separate lawsuits, one against each defendant. This dismissal without prejudice does not prevent Finisar from bringing a new similar lawsuit against the Company. The Company and Finisar had agreed to suspend their respective claims for a 90 day period and not to refile the originally asserted 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 suspension period, which ended in December 2010. On January 18, 2011, the Company and Finisar again agreed to suspend their respective claims 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. This tolling period expired on April 30, 2012. On May 3, 2012 the Company and Finisar agreed to further toll their respective claims until the refiling of certain of the previously asserted claims from this dispute. As a result, Finisar is permitted to bring a new lawsuit against the Company if it chooses to do so, and the Company may bring new claims against Finisar upon seven days written notice prior to filing such claims.

**Table of Contents***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, 2012, total outstanding purchase obligations were \$8.0 million, primarily due within the next 12 months.

*Contingent consideration*

In connection with the Company's acquisition of Santur Corporation (Santur) in October 2011, the Company may be required to pay the former stockholders of Santur up to an additional \$7.5 million in cash, contingent upon Santur's gross profit performance during 2012. The fair value of the contingent consideration was measured at the date of acquisition and is remeasured each reporting period and any changes in the fair value of the contingent consideration are recognized as a gain or loss in the consolidated statements of operations. The contingent consideration is valued with level three inputs. The Company estimated the fair value of its liability using the expected cash flow approach with inputs being probability-weighted revenue and gross margin projections and a discount rate based on a weighted-average cost of capital of 19%. As of December 31, 2011, the fair value of the contingent consideration was \$1.5 million. As of September 30, 2012, the fair value of the contingent consideration was \$1.3 million and is included in other current liabilities on the Company's consolidated balance sheet. During the three and nine months ended September 30, 2012, the Company recorded adjustments to the fair value of the consideration of \$(0.9) million and \$(0.2) million, respectively. The Company expects the amount of contingent consideration accrued to fluctuate throughout the remainder of fiscal year as a result of changes and other economic conditions.

**Note 9. Stockholder's equity***Common Stock*

As of September 30, 2012, the Company had reserved the following shares of authorized but unissued common stock:

Stock option plans	4,092,600
Stock purchase plan	520,490
Warrants	4,482
	4,617,572

*Private Sale of Common Stock*

On April 27, 2012, the Company issued and sold approximately 4.97 million shares of its common stock in a private placement transaction at a price of \$8.00 per share for proceeds, net of offering costs of approximately \$39.6 million. The shares of common stock are restricted from transfer pursuant to a lockup agreement for up to two years, at the end of which the Company is obligated to file one or more registration statements covering the potential resale of the shares of common stock. In connection with the private placement transactions, the Company agreed to use at least \$30.0 million of the proceeds received to establish a wholly-owned subsidiary and facility in the Russian Federation for the benefit of the Company's global organization. The Company has agreed to satisfy the performance obligations by July 31, 2014. In the event the Company has not recorded aggregate revenue from sales of its products in the Russian Federation of at least \$26.8 million during the period beginning July 1, 2012 and ending June 30, 2014, then the date to achieve the performance obligations shall be extended from July 31, 2014 to March 31, 2015. If the Company fails to meet these performance obligations by the deadline, the Company will be required to pay \$5.0 million.

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The private placement transaction was recorded as an equity transaction. Of the common stock, \$5.0 million is considered redeemable, as the Company may be required to pay this amount if it is unable to achieve its performance obligations by the date specified. While the Company intends to comply with its performance obligations, it has determined that some of these obligations are contingent upon government approval and maybe outside of the Company's control. Therefore, the redeemable common stock is classified outside of equity on the Company's consolidated balance sheet.

**Equity Incentive Programs**

The Company grants stock options, restricted stock units, stock appreciation units and stock purchase rights pursuant to stockholder and board approved equity incentive plans. These equity incentive plans are described in further detail in Note 13 of Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

**Stock options and restricted stock units**

The following table summarizes the Company's stock option activity during the nine months ended September 30, 2012:

	Stock Options			Restricted Stock Units	
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Number of Units	Weighted Average Grant Date Fair Value
Balance at December 31, 2011	330,177	2,631,524	\$ 5.99	517,445	\$ 6.97
Authorized for issuance	870,190	0	0.00	0	0.00
Granted	(867,084)	251,475	4.90	615,609	5.27
Exercised/Converted	0	(53,851)	4.23	(158,496)	7.00
Forfeited	119,205	(103,623)	7.36	(59,971)	6.68
Balance at September 30, 2012	452,488	2,725,525	5.87	914,587	5.85

The following table summarizes information about stock options outstanding as of September 30, 2012:

	Options Outstanding			
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in thousands)
Vested and expected to vest	2,631,650	\$ 5.87	6.81	\$ 2,389
Exercisable	1,605,312	\$ 5.50	5.53	\$ 2,019

The intrinsic value of options vested and expected to vest and exercisable as of September 30, 2012 is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of September 30, 2012. The intrinsic value of options exercised during the three months ended September 30, 2012 and 2011 was \$0.01 million and \$0.04 million, respectively. The intrinsic value of options exercised during the nine months ended September 30, 2012 and 2011 was \$0.05 million and \$0.4 million, respectively.

The following table summarizes information about restricted stock units outstanding as of September 30, 2012:

**Restricted Stock Units Outstanding**

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	Number of Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in thousands)
Vested and expected to vest	812,665	\$ 5.85	1.56	\$ 4,746

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The intrinsic value of restricted stock units vested and expected to vest as of September 30, 2012 is calculated based on the fair value of the Company's common stock as of September 30, 2012. The intrinsic value of restricted stock units converted during the three and nine months ended September 30, 2012 was \$0.9 million. There were no restricted stock units converted during the three and nine months ended September 30, 2011.

*Stock appreciation units*

The following table summarizes the Company's stock appreciation unit activity during the nine months ended September 30, 2012:

	Stock Appreciation Units	Weighted Average Exercise Price
Stock appreciation units outstanding as of December 31, 2011	261,627	\$ 6.86
Stock appreciation units cancelled	(29,001)	6.60
Stock appreciation units exercised	(15,585)	4.25
Stock appreciation units outstanding as of September 30, 2012	217,041	7.08

The following table summarizes information about stock appreciation units outstanding as of September 30, 2012:

	Stock Appreciation Units Outstanding			
	Number of Units	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate intrinsic Value (in thousands)
Vested and expected to vest	215,798	\$ 7.07	6.57	\$ 190
Exercisable	170,660	\$ 6.55	6.33	\$ 177

The intrinsic value of stock appreciation units vested and expected to vest and exercisable as of September 30, 2012 is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of September 30, 2012. The intrinsic value of stock appreciation units exercised during the three months ended September 30, 2012 and 2011 was \$0.01 million. The intrinsic value of stock appreciation units exercised during the nine months ended September 30, 2012 and 2011, was \$0.01 million.

**Note 10. Stock-based compensation***Stock-based compensation expense*

The Company's stock-based compensation expense was recorded as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of goods sold	\$ 228	\$ (133)	\$ 553	\$ 382
Research and development	404	216	1,268	778
Sales and marketing	242	173	656	502
General and administrative	408	224	958	706
	\$ 1,282	\$ 480	\$ 3,435	\$ 2,368





**Table of Contents***Stock options*

The following tables summarize the components of stock-based compensation expense for stock options for the three and nine months ended September 30, 2012 and 2011 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of goods sold	\$ 90	\$ 49	\$ 204	\$ 116
Research and development	150	166	569	380
Sales and marketing	79	140	263	338
General and administrative	217	223	567	558
	\$ 536	\$ 578	\$ 1,603	\$ 1,392

The weighted-average fair value of options granted was \$3.27 and \$4.60 for the three months ended September 30, 2012 and 2011, respectively. The weighted-average fair value of options granted was \$3.23 and \$4.95 per share for the nine months ended September 30, 2012 and 2011, respectively. At September 30, 2012, there was \$3.8 million of unrecognized stock-based compensation expense that will be recognized over the remaining weighted-average period of 2.66 years.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
Stock Options	2012	2011	2012	2011
Weighted-average expected term (years)	6.78	6.69	6.77	6.69
Weighted-average volatility	71%	71%	71%	71%
Risk-free interest rate	1.07%	1.83 - 2.13%	1.07 - 1.83%	1.83 - 2.92%
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.

*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, 2012 and 2011 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of goods sold	\$ 19	\$ (186)	\$ (20)	\$ 224
Research and development	27	9	19	218
Sales and marketing	10	20	0	89
General and administrative	81	(6)	80	80
	\$ 137	\$ (163)	\$ 79	\$ 611

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As of September 30, 2012 and December 31, 2011, the liabilities for the settlement of the stock appreciation units were \$0.4 million and were included in accrued and other current liabilities on the condensed consolidated balance sheet.

Based on the fair value of the stock appreciation units as of September 30, 2012, the Company had \$0.1 million of unrecognized stock-based compensation expense that would be recognized over the remaining weighted-average period of 1.50 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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Weighted-average expected term (years)	3.10	3.78	3.27	3.98
Weighted-average volatility	65%	75%	68%	74%
Risk-free interest rate	0.30 - 0.57%	0.43 - 1.23%	0.30 - 1.04%	0.43 - 2.42%
Expected dividends	0%	0%	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 ( ESPP )

The following tables summarize the components of ESPP expense for the three and nine months ended September 30, 2012 and 2011 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of goods sold	\$ 29	\$ 4	\$ 150	\$ 42
Research and development	64	41	317	180
Sales and marketing	19	13	85	75
General and administrative	13	7	69	68
	\$ 125	\$ 65	\$ 621	\$ 365

As of September 30, 2012, there was \$0.1 million of unrecognized stock-based compensation expense for stock purchase rights that will be recognized over the remaining offering period, through November 2012.

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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:

	Purchase Period Ending		Purchase Period Ending	
	May 15, 2012	November 15, 2012	May 15, 2011	November 15, 2011
<b>Stock Purchase Rights</b>				
Weighted-average expected term (years)	0.49	0.99	0.28	0.77
Weighted-average volatility	70%	72%	58%	58%
Risk-free interest rate	0.04%	0.11%	0.15%	0.22%
Expected dividends	0%	0%	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, 2012 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of goods sold	\$ 90	\$ 0	\$ 219	\$ 0
Research and development	163	0	363	0
Sales and marketing	134	0	308	0
General and administrative	97	0	242	0
	\$ 484	\$ 0	\$ 1,132	\$ 0

At September 30, 2012, the Company has \$4.2 million of unrecognized stock-based compensation expense that will be recognized over the remaining weighted-average period of 2.4 years.

**Note 11. Income taxes**

The Company's income tax expense for the three and nine months ended September 30, 2012 is primarily related to income taxes of the Company's non-U.S. operations. The Company recorded income tax provision of \$0.6 million and \$0.9 million for the three and nine months ended September 30, 2012, as compared to an income tax provision of \$0.3 million and \$1.2 million for the three and nine months ended September 30, 2011. The Company had an effective tax rate of 44% in the three months ended September 30, 2012, primarily due to the level of foreign withholding tax and income taxes paid based on earnings generated by our foreign subsidiaries, compared with an effective tax rate of negative 7% in 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.



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The Company conducts its business globally. However, operating income is subject to varying rates of tax in the United States, China and other foreign jurisdictions. 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 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.

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. federal and state deferred tax assets.

As of September 30, 2012, there were no material changes to either the nature or the amounts of the uncertain tax positions previously determined for the year ended December 31, 2011.

### **Note 12. Acquisition of Santur**

On September 29, 2011, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement"), by and among the Company, Dulcimer Acquisition Corp., a wholly owned subsidiary of the Company ("Merger Sub"), Santur and Shareholder Representative Services, LLC, solely in its capacity as the Stockholder Representative. On October 12, 2011 the Company completed its acquisition and in accordance with the terms of the Merger Agreement, Merger Sub merged with and into Santur (the "Merger"), with Santur continuing as the surviving corporation and becoming a wholly owned subsidiary of the Company.

Santur is headquartered in Fremont, California, and is a leading designer and manufacturer of Indium Phosphide (InP)-based PIC products. Santur products are designed for 40Gbps and 100Gbps networks and include lasers, modulators and photodiodes. The acquisition of Santur enhances our existing product portfolio. In addition, the Company combines Santur's technology with its own to create new products for 100Gbps coherent systems.

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### **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, 2012 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, 2011 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, 2012 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, 2012 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, 2011, as filed with the SEC on March 30, 2012. 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 or indium phosphide or hybrid 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.

We have research and development and wafer fabrication facilities in San Jose and Fremont, California which coordinate with our research and development and manufacturing facilities in Shenzhen and Wuhan, China, Tokyo, Japan, and Ottawa, Canada. 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., ECI Telecom Ltd., Telefonaktiebolaget LM Ericsson, FiberHome Technologies Group, Fujitsu Limited, Huawei Technologies Co., Ltd., Juniper Networks, Inc., Mitsubishi Electric Corporation, NEC Corporation, Nokia Siemens Networks B.V. and ZTE Corporation. We refer to these companies as our Tier 1 customers.

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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 in the U.S., China, Canada, Israel, Japan, the Russian Federation 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 worldwide 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 \$88.2 million before offering expenses. 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.

In October 2011, we acquired Santur Corporation, a designer and manufacturer of Indium Phosphide (InP) based PIC products. The acquisition of Santur enhances the Company's position in PIC-based modules and subsystems for high speed networks.

On April 27, 2012, we issued and sold approximately 4.97 million shares of our common stock in a private placement transaction at a price of \$8.00 per share for gross proceeds of approximately \$39.8 million. The shares of common stock are restricted from transfer pursuant to a lockup agreement for up to two years, at the end of which we are obligated to file one or more registration statements covering the potential resale of the shares of common stock. We intend to use a portion of the net proceeds from the sale of the shares of common stock for general corporate purposes and to establish a presence in the Russian Federation. In addition, we intend to establish a production facility in the Russian Federation, in accordance with the terms of a rights agreement entered into in connection with the private placement, for the benefit of the global organization. The expansion into the Russian Federation is targeted for completion by July 31, 2014.

For the nine months of fiscal 2012 compared to the same period in fiscal 2011, we experienced an increase in demand for our 40Gbps and 100Gbps speed products as carriers continued to accelerate deployment of high capacity optical transport networks. Additionally, we experienced an increase in demand for our products as ROADM deployments continued. In the first nine months of fiscal 2012, demand for our access products also increased as fiber-to-the-home deployments continued around the world, particularly in China. 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, could impact our Company's results.

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

There have been no material changes to our critical accounting policies and estimates during the nine months ended September 30, 2012 from those disclosed in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2011 Form 10-K.

### **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 Renminbi ( RMB ) or U.S. dollars. For the three and nine months ended September 30, 2012, 42% and 46% of our sales were derived from our China-based subsidiaries, respectively, the majority of which were denominated in RMB. Revenue is driven by the volume of shipments and may be impacted by pricing pressures. 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 91% of our revenue in both of the three months ended September 30, 2012 and 2011, and 90% and 91% of our revenue in the nine months ended September 30, 2012 and 2011, respectively.



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(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Total revenue	\$ 66,152	\$ 42,848	\$ 183,400	\$ 143,845

Revenue increased by \$23.3 million in the three months ended September 30, 2012 compared to the three months ended September 30, 2011, representing a 54% increase. Total revenue increased by \$39.6 million in the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011, representing a 27% increase. The increase was primarily attributable to growth in our speed and agility products as carriers increased deployments of 40Gbps and 100Gbps telecommunications networks. The increase included NeoPhotonics developed products, as well as those derived from Santur, which was acquired by us in October of 2011. The increase was partially offset by decrease in revenue from our access products and other telecom products primarily as a result of decrease in demand relating to applications below 10Gbps.

Typically, revenue from our top 5 customers comprises more than 50% of our total revenue. In addition, our largest customer, Huawei Technologies, represented 29% and 35% of our total revenue for the three and nine month periods ended September 30, 2012, respectively, and 43% and 52% of our total revenue for the three and nine month periods ended September 30, 2011, respectively. Alcatel-Lucent SA and Ciena Corporation represented 20% and 18% of our total revenue for the three months ended September 30, 2012, respectively, and 16% and 15% of our total revenue for the nine months ended September 30, 2012, respectively. We expect that a significant portion of our revenue will continue to be derived from a limited number of customers. 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.

In addition, 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, 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 and acquisition-related fair value adjustments, 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, inventory changes, 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 inventories. 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.

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(in thousands, except percentages)	Three Months Ended September 30, 2012		2011		Nine Months Ended September 30, 2012		2011	
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
Cost of goods sold	\$ 45,536	69%	\$ 30,827	72%	\$ 135,773	74%	\$ 106,034	74%

	Three Months Ended September 30, 2012		2011		Nine Months Ended September 30, 2012		2011	
Gross margin	31%		28%		26%		26%	

Cost of goods sold increased by \$14.7 million in the three months ended September 30, 2012 compared to the three months ended September 30, 2011, representing a 48% increase. Cost of goods sold increased primarily from higher sales volumes, additional direct labor and overhead costs, as a result of increased salary and employee benefit costs, and the amortization of intangible assets. The acquisition of Santur significantly increased our cost of goods sold. Gross margin was 31% for the three months ended September 30, 2012, compared to 28% for the three months ended September 30, 2011. The increase in gross margin was primarily due to higher revenue during the quarter as a result of higher demand of our speed and agility products for 40Gbps and 100Gbps telecommunications networks.

Cost of goods sold increased by \$29.7 million in the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011, representing a 28% increase. \$28.0 million of the increase was due primarily to the acquisition of Santur. Gross margin was 26% for the nine months ended September 30, 2012 and 2011, which remained relatively constant notwithstanding a change in product and customer mix.

We expect 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, amortization of purchased intangible assets, and adjustment to the fair value of contingent consideration. 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, 2012		2011		Nine Months Ended September 30, 2012		2011	
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
Research and development	\$ 9,893	15%	\$ 7,059	16%	\$ 29,753	16%	\$ 19,816	14%
Sales and marketing	3,354	5%	3,103	7%	9,783	5%	8,318	6%
General and administrative	6,770	10%	5,877	14%	20,616	11%	14,613	10%
Amortization of purchased intangible assets	321	0%	104	0%	996	1%	668	0%
Adjustment to fair value of contingent consideration	(850)	(1)%	0	0%	(246)	0%	0	0%
Total operating expenses	\$ 19,488	29%	\$ 16,143	38%	\$ 60,902	33%	\$ 43,415	30%

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### *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 \$2.8 million in the three months ended September 30, 2012, compared to the three months ended September 30, 2011, representing a 40% increase. This increase was primarily due to a \$3.0 million increase in additional payroll and employee-related costs mainly due to our acquisition of Santur.

Research and development expense increased by \$9.9 million in the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011, representing a 50% increase. This increase was primarily due to a \$9.7 million increase in additional payroll and employee-related costs mainly due to the result of our acquisition of Santur.

We intend to continue to invest in research and development and expect this expense to increase as we grow our business. As a percentage of total revenue, our research and development expense may vary as our revenue changes over time.

### *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.

Sales and marketing expense increased by \$0.3 million in the three months ended September 30, 2012 compared to the three months ended September 30, 2011, representing an 8% increase. This increase was primarily due to a \$0.2 million increase in additional payroll and employee-related costs mainly as the result of our acquisition of Santur.

Sales and marketing expense increased by \$1.5 million in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, representing an 18% increase. This increase was primarily due to a \$1.5 million increase in additional payroll and employee-related costs.

We expect our sales and marketing expense to increase as a result of the acquisition of Santur and as we grow our business, expand our marketing activities, increase the number of sales and marketing professionals and incur higher stock-based compensation expense and employee-related costs accordingly. As a percentage of total revenue, our sales and marketing expense may vary as our revenue changes over time.

### *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, facility costs and restructuring charges.

General and administrative expense increased by \$0.9 million in the three months ended September 30, 2012, compared to the three months ended September 30, 2011, representing a 15% increase. This increase was primarily due to a \$1.0 million increase in payroll and employee-related costs.

General and administrative expense increased by \$6.0 million in the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011, representing a 41% increase. This increase was primarily due to a \$3.5 million increase in payroll and employee-related costs, \$1.2 million increase in overall expense as a result of our acquisition of Santur, a \$0.6 million increase in integration expenses as a result of acquisition activities, a \$0.3 million increase in professional services expense related to public company compliance expenses and legal fees, and a \$0.2 million increase in depreciation expense.

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. As a percentage of total revenue, our general and administrative expense may vary as our revenue changes over time.



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### *Amortization of purchased intangible assets*

We completed a series of business acquisitions in 2005 and 2006 and, more recently, in the fourth quarter of 2011, which included the acquisition of intangible assets. These intangible assets are being amortized over their estimated useful lives. Amortization expense relating to technology and patents and leasehold interests are included within cost of goods sold, while customer relationships and noncompete agreements are recorded within operating expenses.

Amortization of purchased intangible assets increased by \$0.2 million in the three months ended September 30, 2012, compared to the three months ended September 30, 2011, representing a 209% increase. Amortization of purchased intangible assets increased by \$0.3 million in the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011, representing a 49% increase. The increases were primarily due to amortization of purchased intangible related to our acquisition of Santur.

### *Adjustment to the fair value of contingent consideration*

In connection with our acquisition of Santur in October 2011, we may be required to pay the former stockholders of Santur up to an additional \$7.5 million in cash, contingent upon Santur's gross profit performance during 2012. The fair value of the contingent consideration was measured at the date of acquisition and is remeasured each reporting period and any changes in the fair value of the contingent consideration are recognized as a gain or loss in the consolidated statements of operations. As of December 31, 2011, the fair value of the contingent consideration was \$1.5 million. As of September 30, 2012, the fair value of the contingent consideration was \$1.3 million and is included in other current liabilities on our consolidated balance sheet. During the three and nine months ended September 30, 2012, we recorded adjustments to the fair value of the consideration of \$(0.9) million and \$(0.2) million, respectively. We expect the amount of contingent consideration accrued to fluctuate throughout the remainder of the fiscal year as a result of changes and other economic conditions.

### *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 primarily consists 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 RMB and the foreign currency transaction gains and losses of our subsidiaries in China primarily result from their transactions in U.S. dollars.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2012	2011	2012	2011
Interest income	\$ 147	\$ 76	\$ 424	\$ 155
Interest expense	(135)	(52)	(434)	(230)
Other income (expense), net	154	191	(538)	14,299
Total	\$ 166	\$ 215	\$ (548)	\$ 14,224

Total interest and other income (expense), net decreased by \$0.05 million in the three months ended September 30, 2012, compared to the three months ended September 30, 2011. Total interest and other income (expense), net decreased by \$14.8 million in the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011. The decrease for the nine months ended September 30, 2012 compared to same period in 2011 was primarily related to a gain of \$13.8 million from the sale of an unconsolidated investee recorded in the second quarter of 2011.

We expect our interest income to remain relatively modest given the low yields available in the marketplace and lower investable balances.

**Table of Contents***Income taxes*

We conduct our business globally. Therefore, our operating income is subject to varying rates of tax in the U.S., China and other various foreign jurisdictions. 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 U.S. and in the short term, we expect this trend to continue. In China, one of our subsidiaries 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 2012 and 2011, and we have been approved for the rate to remain at 15% for 2013 and 2014.

(in thousands, except percentages)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Provision for income taxes	\$ (571)	\$ (258)	\$ (888)	\$ (1,177)
Effective tax rate	44%	(7)%	(6)%	14%

Our income tax expense for the three months ended September 30, 2012 is primarily related to income taxes of our non U.S. operations. We recorded an income tax provision of \$0.6 million in the three months ended September 30, 2012, compared with an income tax provision of \$0.3 million in the three months ended September 30, 2011. We had an effective tax rate of 44% and negative 6% in the three and nine months ended September 30, 2012, respectively, primarily due to the level of foreign withholding tax and income taxes paid based on earnings generated by our foreign subsidiaries, compared with an effective tax rate of negative 7% and 14% in the three and nine 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.

**Liquidity and capital resources**

We have financed our operations through issuances of equity securities and cash generated from operations and from various lending arrangements. As of September 30, 2012, our cash and cash equivalents totaled \$38.6 million, and our short-term investments totaled \$67.3 million. Cash and cash equivalents were held for working capital purposes and were invested primarily in money market funds. We do not enter into investments for trading or speculative purposes.

On April 27, 2012, we issued and sold approximately 4.97 million shares of our common stock in a private placement transaction at a price of \$8.00 per share for gross proceeds of approximately \$39.6 million. The shares of common stock are restricted from transfer pursuant to a lockup agreement for up to two years, at the end of which we are obligated to file one or more registration statements covering the potential resale of the shares of common stock. We intend to use a portion of the net proceeds from the sale of the shares of common stock for general corporate purposes and to establish a presence in the Russian Federation. In addition, we intend to establish a production facility in the Russian Federation, in accordance with the terms of a rights agreement entered into in connection with the private placement, for the benefit of the global organization. The expansion into the Russian Federation is targeted for completion by July 31, 2014. Of the common stock, \$5.0 million is considered redeemable, as we may be required to pay this amount if we are unable to achieve our performance obligations by the date specified.

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. Our future capital 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 nine 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.

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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 nine 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 consolidated balance sheets. As of September 30, 2012, our restricted cash totaled \$2.7 million.

We have lending arrangements with several financial institutions, including a loan and security agreement with Comerica Bank in the U.S. and several line of credit arrangements for our subsidiaries in China.

As of September 30, 2012, our loan and security agreement in the U.S. included the following:

An \$8.0 million revolving line of credit available through September 2014 and bearing interest at a rate of LIBOR plus 2%. As of September 30, 2012, \$8.0 million was outstanding under the revolving line of credit and \$0.0 million was available for borrowing.

A \$20.0 million acquisition advance, expiring in September 2015 and bearing interest at a rate of LIBOR plus 2%. 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. In October 2011, we drew down the full \$20.0 million in connection with its acquisition of Santur. As of September 30, 2012, \$15.4 million was outstanding under the acquisition advance and the total available borrowing capacity under this facility was \$4.6 million.

A \$7.0 million equipment line advance for capital expenditures in the U.S. 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 bear interest at a rate of LIBOR plus 2%. As of September 30, 2012, no amount was outstanding under the acquisition advance and the total available borrowing capacity under this facility was \$7.0 million.

Our U.S. 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, 2012, we were in compliance with all covenants contained in this agreement.

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, 2012. 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, 2012, we had no short-term loans outstanding.

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

(in thousands)	Nine Months Ended September 30,	
	2012	2011
Net cash used in operating activities	\$ (7,377)	\$ (9,910)
Net cash used in investing activities	(20,115)	(59,479)
Net cash provided by financing activities	33,590	75,192
Effect of exchange rates on cash and cash equivalents	(4)	234
Net increase in cash and cash equivalents	\$ 6,094	\$ 6,037

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### *Operating activities*

During the nine months ended September 30, 2012, net cash used in operating activities was \$7.4 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, 2012, we recognized a net loss of \$14.5 million. However, that net loss incorporated non-cash charges, including depreciation and amortization of \$14.3 million, stock-based compensation expenses of \$3.4 million, and non-cash increases to our asset reserve accounts of \$3.6 million, partially offset by \$0.8 million gain on sale of Shenzhen Photon Broadband Technology Co., Ltd. ( Broadband ), a China subsidiary. During the nine months ended September 30, 2012, there was an increase of \$1.2 million in accounts payable, accrued and other liabilities. These amounts were partially offset by an increase of \$12.7 million in the purchase of inventory to replenish our inventories in preparation for expected higher potential customer demands in future periods.

During the nine months ended September 30, 2011, net cash used in operating activities was \$9.9 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 gain on sale of an unconsolidated investee, net of direct cost, of \$13.9 million, and non-cash charges, including 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 \$0.7 million during the period.

### *Investing activities*

Our investing activities consisted primarily of purchases and sales of investments 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, 2012, net cash used in investing activities was \$20.1 million, mainly due to the purchase of available-for-sale securities of \$151.9 million and the purchase of capital equipment of \$9.0 million, partially offset by proceeds from the sale and maturity of equity securities of \$138.4 million and proceeds from the sale of Broadband of \$1.8 million.

During the nine months ended September 30, 2011, net cash used in investing activities was \$59.5 million, mainly due to the purchase of available-for-sale securities of \$148.9 million and the purchase of capital equipment of \$8.6 million, partially offset by proceeds from sale and maturity of securities of \$76.4 million and proceeds from the sale of our equity investment in Ignis of \$21.4 million.

We expect our purchases of capital equipment to increase over the remainder of 2012 as we invest in manufacturing capacity to help meet anticipated demand for certain of our products.

### *Financing activities*

Our financing activities consisted primarily of proceeds from the issuance of stock and activity associated with our various lending arrangements.

During the nine months ended September 30, 2012, net cash provided by financing activities was \$33.6 million. Our private placement transaction generated proceeds of \$39.6 million, net of offering expenses, which was partially offset by \$3.4 million for the repayment of notes payable, net of proceeds, and \$3.8 million for the repayment of debt.

During the nine months ended September 30, 2011, net cash provided by financing activities was \$75.2 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.



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

The following summarizes our contractual obligations as of September 30, 2012:

(in thousands)	Total	Payments due by period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Notes payable <sup>(1)</sup>	11,098	11,098	0	0	0
Debt obligations <sup>(2)</sup>	23,417	5,000	18,417	0	0
Operating leases <sup>(3)</sup>	6,621	1,820	2,434	1,272	1,095
Purchase commitments <sup>(4)</sup>	8,027	8,027	0	0	0
Contingent consideration <sup>(5)</sup>	7,500	7,500	0	0	0
Asset retirement obligations <sup>(6)</sup>	1,000	0	0	0	1,000
	57,663	33,445	20,851	1,272	2,095
Expected interest payments <sup>(7)</sup>	957	477	480	0	0
Total commitments	58,620	33,922	21,331	1,272	2,095

- (1) Frequently, we direct our banking partners to issue notes payable to our suppliers in China in exchange for accounts payable. The notes payable are non-interest bearing and are generally due within nine months of issuance. The amount presented in the table represents the principal portion of the obligations.
- (2) We have a loan and security agreement in the U.S. that provide various credit facilities, including a line of credit and term loan. The amount presented in the table represents the principal portion of the obligations. The debt obligations outstanding as of September 30, 2012 bear interest at a rate of approximately 2.24%. All of the outstanding debt was subject to fluctuations in interest rates. Interest is paid monthly over the term of the debt arrangement.
- (3) We have entered into various non-cancelable operating lease agreements for our offices in China, the U.S. and Japan.
- (4) We are obligated to make payments under various arrangements with suppliers for the procurement of goods and services.
- (5) We are obligated to pay up to an additional \$7.5 million for the acquisition of Santur, contingent upon Santur meeting gross profit performance objectives in 2012. As of September 30, 2012, the fair value of the contingent consideration was \$1.3 million.
- (6) We have an asset retirement obligation of \$1.0 million associated with our facility lease in California, which expires in October 2019. This obligation is included in other noncurrent liabilities in the condensed consolidated balance sheet as of September 30, 2012.
- (7) We calculate the expected interest payments based on our outstanding debt obligations at prevailing interest rates as of September 30, 2012.

**Off-balance sheet arrangements**

During the nine months ended September 30, 2012, we did not have any significant off-balance sheet arrangements.

**Recent accounting pronouncements**

See Note 2 Significant accounting policies in the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a description of recent accounting pronouncements and accounting changes.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***Interest rate fluctuation risk*

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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 portfolio due to fluctuations in interest rates.

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We started to invest our excess cash in short-term and long-term marketable securities in 2011 to take advantage of higher yields generated by these investments. As of September 30, 2012 and 2011, the gross unrealized gains or losses on our investments classified as available-for-sale 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, 2012 and 2011, are temporary in nature. We may sell these marketable securities investments in the future to fund future operating needs. As a result, we recorded all our marketable securities in short-term investments as of September 30, 2012, 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, 2012, we did not have outstanding debt in China. As of September 30, 2012, our U.S. debt was based on floating rates of interest and is subject to fluctuations in interest rates. 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 did not have outstanding debt in the U.S. As of September 30, 2012 and 2011, we had not hedged our interest rate risk.

### *Foreign currency exchange risk*

Foreign currency exchange rates are subject to fluctuation and may cause us to recognize transaction gains and losses in our statement 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, 2012 and 2011, we recognized foreign currency transaction gain/(losses) of \$(97,000) and \$8,000, respectively. During the nine months ended September 30, 2012 and 2011, we recognized foreign currency transaction losses of \$0.1 million and \$35,000, 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, 2012, a 10% depreciation in RMB against the U.S. dollar would have resulted in a \$2.5 million and \$7.6 million decrease in our revenue, respectively, and a \$0.3 million and \$0.5 million decrease in our net income, respectively. Comparatively, 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 \$2.4 million and \$8.4 million decrease in our revenue, respectively, and a \$0.1 million and \$0.6 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.

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### **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, 2012. 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, 2012, 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.

#### ***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.

## **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. However, as described below, a certain pending dispute involves a claim by a third party that our activities infringe their intellectual property rights. This and other types of intellectual property rights claims 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.

#### ***Finisar Corporation v. Source Photonics, Inc., et al.***

On January 5, 2010, Finisar Corporation, or Finisar, filed a complaint in the U.S. 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 or offer to sell certain optical transceiver products in the U.S. 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.



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In January 2011, we and Finisar agreed to toll our respective claims 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. In December 2011, Oplink and Finisar settled their lawsuit, commencing the tolling period, which expired on April 30, 2012. On May 3, 2012, we and Finisar agreed to further toll our respective claims until the refiling of certain of the previously asserted claims from this dispute. As a result, Finisar is permitted to bring a new lawsuit against us if it chooses to do so, and we may bring new claims against Finisar upon seven days written notice prior to filing such claims. 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 U.S., 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 by either party, would be likely to divert the efforts and attention of our management and technical personnel, which could harm 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, 2011, as filed with the SEC on March 30, 2012, which risk factors are set forth below, except for those risk factors denoted by an asterisk (\*).*

#### **Risks related to our business**

##### ***\*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, 2012, our accumulated deficit was \$245.1 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, which could adversely affect our business and financial results.**

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.

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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. In 2012, there has been an increase in the number of our customers utilizing VMI, which may increase our exposure to risks of wide fluctuations in demand from VMI customer locations. 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 other 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 2011, our largest customer, Huawei Technologies, represented 50.7% of our total revenue and our top ten customers represented 90.6% of our total revenue. 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, 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.

***We are under continuous pressure to reduce the prices of our products, which may adversely affect our gross margins.***

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 adversely 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.

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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 and financial results 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 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.



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***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 facilities 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 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 will initially depend upon an outside contract manufacturer for a portion of the manufacturing process for our Santur products. Our operations and revenue related to these products could be adversely affected if we encounter problems with this contract manufacturer.***

In October 2011, we acquired Santur, a designer and manufacturer of InP-based PIC products. Although almost all of our other products are manufactured internally, we will initially rely upon a contract manufacturer in Malaysia to produce the finished portion of our Santur products. Our reliance on a contract manufacturer for these products makes us vulnerable to possible capacity constraints and reduced control over delivery schedules, manufacturing yields, manufacturing quality/controls and costs. For instance, recently our contract manufacturer has been unable to meet all of our customer demand in a timely fashion. Although we have experience any adverse impact from these delays, if these issues continue, they could have a materials adverse effect on the revenue from our Santur products. If the contract manufacturer for our Santur products were unable or unwilling to manufacture our Santur products in required volumes and at high quality levels or to continue our existing supply arrangement, we would have to identify, qualify and select an acceptable alternative contract manufacturer or move these manufacturing operations to our internal manufacturing facilities. An alternative contract manufacturer may not be available to us when needed or may not be in a position to satisfy our quality or production requirements on commercially reasonable terms, including price. Any significant interruption in manufacturing our Santur products would require us to reduce our supply of Santur products to our customers, which in turn would reduce our revenue, harm our relationships with the customers of these Santur products and cause us to forego potential revenue opportunities.

***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 addition, while we have recently committed to establish a Russian subsidiary and operations in the next two years, we have limited history operating in the Russian Federation, which makes it difficult to evaluate our business and financial prospects there. 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.

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*We must continually achieve new design wins and enhance existing products or our business and future revenue 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.

*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.

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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.

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.

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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 where 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 and financial results.***

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 disruption relating to the 2011 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.



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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 U.S. and in other foreign countries, some of which have been issued. In addition, we have registered the trademark NeoPhotonics in the U.S. 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 U.S. 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, or in the Russian Federation, where we intend to expand 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 U.S.

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 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.

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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 U.S. 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 U.S. 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.

In January 2011, we and Finisar agreed to toll our respective claims 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. In December 2011, Oplink and Finisar settled their lawsuit, commencing the tolling period. On May 3, 2012, we and Finisar agreed to further toll our respective claims until the refiling of certain of the previously asserted claims from this dispute. As a result, Finisar is permitted to bring a new lawsuit against us if it chooses to do so, and we may bring new claims against Finisar upon seven days written notice prior to filing such claims.





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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 U.S., 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 by either party, 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 business and results of operations 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 and financial results 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 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.

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### ***Natural disasters, terrorist attacks or other catastrophic events could harm our operations and our financial results.***

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 continuous effects from the 2011 floods in Thailand and the 2011 earthquakes, tsunami and subsequent crisis relating to nuclear power facilities in Japan may adversely impact our revenue from customers located in Thailand and Japan and/or our ability to source parts from companies located in Thailand and Japan. In addition, the combined effects of these natural disasters have created significant uncertainty, and it is possible that these events could result in continued 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/or Japan; a disruption to the global supply chain for products manufactured in Thailand and/or 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 2011 flooding in Thailand may adversely impact our revenue. 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 Silicon Valley, California and our Tokyo, Japan facility 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.

### ***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.

### ***We have pursued and may continue to pursue acquisitions. 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. Any of these transactions could be material to our financial condition and results of operations. For instance, in October 2011, we completed the acquisition of Santur, a designer and manufacturer of InP-based PIC products. 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.

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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;

exposure to environmental liabilities that have not yet been discovered associated with acquired businesses' facilities;

expenses, distractions and actual or threatened claims or litigation resulting from acquisitions, whether or not they are completed;

inability to generate sufficient revenue to offset increased expenses associated with any acquisition;

the incurrence of debt to provide capital for any cash-based acquisitions;

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.

The failure to successfully evaluate and execute acquisitions or otherwise adequately address these risks could materially harm our business and financial results.

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

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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.

***Failure to realize the anticipated benefits from our acquisition of Santur may affect our future results of operations and financial condition.***

In connection with our acquisition of Santur, we have recently integrated Santur's commercial operations and personnel into our existing infrastructure. If there are unexpected difficulties in our integration of the Santur business, the anticipated benefits of the transaction may not be realized or may take longer to realize than expected. The anticipated benefits of the acquisition could be materially reduced by a number of factors, including the following:

the future revenue and gross margins of the Santur products may be materially different from those we originally anticipated;

we could incur material unanticipated expenses;

the Santur products may not achieve the performance levels or specifications required by our customers;

we could have difficulty integrating and managing Santur's international business locations in places where we did not previously have a business presence, including Malaysia and Canada;

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claims or lawsuits may arise from the acquisition transaction or from Santur's previous business operations;

we may experience difficulties in implementing effective internal controls over financial reporting as part of our integration of Santur, which was historically a private company and not subject to the internal control requirements of a public company; and

potential growth, expected financial results, perceived synergies and anticipated opportunities may not be realized through the ongoing integration of our and Santur's businesses.

The occurrence of any or all of these events may have an adverse effect on our business and results of operations.

***\*Failure to realize the anticipated benefits from our planned expansion in the Russian Federation may affect our future results of operations and financial condition.***

In connection with our raising capital in an April 2012 private placement of common stock, we have committed to establish a wholly-owned subsidiary and company operations in the Russian Federation. The establishment of successful operations in the Russian Federation will require significant capital expenditure in a short amount of time, particularly in 2013 and 2014, and will be in part dependent on the cooperation of the Russian government and other third parties. If there are delays in our efforts to establish operations in the Russian Federation, the anticipated benefits of our Russian expansion may not be realized or may take longer to realize than expected. The anticipated benefits of our Russian expansion could be materially reduced by a number of factors, including the following:

the future revenue and gross margins of products produced in the Russian Federation may be materially different from those we originally anticipated;

we could incur material unanticipated expenses; and

we could have difficulty managing a business in the Russian Federation, where we did not previously have a material business presence.

In addition, in connection with the private placement transaction, we entered into a rights agreement with the sponsoring investor. Pursuant to the rights agreement, we have agreed to use at least \$30 million of the proceeds from the private placement to establish a wholly-owned subsidiary and facility in the Russian Federation for the production of certain of our products. Pursuant to the rights agreement, failure to perform certain performance covenants set forth therein by July 31, 2014 (subject to extension to March 31, 2015, as set forth therein), will result in an obligation to pay damages to the investor in the amount of \$5.0 million.

In recent years the Russian Federation has undergone substantial political, economic and social change. As is typical of an emerging market, the business, legal and regulatory infrastructure in the Russian Federation is less well-developed than would generally exist in a more mature free market economy. In addition, the tax, currency and customs legislation within the Russian Federation is subject to varying interpretations and changes, which can occur frequently. The future economic direction of the Russian Federation remains largely dependent upon the effectiveness of economic, financial and monetary measures undertaken by the government, together with tax, legal, regulatory and political developments. Our failure to manage the risks associated with our planned Russian expansion could have a material adverse effect upon our results of operations.

The occurrence of any or all of these events may have an adverse effect on our business, and results of operations and financial condition.

***Potential changes in our effective tax rate could negatively affect our future results.***

We are subject to income taxes in the U.S., China and other 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 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 negatively affect our results of operations.



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***Our future results of operations may be subject to volatility as a result of exposure to fluctuations in foreign exchange rates, primarily the Chinese Renminbi (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 24% appreciation of the RMB against the U.S. dollar between July 21, 2005 and December 31, 2011. 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, 2011, a 10% depreciation in RMB against the U.S. dollar would have resulted in an \$11.2 million decrease in our revenue and a \$0.7 million increase in our net loss for the period. Comparatively, for the year ended December 31, 2010, a 10% depreciation in RMB against the U.S. dollar would have resulted in a \$10.6 million decrease in our revenue and a \$1.3 million decrease 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, which if not adequately managed could adversely affect our business and financial results.***

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 Japan, Canada and a contract manufacturing relationship in Malaysia. We also plan to establish a subsidiary and operations in the Russian Federation. 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;

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

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

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



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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 (including those we recently acquired in the Santur acquisition). 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 or to obtain any required licenses 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.***

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. Beginning with the year ended December 31, 2011, we are required to comply with the internal control requirements of the Sarbanes-Oxley Act of 2002. In addition, we may experience

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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.

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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 is now applicable to us under the rules of the Securities and Exchange Commission, or the SEC. 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 U.S., 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, which could adversely affect our future financial results.***

As of December 31, 2011, we had net operating loss, or NOL, carryforwards for U.S. federal and state tax purposes of \$191.1 million and \$134.6 million, respectively. If not utilized, these NOL carryforwards will expire beginning in 2012. 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 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.

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### ***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 to assist in selling our products, and the failure of these representatives 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. Many of our third-party sales representatives also market and sell competing products from our competitors. Our third-party sales representatives 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 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 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, 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.

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 U.S. 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;

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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 \$129.4 million, or 64%, of our revenue in 2011 was recognized from customers for whom we shipped products to a location in China. Additionally, a substantial portion of our property, plant and equipment, 56% as of December 31, 2011, 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 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. Additionally, China's Communist Party is expected to announce the selection of a new Politburo Standing Committee, which controls government operations in China, in the fourth quarter of 2012, and this forthcoming change in leadership may affect Chinese laws or regulations in a manner that would adversely affect our business as set forth in this risk factor.

***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 increases in the minimum wage for hourly workers in 2011 and 2012. We expect that we will be required to increase wages and/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.



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***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 2011, 2010 and 2009. We realized benefits from this 10% reduction in tax rate of \$0.4 million, \$1.7 million and \$1.0 million for 2011, 2010 and 2009, respectively. The preferential rate also applies to 2012, and we have been approved for the rate to remain at 15% for 2013 and 2014.

***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, 2011, 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.

***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.

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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 U.S. 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.

***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.





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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 have completed 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 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 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, which could adversely affect our business.***

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.

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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.***

From time to time, 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 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.

***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.



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***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 U.S. 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 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 operating costs in China, which could adversely affect our financial results.***

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 power in deciding the probation period, not to exceed nine 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.

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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 and 14% in February 2012. 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, profit 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.

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

Over the past several years, there have been 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;

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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 the future. 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.***

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.

### ***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.***

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As of October 31, 2012, our executive officers and directors, and entities that are affiliated with them, beneficially own an aggregate of approximately 38% 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.



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*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 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

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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. As a result of our initial public offering, we received net proceeds of \$88.2 million before offering expenses. 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.

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We used a portion of our net proceeds to repay a portion of our outstanding indebtedness, make investments in available-for-sale securities, and acquire Santur. We have also used a portion of our net proceeds for working capital. 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 new material acquisitions. We may also use a portion of our net proceeds to repay a portion of our outstanding indebtedness. 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).

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

See Index to Exhibits at the end of this report.

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**NeoPhotonics Corporation**

Date: November 9, 2012

By: /s/ James D. Fay  
Chief Financial Officer and Senior Vice President  
  
(Principal Financial and Accounting Officer)

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**EXHIBIT INDEX**

<b>Exhibit no.</b>	<b>Description of exhibit</b>
3.1(1)	Amended and Restated Certificate of Incorporation of NeoPhotonics Corporation.
3.2(2)	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.
31.1	Certification pursuant to Rule 13a-14(a)/15d-14(a).
31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a).
32.1(3)	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.
+ Management compensatory plan or arrangement. 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 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.
(2)	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.
(3)	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.