

NEOPHOTONICS CORP
Form 10-Q
May 12, 2011
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from _____ to _____

Commission File Number: 001-35061

NeoPhotonics Corporation

(Exact name of registrant as specified in its charter)

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Delaware
(State or other jurisdiction of
incorporation or organization)

94-3253740
(I.R.S. Employer
Identification No.)

2911 Zanker Road

San Jose, California 95134

(Address of principal executive offices, zip code)

(408) 232-9200

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of May 2, 2011, there were 24,655,078 shares of the registrant's Common Stock outstanding.

Table of Contents

NEOPHOTONICS CORPORATION

For the Quarter Ended March 31, 2011

Table of Contents

	Page
<u>Part I. Financial Information</u>	
Item 1. <u>Condensed Consolidated Financial Statements (Unaudited)</u>	1
<u>Condensed Consolidated Balance Sheets as of March 31, 2011 and December 31, 2010 (Unaudited)</u>	1
<u>Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2011 and 2010 (Unaudited)</u>	2
<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2011 and 2010 (Unaudited)</u>	3
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	4
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	23
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	33
Item 4. <u>Controls and Procedures</u>	34
<u>Part II. Other Information</u>	
Item 1. <u>Legal Proceedings</u>	35
Item 1A. <u>Risk Factors</u>	35
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
Item 3. <u>Defaults Upon Senior Securities</u>	59
Item 4. <u>Removed and Reserved</u>	59
Item 5. <u>Other Information</u>	59
Item 6. <u>Exhibits</u>	59
<u>Signatures</u>	60

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

(In thousands, except share and per share data)	March 31, 2011	As of December 31, 2010 *
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 92,539	\$ 25,465
Restricted cash	3,110	3,027
Accounts receivable, net of allowance for doubtful accounts of \$999 and \$2,270 at March 31, 2011 and December 31, 2010, respectively	65,092	54,374
Inventories	25,112	19,426
Prepaid expenses and other current assets	4,027	7,665
Total current assets	189,880	109,957
Property, plant and equipment, net	42,407	43,113
Goodwill	4,323	4,323
Other intangible assets, net	1,967	2,146
Other long-term assets	21,945	12,956
Total assets	\$ 260,522	\$ 172,495
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	\$ 35,863	\$ 29,653
Short-term loans and notes payable	17,381	17,205
Current portion of long-term debt		5,924
Accrued and other current liabilities	11,004	13,046
Total current liabilities	64,248	65,828
Long-term debt, net of current portion		2,912
Deferred income tax liabilities	541	536
Other noncurrent liabilities	1,301	1,316
Total liabilities	66,090	70,592
Commitments and contingencies (Note 8)		
Redeemable convertible preferred stock:		
Series X redeemable convertible preferred stock, \$0.0025 par value		
At March 31, 2011: no shares authorized, issued or outstanding; At December 31, 2010: 20,000 shares authorized, 18,497 shares issued and outstanding, \$92,487 maximum liquidation preference		46,180
Series 1, 2 and 3 redeemable convertible preferred stock, \$0.0025 par value		
At March 31, 2011: no shares authorized, issued or outstanding; At December 31, 2010: 7,400,000 shares authorized, 6,639,513 shares issued and outstanding, \$177,960 liquidation preference		165,361

211,541

Stockholders' equity (deficit):

Preferred stock, \$0.0025 par value

At March 31, 2011: 10,000,000 shares authorized, no shares issued or outstanding; At December 31, 2010:
no shares authorized, issued or outstanding

Common stock, \$0.0025 par value

At March 31, 2011: 100,000,000 shares authorized, 24,647,579 shares issued and outstanding; At December
31, 2010: 14,000,000 shares authorized, 1,955,280 shares issued and outstanding

Additional paid-in capital	62	5
Additional paid-in capital	389,660	93,349
Accumulated other comprehensive income	22,444	12,807
Accumulated deficit	(217,734)	(215,799)

Total stockholders' equity (deficit)	194,432	(109,638)
--------------------------------------	---------	-----------

Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	\$ 260,522	\$ 172,495
--	------------	------------

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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

(In thousands, except share and per share data)	Three months ended March 31,	
	2011	2010
Revenue	\$ 50,922	\$ 40,208
Cost of goods sold	38,504	27,510
Gross profit	12,418	12,698
Operating expenses:		
Research and development	6,559	4,718
Sales and marketing	2,859	2,429
General and administrative	4,163	4,570
Amortization of purchased intangible assets	292	284
Total operating expenses	13,873	12,001
Income (loss) from operations	(1,455)	697
Interest income	37	59
Interest expense	(118)	(214)
Other income (expense), net	(27)	129
Total interest and other expense, net	(108)	(26)
Income (loss) before income taxes	(1,563)	671
Provision for income taxes	(372)	(610)
Net income (loss)	(1,935)	61
Net income attributable to noncontrolling interests		(80)
Net loss attributable to NeoPhotonics Corporation	(1,935)	(19)
Deemed dividend on beneficial conversion of Series X redeemable convertible preferred stock	(17,049)	
Accretion of redeemable convertible preferred stock	(7)	(37)
Net loss attributable to NeoPhotonics Corporation common stockholders	\$ (18,991)	\$ (56)
Net loss per share attributable to NeoPhotonics Corporation common stockholders:		
Basic	\$ (1.26)	\$ (0.03)
Diluted	\$ (1.26)	\$ (0.03)
Weighted average shares used to compute net loss per share attributable to NeoPhotonics Corporation common stockholders:		
Basic	15,069,394	1,928,556
Diluted	15,069,394	1,928,556

See accompanying Notes to Condensed Consolidated Financial Statements.

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

(In thousands)	Three months ended March 31,	
	2011	2010 (As Revised. See Note 1.)
Cash flows from operating activities		
Net income (loss)	\$ (1,935)	\$ 61
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,793	3,156
Stock-based compensation expense	1,962	420
Loss on disposal of fixed assets	25	63
Allowance for doubtful accounts	93	134
Provision for inventories	12	412
Change in assets and liabilities:		
Accounts receivable	(10,268)	2,346
Inventories	(5,591)	(5,376)
Prepaid expenses and other current assets	25	(2,023)
Accounts payable	6,935	6,045
Accrued and other liabilities	(3,339)	(2,932)
Net cash provided by (used in) operating activities	(9,288)	2,306
Cash flows from investing activities		
Purchase of property, plant and equipment	(2,659)	(1,551)
Increase in restricted cash	(52)	(483)
Purchase of long-term investment		(2,702)
Cash transferred upon sale of Archcom		(1,118)
Net cash used in investing activities	(2,711)	(5,854)
Cash flows from financing activities		
Proceeds from initial public offering of common stock, net of issuance costs	87,699	(160)
Proceeds from issuance of preferred stock, net of issuance costs		5,978
Proceeds from exercise of stock options and warrants	127	26
Proceeds from bank loans		2,000
Repayment of bank loans	(8,836)	(11,294)
Proceeds from issuance of notes payable	7,438	6,679
Repayment of notes payable	(7,413)	(6,759)
Net cash provided by (used in) financing activities	79,015	(3,530)
Effect of exchange rates on cash and cash equivalents	58	114
Net increase (decrease) in cash and cash equivalents	67,074	(6,964)
Cash and cash equivalents at the beginning of the period	25,465	43,420
Cash and cash equivalents at the end of the period	\$ 92,539	\$ 36,456

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Supplemental disclosure of noncash investing and financing activities:

Decrease (increase) in accounts payable and accrued liabilities related to property and equipment purchases	\$ 1,191	\$ (1,141)
Accretion of redeemable convertible preferred stock	7	37
Conversion of redeemable convertible preferred stock to common stock	211,541	
Deemed dividend on redeemable convertible preferred stock	17,049	

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

NeoPhotonics Corporation

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 1. Basis of presentation

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

Reverse stock split

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

Initial Public Offering

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

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

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

Reclassification of Consolidated Statement of Cash Flows

In the three months ended March 31, 2011, the Company determined that cash payments made in 2010 for IPO related expenses had been incorrectly classified as operating cash flow activities on the statements of cash flows, and that such payments should be classified as financing cash flow activities. The Company has revised the 2010 statement of cash flows to correct for the classification. The correction resulted in an increase to Net Cash Provided by Operating Activities of \$160,000, with a corresponding increase to Net Cash Used in Financing Activities for the quarter ended March 31, 2010.

Table of Contents

In addition, for the year ended December 31, 2010, the correction would have resulted in an increase to Net Cash Provided by Operating Activities of \$2,441,000, with a corresponding reduction to Net Cash Used in Financing Activities. Management has assessed the impact on the 2010 interim and annual consolidated statements of cash flows and has concluded that the correction is not material to the previously reported cash flows.

Note 2. Significant Accounting Policies

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

Stock-based compensation

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

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

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

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

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

Upon completion of the Company's initial public offering, the Company began recognizing stock-based compensation expense for the stock appreciation units. The Company recorded an expense and an equal liability for the stock appreciation units equal to the fair value of the vested portion of the awards as of March 31, 2011. Each reporting period thereafter, compensation expense will be recorded, based on the remaining service period and the then fair value of the award until vesting of the award is completed. After vesting is completed, the Company will continue to remeasure the fair value of the liability until the award is exercised or expires, with changes in the fair value of the liability recorded in the consolidated statements of operations.

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

Table of Contents

Cash flows resulting from the tax benefits for tax deductions from the exercise of stock options in excess of the compensation expense recorded for those options (excess tax benefits) are classified as cash flows from financing activities. The Company had no excess tax benefits for the three months ended March 31, 2011 and 2010.

Recent accounting pronouncements

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

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

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

Note 3. Fair value measurements

Fair value is defined as the price at which an asset could be exchanged in a current transaction between knowledgeable, willing parties. A liability's fair value is defined as the amount that would be paid to transfer the liability to a new obligor, not the amount that would be paid to settle the liability with the creditor. Where available, fair value is based on observable market prices or parameters or derived from such prices or parameters. Where observable prices or inputs are not available, valuation models are applied. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the instruments or market and the instruments' complexity. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The authoritative accounting guidance describes a fair value hierarchy based on three levels of inputs that may be used to measure fair value, of which the first two are considered observable and the last is considered unobservable. These levels of inputs are as follows:

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

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

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

Table of Contents

Assets measured at fair value

The Company's financial instruments are valued using quoted prices in active markets or based upon other observable inputs. The following table sets forth the fair value of the Company's financial assets as of the date presented (in thousands):

	Money Market Funds ⁽¹⁾			Total
	Level 1	Level 2	Level 3	
March 31, 2011	\$ 20,011	\$	\$	\$ 20,011
December 31, 2010	\$ 6,650	\$	\$	\$ 6,650

(1) Money market funds are included in cash and cash equivalents on the Company's Condensed Consolidated Balance Sheets. The following table sets forth the fair value of the Company's equity security investments as of the date presented (in thousands):

	Equity Investments ⁽¹⁾			Total
	Level 1	Level 2	Level 3	
March 31, 2011	\$ 21,135	\$	\$	\$ 21,135
December 31, 2010	\$ 12,724	\$	\$	\$ 12,724

(1) Equity investments are included in other long-term assets on the Company's Condensed Consolidated Balance Sheets.

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

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

	Three months ended March 31,	
	2011	2010
Numerator:		
Net loss attributable to NeoPhotonics Corporation	\$ (1,935)	\$ (19)
Accretion of redeemable convertible preferred stock	(7)	(37)
Deemed dividend on beneficial conversion of Series X redeemable convertible preferred stock	(17,049)	
Net loss attributable to NeoPhotonics Corporation common stockholders	\$ (18,991)	\$ (56)
Denominator:		
Weighted average shares used to compute basic and diluted net loss per share attributable to NeoPhotonics Corporation common stockholders	15,069,394	1,928,556
Net loss per share attributable to NeoPhotonics Corporation common stockholders:		
Basic and Diluted	\$ (1.26)	\$ (0.03)

The Series X preferred stock contained a special conversion feature which was contingent upon completion of an initial public offering. The beneficial conversion feature is measured as the difference between the offering price of \$11.00 per share and the accounting conversion price of \$6.25 per share. At the closing of the initial public offering, a charge of \$17.0 million related to the beneficial conversion feature was recorded to additional paid-in-capital and represents a deemed dividend in calculating net loss attributable to NeoPhotonics Corporation common stockholders for the three months ended March 31, 2011. For the three months ended March 31, 2011 and 2010, pro forma net loss per share attributable to NeoPhotonics Corporation common stockholders, which assumes all 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):

Table of Contents

	Three months ended March 31,	
	2011	2010
Net loss attributable to NeoPhotonics Corporation	\$ (1,935)	\$ (19)
Pro forma net loss per share attributable to NeoPhotonics Corporation common stockholders		
Basic and Diluted	\$ (0.09)	\$
Weighted average shares used to compute pro forma net loss per share attributable to NeoPhotonics Corporation common stockholders		
Basic and Diluted	20,996,756	15,700,258

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

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

	Three months ended	
	2011	2010
Employee stock options	1,987,603	1,532,041
Common stock warrants	4,482	7,990
Redeemable convertible preferred stock, on an if-converted basis ⁽¹⁾	14,038,489	11,686,850
	16,030,574	13,226,881

- (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.

Table of Contents**Note 5. Balance sheet components***Accounts receivable, net*

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

	March 31, 2011	December 31, 2010
Accounts receivable	\$ 61,762	\$ 53,003
Trade notes receivable	4,329	3,641
Allowance for doubtful accounts	(999)	(2,270)
	\$ 65,092	\$ 54,374

Inventories

Inventories consist of the following (in thousands):

	March 31, 2011	December 31, 2010
Raw materials	\$ 12,573	\$ 8,710
Work in process	6,104	3,316
Finished goods	6,435	7,400
	\$ 25,112	\$ 19,426

Purchased intangible assets

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

	Weighted Average Amortization Period (yrs)	March 31, 2011			December 31, 2010		
		Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Technology and patents	5	\$ 19,379	\$ (19,229)	\$ 150	\$ 19,108	\$ (19,064)	\$ 44
Customer relationships	6	6,568	(6,105)	463	6,513	(5,786)	727
Leasehold interest	45	1,299	(165)	1,134	1,286	(156)	1,130
Noncompete agreements	7	1,076	(856)	220	710	(465)	245
		\$ 28,322	\$ (26,355)	\$ 1,967	\$ 27,617	\$ (25,471)	\$ 2,146

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

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

	Three months ended	
	March 31,	
	2011	2010
Cost of goods sold	\$ 51	\$ 870
Operating expenses	292	284
Total	\$ 343	\$ 1,154

Table of Contents

The estimated future amortization expense of purchased intangible assets as of March 31, 2011, is as follows (in thousands):

2011 (remaining 9 months)	\$ 469
2012	340
2013	141
2014	48
2015	48
Thereafter	921
	\$ 1,967

Accrued and other current liabilities

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

	March 31, 2011	December 31, 2010
Employee-related	\$ 4,986	\$ 7,385
Other	6,018	5,661
	\$ 11,004	\$ 13,046

Warranty Accrual

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

	Three months ended March 31,	
	2011	2010
Beginning balance	\$ 393	\$ 613
Warranty accruals	66	39
Settlements and adjustments	(54)	(48)
Ending balance	\$ 405	\$ 604

Note 6. Equity investment

The Company owns shares of Ignis ASA (Ignis), a Norwegian company traded on the Oslo exchange (Norway stock exchange). As of March 31, 2011 and December 31, 2010 and for each of the three month periods ended March 31, 2011 and 2010, the Company had less than 20% ownership in Ignis. Therefore, the Company applied the cost method of accounting, in which it records the investment in other long-term assets and adjusts unrealized gains or losses due to stock price fluctuation within accumulated other comprehensive income.

As of March 31, 2011 and December 31, 2010, the value of the Company's investment in Ignis was \$21.1 million and \$12.1 million, respectively.

During the three months ended March 31, 2011 and 2010, the Company recorded \$8.5 million and \$0.0 million of unrealized gains, respectively.

Table of Contents**Note 7. Debt**

The components of debt obligations consist of the following (in thousands):

	March 31, 2011	December 31, 2010
Notes payable	\$ 12,898	\$ 12,742
Short-term bank loans	4,483	4,463
Total short-term loans and notes payable	\$ 17,381	\$ 17,205
Total long-term debt	\$	\$ 8,836
Less: current portion of long-term debt		(5,924)
Total long-term debt, net of current portion	\$	\$ 2,912

Notes payable and short-term loans

The Company's subsidiaries in China have trade notes payable and short-term line of credit facilities from various banking institutions. The trade notes are unsecured, noninterest bearing and are due approximately six months after issuance. The weighted average interest rate for short-term loans outstanding was 5.24% and 5.23% as of March 31, 2011 and December 31, 2010, respectively.

Long-term debt

The Company has an \$8.0 million revolving line of credit with extended term through December 2011. The Company repaid the outstanding balance of the revolving line of credit in full in February 2011. Amounts available under the revolving line of credit are reduced by any commercial or stand-by letters of credit issued by the bank to guarantee a loan for the Company's subsidiaries in China. The maximum amount for which a letter of credit may be issued is \$5.0 million. As of March 31, 2011 and December 31, 2010, letters of credit for \$5.0 million were outstanding. As of March 31, 2011 and December 31, 2010, \$0.0 million and \$3.0 million were outstanding under the revolving line of credit, respectively. The total available borrowing capacity under this facility was \$3.0 million and \$0.0 million as of March 31, 2011 and December 31, 2010, respectively.

The Company has an additional \$9.5 million credit facility based on capital expenditures in the United States, with expected repayment of all amounts by June 2013. The Company repaid the outstanding balance of the credit facility in full in March 2011. As of March 31, 2011 and December 31, 2010, \$0.0 million and \$5.8 million were outstanding, respectively. As of March 31, 2011 and December 31, 2010, \$3.5 million was available to borrow under this facility.

In connection with the original loan and security agreement, the Company issued a warrant to the lender to purchase 4,482 shares of common stock at an exercise price of \$29.00 per share. As of March 31, 2011, the warrant had not been exercised.

At March 31, 2011, the Company was in compliance with all of the financial covenants contained in the loan and security agreement and supplemental amendments.

In December 2007, the Company's primary subsidiary in China entered into a term loan agreement with a Chinese bank. The loan is secured by the standby letter of credit described above issued by a U.S. bank. As of both March 31, 2011 and December 31, 2010, \$0.0 million was outstanding under the term loan and \$5.0 million was available under the line of credit.

Table of Contents

The following table provides additional fair value information relating to the Company's outstanding debt instruments (in thousands):

	March 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Notes payable	\$ 12,898	\$ 12,898	\$ 12,742	\$ 12,742
Short-term loans	4,483	4,352	4,463	4,269
Long-term debt, net of current portion			8,836	8,320
Total	\$ 17,381	\$ 17,250	\$ 26,041	\$ 25,331

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

Note 8. Commitments and contingencies*Leases*

The Company leases various facilities under noncancelable operating leases. As of March 31, 2011, the future minimum commitments under all operating leases are as follows (in thousands):

2011 (remaining 9 months)	\$ 1,336
2012	1,511
2013	830
2014	820
2015	698
Thereafter	1,949
	\$ 7,144

Rent expense under the Company's operating leases was \$0.5 million for both of the three months ended March 31, 2011 and 2010.

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. As of the date of this Quarterly Report on Form 10-Q, other than described in ITEM 1A. Risk Factors below, the Company is not involved in any pending litigation that the Company believes could have a material adverse effect on its financial condition, results of operations or cash flows.

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 March 31, 2011, total outstanding purchase obligations were \$30.1 million, primarily due within the next 12 months.

Note 9. Redeemable convertible preferred stock

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

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

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

Table of Contents**Dividends**

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

Note 10. Common stock

On February 10, 2011, the Company filed its Amended and Restated Certificate of Incorporation in connection with the closing of its initial public offering. Following the amendment, the Company's authorized capital stock consists of 110,000,000 shares, comprising: (i) 100,000,000 shares of common stock, par value \$0.0025 per share and (ii) 10,000,000 shares of preferred stock, par value \$0.0025 per share. As of March 31, 2011, the Company had reserved the following shares of authorized but unissued common stock:

Stock option plans	2,842,623
Stock purchase plan	342,568
Warrants	4,482
	3,189,673

Note 11. Equity incentive programs

In February 2011, in connection with the closing of the Company's initial public offering and execution of the associated underwriting agreement, the Company's 2010 Equity Incentive Plan (the "2010 Plan") and 2010 Employee Stock Purchase Plan (the "2010 ESPP") became effective and shares authorized for issuance under the 2004 Stock Option Plan (described below) were cancelled (except for those shares reserved for issuance upon exercise of outstanding stock options). The 2007 Stock Appreciation Grants Plans (described below) remains in effect, however the Company does not intend to grant additional stock appreciation units under that plan.

2004 Stock Option Plan

The 2004 Stock Option Plan provides for the issuance of options to purchase common stock to eligible employees, consultants and independent directors. As of March 31, 2011, options to purchase 1,977,203 shares were outstanding under the 2004 Stock Option Plan and no shares were available for future grant.

2007 Stock Appreciation Grants Plan

The 2007 Stock Appreciation Grants Plan provides for the grant of units ("stock appreciation units") entitling the holder upon exercise to receive cash in an amount equal to the amount by which the Company's common stock has appreciated in value. The stock appreciation units become exercisable upon expiration of the lock-up period associated with the Company's initial public offering. As of March 31, 2011, 295,622 units were outstanding.

2010 Equity Incentive Plan

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

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

Table of Contents

The number of shares reserved for issuance under the 2010 Plan is 865,420 shares and will automatically increase on January 1st each year, starting on January 1, 2012 and continuing through January 1, 2020, by 3.5% of the total number of shares of the Company's common stock outstanding on December 31 of the preceding calendar year, or such lesser number of shares of common stock as determined by the Company's board of directors. The maximum number of shares that may be issued pursuant to the exercise of incentive stock options under the 2010 Incentive Plan is 8,000,000 shares. As of March 31, 2011, stock options to purchase 16,540 shares of common stock were outstanding under the 2010 Plan and 848,888 shares were reserved for future issuance.

2010 Employee Stock Purchase Plan

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

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

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

Stock options

The following table summarizes the Company's stock option activity during the three months ended March 31, 2011:

	Shares Available for Grant	Options Outstanding Number of Shares	Weighted Average Exercise Price
Balance at December 31, 2010	380,016	2,012,637	\$ 5.86
Authorized for issuance - 2010 Plan	865,420		
Granted	(16,540)	16,540	\$ 16.26
Exercised		(28,861)	\$ 4.40
Forfeited or cancelled - 2004 Plan		(6,573)	\$ 5.05
Shares cancelled due to IPO - 2004 Plan	(380,016)		
Balance at March 31, 2011	848,880	1,993,743	\$ 5.97

Table of Contents

The following table summarizes information about stock options outstanding as of March 31, 2011:

	Number of Shares	Options Outstanding Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
Vested and expected to vest	1,808,365	\$ 5.75	7.2	\$ 10,350
Exercisable	1,419,195	\$ 4.63	6.5	\$ 9,523

The intrinsic value of options vested and expected to vest and exercisable as of March 31, 2011 is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of March 31, 2011. The intrinsic value of options exercised during the three months ended March 31, 2011 and 2010, was \$198,000 and \$46,000, respectively, and is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of the exercise date.

Stock appreciation units

The following table summarizes the Company's stock appreciation unit activity during the three months ended March 31, 2011:

	Units	Weighted- Average Exercise Price
Stock appreciation units outstanding as of December 31, 2010	301,594	\$ 6.83
Stock appreciation units cancelled	(5,972)	\$ 8.11
Stock appreciation units outstanding as of March 31, 2011	295,622	\$ 6.80

The following table summarizes information about stock appreciation units outstanding as of March 31, 2011:

	Number of Units	Stock Appreciation Units Outstanding Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
Vested and expected to vest	295,622	\$ 6.80	7.98	\$ 1,394
Exercisable	118,930	\$ 4.34	6.99	\$ 831

The intrinsic value of stock appreciation units vested and expected to vest and exercisable as of March 31, 2011 is calculated based on the difference between the exercise price and the fair value of the Company's common stock as of March 31, 2011.

Employee stock purchase plan

On February 2, 2011, the Company granted share purchase rights under the 2010 Employee Stock Purchase Plan (the "2010 ESPP"). The first purchase date is May 15, 2011 and therefore no shares have been issued under this plan as of March 31, 2011.

Table of Contents**Note 12. Stock-based compensation**

During the three months ended March 31, 2011 and 2010, the Company recognized stock-based compensation expense for the following types of awards (in thousands):

	Three months ended March 31,	
	2011	2010
Stock options	\$ 405	\$ 420
Stock purchase rights	204	
Stock appreciation units	1,353	
	\$ 1,962	\$ 420

During the three months ended March 31, 2011, the Company recorded a catch-up expense associated with vested stock appreciation units. Vested stock appreciation units first become exercisable upon the expiration of the lock-up period associated with the initial public offering. Due to the contingent nature of the awards prior to the initial public offering, the Company had not recorded any compensation expense associated with these awards. Therefore, during the three months ended March 31, 2011, the Company recognized compensation expense representing the number of vested stock appreciation units at that date, multiplied by the fair value of the award. Subsequently, the Company will recognize changes in the fair value of the vested awards.

Stock options

The following table summarizes the stock-based compensation expense recognized for stock options for the three months ended March 31, 2011 and 2010 (in thousands):

	Three months ended March 31,	
	2011	2010
<u>Stock options</u>		
Cost of goods sold	\$ 30	\$ 15
Research and development	102	91
Sales and marketing	106	105
General and administrative	167	209
	\$ 405	\$ 420

The weighted-average fair value of options granted was \$9.92 and \$9.82 per share for the three months ended March 31, 2011 and 2010, respectively. The fair value of all stock options that vested during the three months ended March 31, 2011 was \$0.2 million. At March 31, 2011, there was \$4.7 million of unrecognized stock-based compensation expense that will be recognized over the remaining weighted-average period of 2.8 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 March 31,	
	2011	2010
Weighted-average expected term (years)	6.69	6.56
Weighted-average volatility	71%	76%

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Risk-free interest rate	2.71%	2.92%	2.96%	3.14%
Expected dividends	0%		0%	

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

Table of Contents

Volatility. Since the Company's common stock was publicly traded in February 2011 and therefore the historical data on volatility of the stock is not sufficient for valuation purposes, the expected volatility used is based on volatility of similar entities. In evaluating similarity, the Company considered factors such as industry, stage of life cycle, size, and financial leverage. The term over which volatility was measured was commensurate with the expected term of the options.

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

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

The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. The Company's estimated forfeiture rate was 9.68% and 9.41% for the three months ended March 31, 2011 and 2010, respectively.

Stock appreciation units

The following table summarizes the expense recognized for stock appreciation units for the three months ended March 31, 2011 (in thousands):

	Three months ended March 31, 2011
Cost of goods sold	\$ 640
Research and development	413
Sales and marketing	144
General and administrative	156
	\$ 1,353

As of March 31, 2011, the liability for the settlement of the stock appreciation units was \$1.2 million and is included in accrued and other current liabilities on the condensed consolidated balance sheet. The Company had not recognized a liability related to the stock appreciation units as of December 31, 2010.

Based on the fair value of the stock appreciation units as of March 31, 2011, there was \$1.2 million of unrecognized stock-based compensation expense that would be recognized over the remaining weighted-average period of 2.7 years.

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

	Three months ended March 31, 2011
Weighted-average expected term (years)	4.17
Weighted-average volatility	73%
Risk-free interest rate	1.43% 2.42
Expected dividends	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.

Table of Contents

Volatility. Since the Company's common stock was publicly traded in February 2011 and therefore the historical data on volatility of the stock is not sufficient for valuation purposes, the expected volatility used is based on volatility of similar entities. In evaluating similarity, the Company considered factors such as industry, stage of life cycle, size, and financial leverage. The term over which volatility was measured was commensurate with the expected term.

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

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

Employee stock purchase plan

The following tables summarize the components of ESPP expense for the three months ended March 31, 2011 (in thousands):

	Three months ended March 31, 2011	
Cost of goods sold	\$	11
research and development		107
Sales and marketing		43
General and administrative		43
	\$	204

At March 31, 2011, there was \$0.5 million of unrecognized stock-based compensation expense that will be recognized over the remaining offering period, through November 2011.

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	
	May 15, 2011	November 15, 2011
Expected term (years)	0.28	0.79
Volatility	58%	58%
Risk-free interest rate	15%	23%
Expected dividends	0%	0%

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

Volatility. Since the Company's common stock was publicly traded in February 2011 and therefore the historical data on volatility of the stock is not sufficient for valuation purposes, the expected volatility used is based on volatility of similar entities. In evaluating similarity, the Company considered factors such as industry, stage of life cycle, size, and financial leverage. 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.

Table of Contents

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.

Note 13. Income taxes

The Company's income tax expense for the three months ended March 31, 2011 is primarily related to income taxes of the Company's non-U.S. operations. The Company recorded an income tax provision of \$0.4 million for the three months ended March 31, 2011, as compared to an income tax provision of \$0.6 million during the three months ended March 31, 2010.

The Company conducts its business globally. However, operating income is subject to varying rates of tax in the United States and China. Consequently, the Company's effective tax rate is dependent upon the geographic distribution of earnings or losses and the tax laws and regulations in each geographical region. The Company expects that its income taxes will vary in relation to the Company's profitability and the 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. The preferential rate applies to 2011 and 2010, and the Company intends to reapply for the preferential rate for 2012. If approved, the rate will remain at 15% for 2012 and 2013.

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

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

As of March 31, 2011, 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, 2010.

Table of Contents**Note 14. Other comprehensive income**

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

	Three months ended	
	March 31,	
	2011	2010
Net loss attributable to NeoPhotonics Corporation	\$ (1,935)	\$ (19)
Foreign currently translation adjustment	1,147	123
Unrealized gain on investments	8,491	81
Comprehensive income attributable to NeoPhotonics Corporation	7,703	185
Comprehensive income attributable to noncontrolling interests		80
Comprehensive income	\$ 7,703	\$ 265

Table of Contents

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 March 31, 2011 and the audited consolidated financial statements and notes thereto and management's discussion and analysis of financial condition and results of operations for the fiscal year ended December 31, 2010 included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010. 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 March 31, 2011 contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q for the period ended March 31, 2011 that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Terminology such as believe, may, might, objective, estimate, continue, anticipate, intend, should, plan, expect, predict, potential, or the negative of these terms or other similar expressions is intended to identify forward-looking statements.

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

Business overview

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

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

We have research and development and wafer fabrication facilities in San Jose, California which coordinate with our research and development and manufacturing facilities in Shenzhen, China. We 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 (including its recent acquisition of Nortel's Metro Ethernet Networks business), Cisco Systems, Inc., FiberHome Technologies Group, ECI Telecom Ltd., Telefonaktiebolaget LM Ericsson, Fujitsu Limited, Harmonic, Inc., Huawei Technologies Co., Ltd., Mitsubishi Electric Corporation, NEC Corporation, Nokia Siemens Networks B.V. and ZTE Corporation. We refer to these companies as our Tier 1 customers.

Table of Contents

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 United States, China, Canada, Israel, Japan, Russia and the European Union. These individuals work with our product engineers, and product marketing and sales operations teams, in an integrated approach to address our customers' current and future needs. We also engage independent commissioned representatives and distributors in these and other countries to extend our global reach.

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

Critical accounting policies and estimates

There have been no material changes to our significant accounting policies during the three months ended March 31, 2011 from those disclosed in our 2010 Form 10-K, with the exception of our accounting policy for stock-based compensation, as described in Note 2 of the Notes to the Condensed Consolidated Financial Statements.

Our stock-based compensation expense was recorded as follows:

(in thousands)	Three months ended	
	March 31,	
	2011	2010
Cost of goods sold	\$ 681	\$ 15
Research and development	625	91
Sales and marketing	293	105
General and administrative	366	209
	\$ 1,965	\$ 420

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

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

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

The Black-Scholes pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants. Existing valuation models, including the Black-Scholes model, may not provide reliable measures of the fair value of our

Table of Contents

stock-based awards. Consequently, there is a risk that our estimates of the fair value of our stock-based awards on the measurement dates may bear little resemblance to the actual values realized upon exercise. Stock options may expire or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our consolidated financial statements. Further, the value of share purchase rights recognized on the grant date may differ from the value realized by the employee on the purchase dates. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our consolidated financial statements. With regard to stock appreciation units, the value remeasured each period, may not be representative of the value realized upon exercise.

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

	Three months ended March 31,			
	2011		2010	
Weighted-average expected term (years)	6.69		6.56	
Weighted-average volatility	71%		76%	
Risk-free interest rate	2.71%	2.92	2.96%	3.14
Expected dividends	0%		0%	

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

	Three months ended March 31, 2011	
	Weighted-average expected term (years)	4.17
Weighted-average volatility	73%	
Risk-free interest rate	1.43%	2.42
Expected dividends	0%	

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

	Purchase Period Ending	
	May 15, 2011	November 15, 2011
Expected term (years)	0.28	0.79
Volatility	58%	58%
Risk-free interest rate	15%	23%
Expected dividends	0%	0%

In addition to the assumptions used to calculate the fair value of our options, we are required to estimate the expected forfeiture rate of all stock-based awards and only recognize expense for those awards we expect to vest. Accordingly, the stock-based compensation expense recognized in our consolidated statement of operations for the three months ended March 31, 2011 and 2010 has been reduced for estimated forfeitures. If we were to change our estimate of forfeiture rates, the amount of stock-based compensation expense could differ, materially under certain circumstances, from the amount recognized in our consolidated financial statements. For example, if we had decreased our estimate of expected forfeitures by 50%, our stock-based compensation expense for the three months ended March 31, 2011, net of expected forfeitures, would have increased by \$119,000. This decrease in our estimate of expected forfeitures would increase the amount of expense for all unvested awards that have not yet been recognized by \$277,000 as of March 31, 2011, which would be amortized over a weighted-average period of 5.31 years. In addition, if our stock-based compensation expense increases in the future, the impact of a change in the estimated forfeiture rate could be more significant.

Table of Contents**Results of operations***Revenue*

We sell substantially all of our products to original equipment manufacturers, or OEMs. Revenue is recognized upon delivery of our product to the OEM. We price our products based on market and competitive conditions and may periodically reduce the price of our products as market and competitive conditions change and as manufacturing costs are reduced. Our sales transactions to customers are denominated primarily in Chinese Renminbi (RMB) or U.S. dollars. Revenue is driven by the volume of shipments and may be impacted by pricing pressures. For the three months ended March 31, 2011, 66% of our sales were derived from our China-based subsidiaries, the majority of which were denominated in RMB. In addition, we have generated most of our revenue from a limited number of customers. Given the high concentration of network equipment vendors in our industry, our top ten customers represented 90% and 84% of our revenue in the three months ended March 31, 2011 and 2010, respectively.

(in thousands)	Three months ended	
	March 31,	
	2011	2010
Total revenue	\$ 50,922	\$ 40,208

Total revenue increased by \$10.7 million in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, representing a 27% increase. The increase in revenue was primarily attributable to an increase in demand for our access products and to a lesser extent for our speed and agility products as carrier continued to expand their networks and deploy fiber-to-the-home solutions, plus additional design wins and overall market expansion. Although sales increased on a global basis, the increase was primarily realized in China and to a lesser extent in the United States.

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, warranty, shipping and allocated facilities costs.

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

Table of Contents

(in thousands, except percentages)	Three months ended March 31,			
	2011	% of revenue	2010	% of revenue
	Amount		Amount	
Cost of goods sold	\$ 38,504	76%	\$ 27,510	68%

Gross margin	Three months ended March 31,	
	2011	2010
	24%	32%

Cost of goods sold increased by \$11.0 million in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, representing a 40% increase. Cost of goods sold increased primarily from higher sales volumes, additional direct labor and overhead costs including higher stock compensation expense as a result of stock appreciation units expense, partially offset by improved manufacturing utilization in the three months ended March 31, 2011 and a decrease in amortization of purchased intangible assets, as certain assets became fully amortized. Gross margin was 24% for the three months ended March 31, 2011, compared to 32% for the three months ended March 31, 2010. The decrease in gross margin primarily resulted from the increase in sales of our lower-margin Access products and the impact of lower pricing contracts entered into with customers in the prior quarter.

We expect that we will experience increased demand for our Access products, which can cause our gross margin to be lower than the comparable year-ago periods.

Operating expenses

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

(in thousands, except percentages)	Three months ended March 31,			
	2011	% of revenue	2010	% of revenue
	Amount		Amount	
Research and development	\$ 6,559	13%	\$ 4,718	12%
Sales and marketing	2,859	6	2,429	6
General and administrative	4,163	8	4,570	11
Amortization of purchased intangible assets	292	1	284	1
Total operating expenses	\$ 13,873	28%	\$ 12,001	30%

Research and development

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

Research and development expense increased by \$1.8 million in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, representing a 39% increase. This increase was primarily due to a \$1.5 million increase in additional payroll and employee-related cost, including higher stock-based compensation expense as a result of stock appreciation units expense, and a \$0.4 million increase in facility allocation due to higher space and resources usage to support future anticipated demand.

Table of Contents

We intend to continue to invest in research and development and this expense is expected to increase as we grow our business.

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 \$0.4 million in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, representing an 18% increase. The increase was primarily due to a \$0.3 million increase in additional payroll and employee-related costs, including higher stock compensation expense as a result of stock appreciation units expense, and sales commissions as we strengthened our sales forces in Europe and Asia.

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

General and administrative

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

General and administrative expense decreased by \$0.4 million in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, representing a 9% decrease. The decrease was primarily due to decreases in bonus of \$0.6 million and accounting and tax related costs of \$0.3 million, partially offset by higher facilities-related costs of \$0.4 million and higher stock compensation of \$0.2 million.

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

Amortization of purchased intangible assets

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

Amortization of purchased intangible assets remained flat in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, as we continue to amortize intangible assets associated with business acquisitions made prior to 2007.

Interest and other income (expense), net

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

(in thousands)	Three months ended	
	March 31,	
	2011	2010
Interest income	\$ 37	\$ 59
Interest expense	(118)	(214)
Other income (expense), net	(27)	129
Total	\$ (108)	\$ (26)

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

Total interest and other expense, net increased by \$0.1 million in the three months ended March 31, 2011 compared to the three months ended March 31, 2010, primarily related to a \$0.2 million decrease in government subsidies received by our China subsidiaries, partially offset by a \$0.1 million decrease in interest expense, as a result of our lower loan balance outstanding.

Table of Contents

We expect our interest expense to decline with lower debt balances outstanding.

Income taxes

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

(in thousands, except percentages)	Three months ended	
	March 31,	
	2011	2010
Provision for income taxes	\$ (372)	\$ (610)
Effective tax rate	(24)%	91%

Our Company's income tax expense for the three months ended March 31, 2011 is primarily related to income taxes of the Company's non U.S. operations. We recorded an income tax provision of \$0.4 million in the three months ended March 31, 2011, compared with an income tax provision of \$0.6 million in the three months ended March 31, 2010. We had an effective tax rate of negative 24% in the three months ended March 31, 2011 despite a consolidated loss before income taxes, compared with an effective tax rate of 91% in the three months ended March 31, 2010, primarily due to the level of foreign withholding tax and income taxes paid based on earnings generated by our foreign subsidiaries in each of these periods, respectively.

Liquidity and capital resources

Until the consummation of our initial public offering in February 2011, we financed our operations through private sales of equity securities and cash generated from operations and from various lending arrangements. At March 31, 2011, our cash and cash equivalents totaled \$92.5 million. Cash and cash equivalents are held for working capital purposes and were invested primarily in money market funds. We do not enter into investments for trading or speculative purposes. 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 and the continuing market acceptance of our products. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

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

Frequently, we also direct our banking partners to issue notes payable to our suppliers in China in exchange for accounts payable. Our Chinese subsidiaries' banks issue the notes to vendors and issue payment to the vendors upon redemption. We owe the payable balance to the issuing bank. The notes payable are non-interest bearing and are generally due within six months of issuance. As a condition of the notes payable lending arrangements, we are required to keep a compensating balance at the issuing banks that is a percentage of the total notes payable balance until the notes payable are paid by our subsidiaries in China. These balances are classified as restricted cash on our consolidated balance sheets. As of March 31, 2011, our restricted cash totaled \$3.1 million.

Table of Contents

We have lending arrangements with several financial institutions, including a loan and security agreement with Comerica Bank in the United States, which was amended in December 2009, and several line of credit arrangements for our subsidiaries in China.

As of March 31, 2011, our loan and security agreement in the United States included the following:

An \$8.0 million revolving line of credit. Amounts available under the revolving line of credit are reduced by any commercial or stand-by letters of credit issued under the facility. As of March 31, 2011, we had no outstanding balance under the revolving line of credit and a \$5.0 million letter of credit supporting our China line of credit facility. As of March 31, 2011, \$3.0 million was available under the revolving line of credit.

A \$9.5 million facility under which we can draw down amounts in multiple six month tranches based on our capital expenditures in the United States. Each drawdown is due and payable in up to 30 equal monthly payments such that all amounts are repaid by June 2013. As of March 31, 2011, there is no outstanding balance under this facility. The capacity for future borrowing is limited by specified maximum amounts. As of March 31, 2011, \$3.5 million was available under this facility.

Our loan and security agreement requires us to maintain certain financial covenants, including a liquidity ratio, and restricts our ability to incur additional debt or to engage in certain transactions and is secured by substantially all of our U.S. assets, other than intellectual property assets. As of March 31, 2011, we were in compliance with all covenants contained in this agreement.

Our primary subsidiary in China has a \$5.0 million line of credit facility with a Hong Kong bank. This line of credit agreement is supported by letters of credit issued pursuant to our U.S. loan and security agreement, as referenced above. As of March 31, 2011, we had no outstanding balance under this line of credit, and \$5.0 million was available under the line of credit.

In addition to the \$5.0 million line of credit facility for our primary subsidiary in China referenced above, our subsidiaries in China also 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 March 31, 2011 and bear interest at rates ranging from 4.76% to 5.84%. Amounts requested by us are not guaranteed and are subject to the banks' funds and currency availability. The short-term loan agreements do not contain financial covenants and one such loan agreement is secured by our main manufacturing facility in China. As of March 31, 2011, we had an aggregate of \$4.5 million of short-term loans outstanding.

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

(in thousands)	Three months ended	
	2011	March 31, 2010 (As Revised.)
Net cash provided by (used in) operating activities	\$ (9,288)	\$ 2,306
Net cash used in investing activities	(2,711)	(5,854)
Net cash provided by (used in) financing activities	79,015	(3,530)
Effect of exchange rates on cash and cash equivalents	58	114
Net increase (decrease) in cash and cash equivalents	\$ 67,074	\$ (6,964)

During the three months ended March 31, 2011, we completed an initial public offering of common stock, raising proceeds of \$87.7 million, net of offering expenses paid during the quarter. We used a portion of our net proceeds to repay a portion of our outstanding indebtedness. We intend to use our net proceeds from the offering for working capital, to continue to expand our existing business and general corporate purposes. Accordingly, our management will have broad discretion in the application of our net proceeds from the offering, and investors will be relying on management's judgment regarding the application of these net proceeds. We also may use a portion of our net proceeds from the offering to acquire complementary businesses, products, services or technologies, but we currently have no agreements or commitments relating to any material acquisitions.

Table of Contents*Operating activities*

During the three months ended March 31, 2011, net cash used in operating activities was \$9.3 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 three months ended March 31, 2011, we recognized net loss of \$1.9 million. However, that net loss incorporated non-cash charges, including depreciation and amortization of \$2.8 million and stock-based compensation expenses of \$2.0 million. These amounts were partially offset by the purchase of inventory of \$5.6 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 \$3.6 million during the period.

During the three months ended March 31, 2010, net cash provided by operating activities was \$2.4 million. Cash provided by operating activities primarily related to cash receipts from customers in excess of cash payments to our employees and suppliers. During the three months ended March 31, 2010, we recognized net income of \$0.1 million. However, that net income incorporated non-cash charges, including depreciation and amortization of \$3.2 million, stock-based compensation expenses of \$0.4 million and non-cash increases to our asset reserve accounts of \$0.5 million. In addition, we spent an additional \$5.4 million to replenish our inventories in anticipation of seasonally higher sales volumes in the second and third quarter and extended payment terms with certain suppliers, as evidenced by our net increase in accounts payable and accrued liabilities of \$3.1 million during the period.

During the three months ended March 31, 2010, we determined that cash payments in 2010 for IPO related expenses had been incorrectly classified as operating cash flow activities on the statements of cash flows, and that such payments should be classified as financing cash flow activities. We revised the 2010 statement of cash flows to correct for the classification. The correction resulted in an increase to Net Cash Provided by Operating Activities of \$160,000, with a corresponding increase to Net Cash Used in Financing Activities for the quarter ended March 31, 2010.

Investing activities

Our investing activities consisted primarily of capital expenditures and in the three months ended March 31, 2010, included purchases of equity securities and the sale of our ownership interest in Shenzhen Archcom Technology Co., Ltd. (Archcom).

During the three months ended March 31, 2011, net cash used for investing activities was \$2.7 million, mainly due to the purchase of capital equipment.

During the three months ended March 31, 2010, net cash used for investing activities was \$5.9 million. We invested \$2.7 million in shares of a non-U.S. publicly listed company, purchased \$1.6 million of capital equipment and increased our restricted cash associated with our notes payable in China by \$0.5 million. In addition, we completed our sale of Archcom and, as a result, received the remaining \$0.6 million in cash proceeds, offset by the transfer of the cash of Archcom of \$1.7 million to the buyer.

Financing activities

Our financing activities consisted primarily of proceeds from the issuance of preferred stock and activity associated with our various lending arrangements and in the three months ended March 31, 2011, included proceeds from our initial public offering.

During the three months ended March 31, 2011, net cash provided by financing activities was \$79.0 million. Our initial public offering generated proceeds of \$87.7 million, net of offering expenses paid during the quarter, partially offset by \$8.8 million of net payments on our outstanding bank loans.

During the three months ended March 31, 2010, net cash used for financing activities was \$3.6 million. We paid \$9.3 million, net, against our bank loans and received \$6.0 million in cash from the issuance of preferred stock.

During the three months ended March 31, 2010, we revised the 2010 statement of cash flows which resulted in an increase to Net Cash Provided by Operating Activities of \$160,000, with a corresponding increase to Net Cash Used in Financing Activities for the quarter ended March 31, 2010 as discussed in Operating activities above.

Table of Contents**Contractual obligations and commitments**

The following summarizes our contractual obligations as of March 31, 2011:

(in thousands)	Total	Payments due by period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Short-term loans and notes payable ⁽¹⁾	\$ 17,381	\$ 17,381	\$	\$	\$
Operating leases ⁽²⁾	7,144	1,725	2,156	1,434	1,829
Purchase commitments ⁽³⁾	30,095	30,095			
Asset retirement obligations ⁽⁴⁾	1,000				1,000
	55,620	49,201	2,156	1,434	2,829
Expected interest payments ⁽⁵⁾	135	135			
Total commitments	\$ 55,755	\$ 49,336	\$ 2,156	\$ 1,434	\$ 2,829

- (1) In China, we have several lending arrangements that provide short-term loans with a maturity date of one year or less and frequently we issue notes payable to our suppliers. The notes payable are generally due within six months of issuance. The amount presented in the table represents the principal portion of the obligations. The short-term loans outstanding as of March 31, 2011 bear interest at rates ranging from 4.76% to 5.84%, which interest rate was fixed at the time of drawdown. The notes payable are non-interest bearing.
- (2) We have entered into various non-cancelable operating lease agreements for our offices in China and the United States.
- (3) We are obligated to make payments under various arrangements with suppliers for the procurement of goods and services.
- (4) We have an asset retirement obligation of \$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 consolidated balance sheet as of December 31, 2010.
- (5) We calculate the expected interest payments based on our outstanding short-term loans at prevailing interest rates as of March 31, 2011.

Off-balance sheet arrangements

During the three months ended March 31, 2011, we did not have any significant off-balance sheet arrangements.

Recent accounting pronouncements

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

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

Table of Contents

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate fluctuation risk

As of March 31, 2011, our cash equivalents consisted primarily of money market funds and interest and non-interest bearing bank deposits. The main objective of these instruments was safety of principal and liquidity while maximizing return, without significantly increasing risk. Given the short-term nature of our cash equivalents, we do not anticipate any material effect on our portfolio due to fluctuations in interest rates.

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 March 31, 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 March 31, 2011, we paid off all of our U.S. debt, and therefore, were not subject to interest rate fluctuations.

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 March 31, 2011 and 2010, we recognized foreign currency transaction losses of \$39,000 and \$17,000, 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 months ended March 31, 2011, a 10% depreciation in RMB against the U.S. dollar would have resulted in a \$3.1 million decrease in our revenue and a \$0.2 million decrease in our net income for the period. Comparatively, for the three months ended March 31, 2010, a 10% depreciation in RMB against the U.S. dollar would have resulted in an \$2.8 million decrease in our revenue and a \$0.5 million increase in our net loss 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 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 affect 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.

Table of Contents

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 March 31, 2011. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of March 31, 2011, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

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

Changes in Internal Control

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

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

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

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

Our worldwide operations could be subject to natural disasters and other business disruptions, which could harm our future revenue and financial condition and increase our costs and expenses. For example, the recent earthquakes and tsunami in Japan, and the subsequent crisis relating to nuclear power plants in the affected regions, may adversely impact our revenues from customers located in Japan and/or our ability to source parts from companies located in Japan. Reliable information about the extent of this crisis on our suppliers and customers, including those with substantial operations in Japan, has been limited to date. In addition, the combined effects of these natural disasters have created significant uncertainty, and it is possible that the crisis could result in reduced end user demand due to the economic impact to 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 Japan; a disruption to the global supply chain for products manufactured in 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 Japan.

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

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 December 31, 2010, our accumulated deficit was \$215.8 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.

Table of Contents

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

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

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

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

Historically, we have generated most of our revenue from a limited number of customers. In 2010, our largest customer, Huawei Technologies, represented 48.3% of our total revenue and our top ten customers represented 88.6% of our total revenue. 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. Adverse events affecting our customers could also adversely affect our revenue and results of operations (for instance, in 2009, the filing of a voluntary petition for bankruptcy protection by one of our customers, Nortel Networks Limited, has prevented us from timely collection of our accounts receivable from that customer). In addition, network equipment vendors serving the communications networks industry may continue to consolidate, and we may not be able to offset any potential decline in revenue arising from consolidation of our existing customers with revenue from new customers.

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

The communications networks industry has been characterized by declining product prices over time. We have reduced the prices of many of our products in the past and we expect to experience pricing pressure for our products in the future. When seeking to maintain or increase their market share, our competitors may also reduce the prices of their products. In addition, our customers may have the ability 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.

Table of Contents

Increasing costs may impact our gross margins.

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

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

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

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

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

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

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

Table of Contents

continue to face this risk going forward, as our products are widely deployed throughout the world in multiple demanding environments and applications. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty in order to maintain customer relationships. Any significant product failure could result in lost future sales of the affected product and other products, as well as customer relations problems, litigation and damage to our reputation.

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

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

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

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

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

Our ability to maintain sufficient manufacturing yields is particularly challenging with respect to PICs due to the complexity and required precision of a large number of unique manufacturing process steps. Manufacturing yields for PICs can also suffer if contaminated materials or materials that do not meet highly precise composition requirements are inadvertently utilized. Because a large portion of our PIC manufacturing costs are fixed, PIC manufacturing yields have a substantial effect on our gross margin. Lower than expected manufacturing yields could also delay product shipments and decrease our revenue.

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

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

Table of Contents

frequently encountered by companies operating on a global platform, particularly companies in the rapidly changing communications networks industry. It is difficult for us to accurately forecast our future revenue and gross margin and plan expenses accordingly and, therefore, it is difficult for us to predict our future results of operations.

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

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

Product development delays may result from numerous factors, including:

changing product specifications and customer requirements;

unanticipated engineering complexities;

difficulties in reallocating engineering resources and overcoming resource limitations; and

changing market or competitive product requirements.

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

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

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

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

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

Table of Contents

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. 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 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 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.

In particular we have developed new technologies and products that are key components in our customers' system designs 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.

Table of Contents

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

Our success and ability to implement our business strategy depends upon the continued contributions of our senior management team and others, including our technical and operations employees. Our future success depends, in part, on our ability to attract and retain key personnel, including our senior management and others, and on the continued contributions of members of our senior management team and key technical and operations personnel, each of whom would be difficult to replace. The loss of services of members of our senior management team or key personnel or the inability to continue to attract and retain qualified personnel could have a material adverse effect on our business. Competition for highly skilled technical and operations people, both in the United States and China, 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, this reluctance creates considerable, typically multi-year, gaps between the commencement of new product development and volume purchases. Accordingly, we and our competitors often incur significant research and development and sales and marketing costs for products that, at the earliest, will be purchased by our customers long after much of the cost is incurred and, in some cases, may never be purchased due to changes in industry or customer requirements in the interim.

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

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

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

Our customers generally restrict our ability to change the component parts in our modules without their approval. For more critical components, such as PICs, lasers and photodetectors, any changes may require repeating the entire qualification process. We typically have not entered into long-term or written agreements with our

Table of Contents

suppliers to guarantee the supply of the key components used in our products, and, therefore, our suppliers could stop supplying materials and equipment at any time or fail to supply adequate quantities of component parts on a timely basis. It is difficult, costly, time consuming and, on short notice, sometimes impossible for us to identify and qualify new component suppliers. The reliance on a sole supplier, single qualified vendor or limited number of suppliers could result in delivery and quality problems, reduced control over product pricing, reliability and performance and an inability to identify and qualify another supplier in a timely manner. We have in the past had to change suppliers, which has, in some instances, resulted in delays in product development and manufacturing and loss of revenue. Any such delays in the future may limit our ability to respond to changes in customer and market demands. Any supply deficiencies relating to the quality, quantities or timeliness of delivery of components that we use to manufacture our products could adversely affect our ability to fulfill our customer orders and our results of operations.

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

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

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

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

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

Table of Contents

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

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

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

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

pay substantial monetary damages; or

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

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

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

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

Table of Contents

on commercially reasonable terms and therefore may limit or preclude us from competing in the market for optical transceivers in the United States, which may have a material adverse effect on our results of operations and financial condition, and otherwise materially harm our business.

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

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

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

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

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

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

In recent years, we have experienced significant growth through, among other things, internal expansion programs, product development and acquisitions of other companies. We expect to continue to grow, which could require us to expand our manufacturing operations, including hiring new personnel, purchasing additional equipment, leasing or purchasing additional facilities, developing the management infrastructure and developing our suppliers to manage any such expansion. If we fail to secure these expansion requirements or manage our future growth effectively, our business could suffer.

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

We design our products to conform to regulations established by governments and to standards set by industry standards bodies worldwide, such as The American National Standards Institute, the European Telecommunications Standards Institute, the International Telecommunications Union and the Institute of Electrical and Electronics Engineers, Inc. Various industry organizations are currently considering whether and to what extent to create standards for elements used in 100Gbps systems. Because certain of our products are designed to conform to current

Table of Contents

specific industry standards, if competing or new standards emerge that are preferred by our customers, we would have to make significant expenditures to develop new products. If our customers adopt new or competing industry standards with which our products are not compatible, or the industry groups adopt standards or governments issue regulations with which our products are not compatible, our existing products would become less desirable to our customers and our revenue and results of operations would suffer.

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

As part of our business strategy, we have pursued and intend to continue to pursue acquisitions of complementary businesses, products, services or technologies that we believe could accelerate our ability to compete in our existing markets or allow us to enter new markets.

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

diversion of financial and management resources from existing operations;

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

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

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

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

inability to generate sufficient revenue to offset acquisition costs;

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

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

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

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

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

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

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

We are exposed to foreign exchange risks. Foreign currency fluctuations may adversely affect our revenue and our costs and expenses, and hence our results of operations. A substantial portion of our business is conducted through our subsidiaries based in China, whose functional currency is the RMB. The value of the RMB against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in political and

Table of Contents

economic conditions. Since July 21, 2005, the RMB has no longer been pegged solely to the value of the U.S. dollar. Instead, the RMB is now pegged against a basket of currencies, determined by the People's Bank of China, against which it can rise or fall by as much as 0.5% each day. This change in policy has resulted in approximately 20% appreciation of the RMB against the U.S. dollar between July 21, 2005 and December 31, 2010. While the international reaction to the RMB revaluation has generally been positive, there remains significant international pressure on the Chinese government to adopt an even more flexible currency policy, which may result in a further and more significant appreciation of the RMB against the U.S. dollar. In the long term, the RMB may appreciate or depreciate significantly in value against the U.S. dollar, depending upon the fluctuation of the basket of currencies against which it is currently valued, or it may be permitted to enter into a full float, which may also result in a significant appreciation or depreciation of the RMB against the U.S. dollar.

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

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

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. 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;

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;

fluctuations in foreign economies;

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

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.

Table of Contents

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 the company, violations of our compliance program may result in criminal or civil sanctions, including material monetary fines, penalties and other costs against us or our employees, and may have a material adverse effect on our business.

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

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

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

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

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

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. Any failure of our internal controls could also adversely affect the results of the periodic management evaluations and annual independent registered public accounting firm attestation reports regarding the effectiveness of our internal control over financial reporting that will be required when the rules of the Securities and Exchange Commission, or the SEC, under Section 404 of the Sarbanes-Oxley Act, become applicable to us beginning with the filing of our Annual Report on Form 10-K for the year ended December 31, 2011. Effective internal controls are necessary for us to produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and results of operations could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.

Table of Contents

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

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

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

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

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

We became a public reporting company in February 2011. As a public company, we incur legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act, as well as rules subsequently implemented by the SEC and the New York Stock Exchange, imposes additional requirements on public companies, including specific corporate governance practices. For example, the listing requirements of the New York Stock Exchange require that we satisfy certain corporate governance requirements relating to independent directors, audit and compensation committees, distribution of annual and interim reports, stockholder meetings, stockholder approvals, solicitation of proxies, conflicts of interest, stockholder voting rights and codes of conduct. Our management and other personnel need to devote a substantial amount of time to these compliance initiatives. Moreover, these rules and regulations increase our legal and financial compliance costs and make some activities more time-consuming and costly. For example, these rules and regulations may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantial additional costs to maintain the same or similar coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers.

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

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

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

Although we primarily sell our products through direct sales to systems vendors, we also sell our products to some of our customers through third-party sales representatives and distributors. Many of our third-party sales representatives and distributors also market and sell competing products from our competitors. Our third-party sales representatives and distributors may terminate their relationships with us at any time, or with short notice. Our future performance will also depend, in part, on our ability to attract additional third-party sales representatives and

Table of Contents

distributors that will be able to market and support our products effectively, especially in markets in which we have not previously distributed our products. If our current third-party sales representatives and distributors fail to perform as expected, our revenue and results of operations could be harmed.

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

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

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

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

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

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

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

expand our operating or manufacturing infrastructure;

acquire complementary businesses, products, services or technologies; or

otherwise pursue our strategic plans and respond to competitive pressures.

If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders could be significantly diluted, and these newly-issued securities may have rights, preferences or privileges senior to those of existing stockholders, including those acquiring shares in our initial public offering. We cannot assure you that additional financing will be available on terms

favorable to us, or at all. If

Table of Contents

adequate funds are not available or are not available on acceptable terms, if and when needed, our ability to fund our operations, take advantage of unanticipated opportunities, develop or enhance our products, or otherwise respond to competitive pressures could be significantly limited.

Risks related to our operations in China

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

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

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

Furthermore, while China's economy has experienced rapid growth in the past 20 years, growth has been uneven across different regions, among various economic sectors and over time. China has also in the past and may 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, stock market volatility and global economic conditions. Any of these developments could contribute to a decline in business and consumer spending in addition to other adverse market conditions, which could adversely affect our business.

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

The labor market in China, particularly in the manufacturing-heavy Southeast region of China where our manufacturing facilities are located, has experienced higher costs due to increased wages. We expect that we will be required to increase wages in the future due to market conditions and/or government mandates. If labor costs in China continue to increase, our gross margins and profit margins and results of operations may be adversely affected. In addition, our competitive advantage against competitors with manufacturing in traditionally higher cost countries would be diminished.

The termination and expiration or unavailability of our preferential income tax treatments 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

Table of Contents

for new and high technology enterprises. The preferential rate applies to 2010, 2009 and 2008. We realized benefits from this 10% reduction in tax rate of \$1.7 million, \$1.0 million and \$0.2 million for 2010, 2009, and 2008, respectively. We intend to reapply for the preferential rate for 2011. If approved, the income tax rate will remain at 15%, otherwise, we anticipate that our income tax rate in China will be 24% for 2011 and 25% thereafter.

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

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

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

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

In August 2008, SAFE promulgated the *Circular on the Relevant Operating Issues Concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign-invested Enterprises*, or Circular 142, a notice regulating the conversion by foreign-invested enterprises 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.

Table of Contents

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

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

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

On March 28, 2007, SAFE promulgated the *Application Procedure of Foreign Exchange Administration for Domestic Individuals Participating in Employee Stock Holding Plan or Stock Option Plan of Overseas-Listed Company*, or the Stock Option Rule. Under the Stock Option Rule, Chinese residents who are granted stock options by an overseas publicly-listed company are required, through a Chinese agent or Chinese subsidiary of such overseas publicly-listed company, to register with SAFE and complete certain other procedures. We and our Chinese

Table of Contents

employees who have been granted stock options are subject to the Stock Option Rule. We are currently in the process of registering our stock option and appreciation plans with SAFE. If we or our optionees in China fail to comply with these regulations, we or our optionees in China may be subject to fines and legal sanctions. Several of our employees in China have exercised their stock options prior to our becoming an overseas publicly-listed company. Since there is not yet a clear regulation on how and whether Chinese employees can exercise their stock options granted by overseas private companies, it is unclear whether such exercises are permissible by Chinese laws and it is uncertain how SAFE or other government authorities will interpret or administer such regulations. Therefore, we cannot predict how such exercises will affect our business or operations. For example, we may be subject to more stringent review and approval processes with respect to our foreign exchange activities, such as remittance of dividends and foreign-currency-denominated borrowings, which may affect our results of operations and financial condition.

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

The State Administration of Taxation has issued several circulars concerning employee stock options. Under these circulars, our Chinese employees (which could include both employees in China and expatriate employees subject to individual income tax in China) who exercise stock options will be subject to individual income tax in China. Our subsidiaries in China have obligations to file documents related to employee stock options with relevant tax authorities and withhold and pay individual income taxes for those employees who exercise their stock options. However, since there is not yet a clear regulation on how and whether Chinese employees can exercise stock options granted by overseas private companies and how Chinese employers shall withhold and pay individual taxes, the relevant tax authority has verbally advised us that due to the difficulty in determining the fair market value of our shares as a private company, we did not withhold and pay the individual income tax for the exercises until after we completed our initial public offering in February 2011. Thus, we have not withheld and paid the individual income tax for the option exercises through the date of our initial public offering. However, we cannot assure you that the Chinese tax authorities will not act otherwise and request us to withhold and pay the individual income tax immediately and impose sanctions on us.

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

Chinese companies have historically not adopted a western style of management and financial reporting concepts and practices, which includes strong corporate governance, internal controls and computer, financial and other control systems. Most of our middle and top management staff in China are not educated and trained in the western system, and we may have difficulty hiring new employees in China with experience and expertise relating to accounting principles generally accepted in the United States and U.S. public-company reporting requirements. As a result of these factors, we may experience difficulty in establishing management, legal and financial controls,

Table of Contents

collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet U.S. public-company reporting requirements. We may, in turn, experience difficulties in implementing and maintaining adequate internal controls as required under Section 404 of the Sarbanes-Oxley Act. This may result in material weaknesses in our internal controls which could impact the reliability of our consolidated financial statements and prevent us from complying with SEC rules and regulations and the requirements of the Sarbanes-Oxley Act. Any such material weaknesses or lack of compliance with SEC rules and regulations could result in restatements of our historical consolidated financial statements, cause investors to lose confidence in our reported financial information, have an adverse impact on the trading price of our common stock, adversely affect our ability to access the capital markets and our ability to recruit personnel, lead to the delisting of our securities from the stock exchange on which they are traded. This could lead to litigation claims, thereby diverting management's attention and resources, and which may lead to the payment of damages to the extent such claims are not resolved in our favor, lead to regulatory proceedings, which may result in sanctions, monetary or otherwise, and have a material adverse effect on our reputation and business.

See also Risk Factors Risks related to our business If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.

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

China Labor Contract Law, effective January 1, 2008, together with its implementing rules, effective September 18, 2008, provides more protection to Chinese employees. Previously, an employer had discretionary power in deciding the probation period, not to exceed six months. Additionally, the employment contract could only be terminated for cause. Under the new rules, the probation period varies depending on contract terms and the employment contract can only be terminated during the probation period for cause upon three days notice. Additionally, an employer may not be able to terminate a contract during the probation period on the grounds of a material change of circumstances or a mass layoff. The new law also has specific provisions when an employer has to sign an employment contract with open-ended terms. If an employer fails to enter into an open-ended contract in certain circumstances, the employer must pay the employee twice their monthly wage beginning from the time the employer should have executed an open-ended contract. Additionally an employer must pay severance for nearly all terminations, including when an employer decides not to renew a fixed-term contract.

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

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

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

Table of Contents

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

Risks related to ownership of our common stock

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

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

fluctuations in demand for our products;

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

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

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

quality control or yield problems in our manufacturing operations;

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

length and variability of the sales cycles of our products;

unanticipated increases in costs or expenses; and

fluctuations in foreign currency exchange rates.

The foregoing factors are difficult to forecast, and these, as well as other factors, could materially adversely affect our quarterly and annual results of operations. In addition, a significant amount of our operating expenses is relatively fixed in nature due to our internal manufacturing, research and development, sales and general

Table of Contents

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, 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.

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

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

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

800,938 shares will be eligible for sale in May 2011;

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

Table of Contents

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

The lock-up agreements will expire at the end of the last day of the lock-up period, July 31, 2011, subject to potential extension in the event we release earnings results or material news or a material event relating to us occurs near the end of the lock-up period. Merrill Lynch, Pierce, Fenner & Smith Incorporated, as a representative of the underwriters, may, in its discretion and at any time without notice, release all or any portion of the securities subject to lock-up agreements. Merrill Lynch, Pierce, Fenner & Smith Incorporated has agreed not to release any of the lock-up agreements with our directors and executive officers and substantially all of our stockholders without the prior written consent of Deutsche Bank Securities Inc.

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

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

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

We currently do not plan to declare dividends on shares of our common stock in the foreseeable future. In addition, the terms of our loan and security agreement with Comerica Bank restrict our ability to pay dividends. See [Dividend policy](#) for more information. 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.

Edgar Filing: NEOPHOTONICS CORP - Form 10-Q

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. See [Description of capital stock Preferred stock](#) and [Description of capital stock Anti-takeover effects of provisions of our amended and restated certificate of incorporation, our bylaws and Delaware law](#).

Table of Contents

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

Unregistered Sales of Equity Securities

None.

Use of proceeds

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

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).

From the effective date of the registration statement through March 31, 2011, we have used the net proceeds of the offering for working capital purposes, including expenditures for inventory, personnel costs, equipment and other operating expenses and to repay a portion of our outstanding indebtedness.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

Table of Contents

SIGNATURE

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

NeoPhotonics Corporation

Date: May 12, 2011

By: */s/* JAMES D. FAY
James D. Fay

Chief Financial Officer
(Principal Financial and Accounting Officer)

Table of Contents

Exhibit no.	Description of exhibit
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.
10.4+(3)	2010 Equity Incentive Plan and forms of agreement thereunder.
10.5+	2010 Employee Stock Purchase Plan.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
32.1(4)	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.

* Translation to English of an original Chinese 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) Filed as the like-numbered exhibit to the Annual Report on Form 10-K (File No. 001-35061), filed with the SEC on March 28, 2011, and incorporated herein by reference.

(4) 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.