

NEOPHOTONICS CORP  
Form 10-K  
March 28, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

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

For the fiscal year ended December 31, 2010

OR

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

For the transition period from to

001-35061

(Commission File No.)

**NeoPhotonics Corporation**

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

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

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

**2911 Zanker Road,**

**San Jose, California 95134**

(Address of principal executive offices, zip code)

**Registrant's telephone number, including area code:**

**(408) 232-9200**

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

<b>Title of Each Class</b>	<b>Name of Exchange on Which Registered</b>
Common Stock, par value \$0.0025 per share	New York Stock Exchange

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

**None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the Exchange Act). Yes  No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input checked="" type="checkbox"/> (Do not check if a smaller reporting Company)	Small reporting company <input type="checkbox"/>

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

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As of June 30, 2010, the last business day of the Registrant's most recently completed second fiscal quarter, the registrant's common stock was not listed on any exchange or over-the-counter market. The Registrant's common stock began trading on the New York Stock Exchange on February 2, 2011.

As of February 28, 2011, the Registrant had 24,626,001 outstanding shares of Common Stock.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy Statement for the Registrant's 2011 Annual Meeting of Stockholders are incorporated by reference in Part III of this Annual Report on Form 10-K to the extent stated herein. The Proxy Statement will be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days of the Registrant's fiscal year ended December 31, 2010.

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**NEOPHOTONICS CORPORATION**

**ANNUAL REPORT ON FORM 10-K**

**For the Fiscal Year Ended December 31, 2010**

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**PART I**

**ITEM 1. BUSINESS  
FORWARD LOOKING STATEMENTS**

*You should read the following discussion in conjunction with our Consolidated Financial Statements and the related Notes to Consolidated Financial Statements, and Financial Statements and Supplementary Data included in this Annual Report on Form 10-K. This discussion contains forward-looking statements including statements concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, industry environment, potential growth opportunities and the effects of competition. Forward-looking statements include statements that are not historical facts and can be identified by terms such as anticipates, believes, could, seeks, estimates, expects, intends, may, plans, potential, predicts, projects, should, will, would or similar expressions and the negatives of those terms. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. These risks, uncertainties and other factors in this Annual Report on Form 10-K are discussed in greater detail under the heading Risk Factors. Given these uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our management's beliefs and assumptions only as of the date of this Annual Report on Form 10-K. You should read this Annual Report on Form 10-K completely and with the understanding that our actual future results may be materially different from what we expect. Except as required by law, we assume no obligation to update these forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.*

**BUSINESS**

**Overview**

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

Our products are designed to enable cost-effective, high-speed data transmission and efficient allocation of bandwidth over communications networks. We have a portfolio of over 300 products, including products that enable data transmission at 10 gigabits per second, or Gbps, 40Gbps and 100Gbps, agility products such as ROADMs, or reconfigurable add/drop multiplexers, that dynamically allocate bandwidth to adjust for traffic patterns, and access products that provide high-bandwidth connections to more devices and people over fixed and wireless networks.

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

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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. In 2010, we had revenue of \$184.1 million and net income of \$3.3 million.

### **Our solutions**

We offer a broad portfolio of products that are critical in enabling speed, agility and access across communications networks. The key benefits of our solutions include:

*Enabling service providers to cost-effectively deploy and rapidly scale high-bandwidth capacity networks.* Our solutions are designed to be compatible with existing network architectures and enable incremental system upgrades, enabling service providers to scale network capacity and cost-effectively deploy enhanced services over existing optical fiber infrastructure.

*Simplifying communications networks implementation through large scale integration.* Our products are designed to simplify communications networks deployments by delivering high levels of functional integration through our PIC solutions, which combine multiple discrete elements on a single silicon chip. Our PIC-based approach is designed to enable us to deliver the increased performance necessary for 100Gbps, while also being designed to reduce cost and physical size.

*Enabling acceleration of time-to-market for network equipment vendors.* We believe our technology enables service providers to implement new features and scale network capacity rapidly and cost-effectively to meet time-to-market requirements. Our products are developed using proprietary PIC-based design elements, which are similar in concept to standard cells used in the semiconductor industry. These elements can be used as building blocks to construct complex modules and subsystems.

*Satisfying our customers' quality and volume requirements.* We believe we are one of the highest volume PIC manufacturers in the world and have the ability to grow our capacity to meet customer demand. Our San Jose, CA and China-based manufacturing facilities utilize semiconductor manufacturing techniques, such as statistical processing control and wafer scale fabrication, which are designed to perform at nanoscale tolerances with high yields.

### **Our strengths**

Our key competitive strengths include the following:

*Leading provider of PIC technology.* We believe we are one of the highest volume PIC manufacturers in the world. We have completed large scale photonic integration of multiple functions at nanoscale tolerances using our design expertise and semiconductor manufacturing process capabilities. By using monolithic and hybrid integration techniques, we are able to combine the materials necessary to perform several functions on a single chip. We believe this differentiated approach to PIC technology is critical for the deployment of cost-effective, high-speed communications networks.

*Tier 1 global customer base and leading supplier to fast growing Asian markets.* We are focused on serving our global Tier 1 customer base of network equipment vendors. We believe the rapid growth of our industry in Asia is driven by infrastructure investment in China and the success of Chinese companies worldwide.

*Broad portfolio of products that address bandwidth bottlenecks across various network segments.* Our products range from single function devices to modules and subsystems that enable speed, agility and access across communications networks, such as wireless backhaul, fiber-to-the-home, cable and transport. We believe our product portfolio will help us to grow our business with our Tier 1

customer base.

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*Global, vertically integrated volume manufacturing platform.* Our vertically integrated design and manufacturing process in the United States and China encompasses the range of steps from wafer design and fabrication to module and subsystem assembly and test, and is designed to provide rapid iterations in development cycles and rapid time-to-market for our products.

*Strong knowledge base and intellectual property portfolio.* We have a broad intellectual property portfolio relating to PIC design and fabrication, methods for assembly and packaging and other product designs and technologies. In addition, currently we employ over 300 people in our research and development departments.

### **Our strategy**

Our goal is to become the leading global supplier of high-performance optical technologies that enable the speed, agility and access required to support the rapid growth in traffic over communications networks. Key elements of our strategy include:

*Extending our leadership in photonic integration technologies.* We plan to strengthen our technology leadership and leading product performance to accelerate design wins with our customers. We believe our comprehensive research and development programs and manufacturing capabilities enable us to enhance and extend our PIC capabilities across multiple product lines, including 40Gbps, 100Gbps, ROADM and PON, or passive optical networks, products.

*Strengthening our relationships with our Tier 1 customers and penetrating new customers and geographies.* We intend to deepen our relationships with our Tier 1 customers by increasing design wins in their systems, and by further collaborating to create new solutions to meet the demands of our customers. Additionally, we intend to penetrate new high-growth network equipment vendors, and emerging markets with growing economies.

*Expanding our product development and vertically integrated volume manufacturing capabilities.* We plan to continually leverage our vertically integrated manufacturing model to further enhance our design-for-manufacturing capabilities, reduce our costs and provide highly integrated PIC-based and other communications solutions.

*Extending our product portfolio into additional segments of the network.* Given the performance and reliability of our PIC-based products, we intend to leverage our technology to pursue new opportunities within communications networks.

*Pursuing opportunistic acquisitions.* Historically, we have used acquisitions to expand our technology capabilities and grow our customer base. We regularly evaluate potential acquisition opportunities and intend to opportunistically pursue acquisitions that we believe provide complementary technology and can help accelerate our growth and strengthen our market position.

### **Technology**

We have developed expertise in the design, large-scale fabrication, high-volume module manufacturing and commercial deployment of our PIC products and technologies. The process of designing and manufacturing PICs in high volume with predictable, well-characterized performance and low manufacturing costs is complex and multi-faceted. We believe we have been able to develop the technologies that address and solve a range of interrelated problems that enable the efficient design and manufacture of complex, high-performance components, modules and subsystems for fiber optic networks. The basic elements of our technology are as follows:

*Photonic integrated circuits (PICs).* We have developed a set of proprietary design elements that provide optical functionality on a silicon chip. We utilize micron and sub-micron scale structures of multiple precision-doped silica planar waveguides to fabricate functional elements such as integrated optical filters, switches and

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variable attenuators. By increasing the level of material doping in our planar waveguides, we decrease the size of our functional elements, thereby creating a path for larger scale integration of multiple elements in the same chip area. We integrate these functional design elements into optical circuits to achieve a desired functionality and specification that is incorporated in our products.

*Hybrid PIC integration.* Through precise fabrication and positioning of physical features, we can integrate PIC devices fabricated on separate wafers out of different materials, matching the material to the function to improve performance attributes and reduce production costs. Our hybrid integration allows us to integrate active devices, such as photodiodes, with high-performance passive devices, such as switches, routers and filters, to provide the desired network functions on a single PIC.

*Hardware and firmware integration.* We also sell our products as modules and subsystems which contain electronic hardware and firmware control that can be interfaced directly with customer systems. We design the electronic hardware and develop the firmware to integrate these with our optical products to meet customer specifications.

*Fabrication and manufacturing processes.* We have developed expertise in the technology domains relevant to high-volume fabrication and manufacturing of our PIC products with wafer-scale processes, including the complex interaction of electro-optic, thermal-optic and mechanical micro-thermal features. We have developed and characterized our complex manufacturing steps, which are analogous to those used in the semiconductor industry. Each PIC element is tested and characterized using our proprietary equipment before incorporation into our products.

*Circuit design and design-for-manufacturing tools.* We utilize a comprehensive set of proprietary as well as industry standard software design tools, which permit us to model relevant geometries, dimensions and thermal management for a broad range of photonic devices, which then allows us to develop products with minimal design iterations and to manufacture to a range of specifications.

**Products**

We have a broad portfolio of over 300 products, including high-speed products that enable data transmission at 10Gbps, 40Gbps and 100Gbps, agility products such as ROADMs that dynamically allocate bandwidth to adjust for volatile traffic patterns, and access products that provide high-bandwidth connections to more devices and people over fixed and wireless networks. As of December 31, 2010, we categorized our products into 35 product families.

*Speed*

Speed refers to the ability to transmit data at high data rates. A key limitation of network capacity is the amount of data that can be transmitted through a single fiber from one point to another. To address this limitation, we have a portfolio of products enabling data transmission at speeds of 2.5Gbps, 10Gbps, 40Gbps and 100Gbps, shown below.

<b>Product category</b>	<b>Product description and key attributes</b>
Transceivers	Transmits data into or receives data from optical fiber
	Transmission speeds from 2.5Gbps to 10Gbps
	SFP, XFP, XFP-E and SFP+ form factors
	2 to 80 kilometer transmission distances

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<b>Product category</b>	<b>Product description and key attributes</b>
Arrayed waveguide multiplexers	<p>Combines or separates from 4 to 88 different optical wavelength channels on a single optical fiber</p> <p>33GHz to 100GHz channel spacing</p> <p>Manages wavelength differences for channel separation</p>
Coherent mixers	<p>Decodes multiple signals transmitted on the same optical wavelength by comparison to an external laser</p> <p>Used to prepare coherent optical signals for detection</p> <p>For use in coherent 40Gbps and 100Gbps systems</p>
Differential quadrature phase shift keying (DQPSK) demodulators	<p>Decodes multiple signals transmitted on the same optical wavelength by comparison to a time-delayed version of the incoming signal</p> <p>Used to prepare optical signals for detection</p> <p>For use primarily in 40Gbps systems</p>
Integrated coherent receivers	<p>Decodes multiple phase-modulated optical signals and converts them to electrical form</p> <p>For use in 40Gbps and 100Gbps coherent systems</p> <p>Integrates a coherent mixer with photodiode detectors and amplifiers</p>

*Agility*

Agility refers to the tunability and re-configurability of products to support efficient bandwidth allocation for growing and changing traffic patterns over communications networks. We provide a portfolio of products that enable network agility, shown below.

<b>Product category</b>	<b>Product description and key attributes</b>
ROADMs and OADMs	Optical add and drop multiplexers that dynamically or statically remove or add individual optical wavelengths from a single optical fiber

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Reconfigurable optical add drop multiplexer, or ROADM, variable optical attenuator multiplexer, or VMUX and other OADM configurations

30 to 48 wavelengths

Optional features include monitoring, power management, and switching

Arrayed waveguide gratings (AWG)

Combines or separates multiple different optical wavelengths on a single optical fiber

Thermal and athermal configurations for stabilization against ambient temperature variations

50GHz to 100GHz channel spacing

32 to 88 wavelengths

Variable optical attenuators

Adjusts the power of a signal in an optical fiber

Utilizes micro electro-mechanical systems, or MEMS, for attenuator control

Low optical signal loss, polarization and wavelength dependence

Per channel power control

Shelf-level modules and subsystems

Chassis level modules and subsystems integrating multiple optical devices

Includes integration of software and electronic control circuitry

Optional configurations include OADMs, AWGs and other modules and functionality

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*Access*

Access refers to the ability to provide high-bandwidth connections to more devices and people over fixed and wireless networks. We offer a portfolio of products for wireless backhaul applications, fiber-to-the-home network standards and point to point networks, shown below.

<b>Product category</b>	<b>Product description and key attributes</b>
Optical line terminals	<p>Central office equipment connecting up to 64 users to the fiber optic network</p> <p>10GEPON, GEAPON and GPON compatible</p> <p>Includes a burst mode receiver</p> <p>Transmission speeds up to 10Gbps</p>
Optical network units	<p>Customer premise equipment providing voice, data and internet access over optical fiber- to-the-home or business</p> <p>10GEPON, GEAPON and GPON compatible</p> <p>Converts and reconverts optical signals to electrical signals</p> <p>2 wavelengths with bandwidths up to 10Gbps upstream and 10Gbps downstream</p>
Triplexers	<p>Customer premise equipment providing voice, data, internet and analog video access over optical fiber to the home or business</p> <p>GEAPON and GPON compatible</p> <p>3 wavelengths with digital bandwidth up to 1.25Gbps upstream and 2.5Gbps downstream and analog bandwidth of 800MHz downstream</p>
Transceivers	<p>Transmits data into or receives data from optical fiber for wireless backhaul and point to point applications</p>

3G and LTE backhaul compatible

Transmission speeds up to 10Gbps

SFP, XFP and SFP+ form factors

2 to 80 kilometer transmission distances

AWGs and splitters

Products for outdoor use connecting up to 64 end users to a single optical fiber

Athermal configuration for stabilization against ambient temperature variations

AWGs for use with wave-length division multiplexing passive optical network, or WDM-PON, systems

Splitters with split ratios ranging from 1x4 to 2x64

Cable television subsystems

Hybrid fiber coaxial subsystems for cable television transmission

Transmitters, receivers, amplifiers and compact optical receiver nodes for outdoor and indoor use

Regular and high definition video delivery

Digital data and internet over cable, or DOCSIS 3.0, transmission

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**Customers**

We focus on a global customer base of network equipment vendors who we refer to as our Tier 1 customers. These customers include:

ADVA AG Optical Networking Ltd.	Telefonaktiebolaget LM Ericsson	Mitsubishi Electric Corporation
Alcatel-Lucent SA	FiberHome Technologies Group	NEC Corporation
Ciena Corporation	Fujitsu Limited	Nokia Siemens Networks B.V.
Cisco Systems, Inc.	Harmonic, Inc.	ZTE Corporation
ECI Telecom Ltd.	Huawei Technologies Co., Ltd.	

We also sell our products to numerous other customers globally.

We calculate the percentage of our total revenue attributable to specific customers based on sales to the customers that qualified our products. In 2010, 2009 and 2008, our ten largest customers accounted for 89%, 83% and 71%, respectively, of our total revenue. In 2010, 2009 and 2008, sales to Huawei Technologies accounted for 48%, 53% and 34%, respectively, of our total revenue, while sales to Mitsubishi accounted for 12% of our total revenue in 2008 and less than ten percent of our total revenue in 2009 and 2010. We focus on increasing our penetration of our Tier 1 customers by adding design wins across our product families. Additionally, we plan to continue to develop relationships and achieve design wins with new and existing high-growth customers.

**Sales and marketing**

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. Our sales cycles typically require a significant amount of time and a substantial expenditure of resources before we can realize revenue from the sale of products. The length of our sales cycle, from initial request to design win, is typically 6 to 12 months for an existing product and 18 months or longer for a new product.

Our sales process involves collaboration and regular discussion with our customers early in their design cycles to implement new product development programs. Our sales organization facilitates these activities by working with our product engineering managers and design teams to conduct periodic engineering reviews and program reviews with counterparts at our customers. We believe that these collaborative engineering activities provide us insight into our customers' broader and longer term needs.

We use a direct sales force based 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 believe we are well positioned to capitalize on the migration of our customers' operations to China, where our Shenzhen-based sales and engineering staff is able to support our customers. We also engage independent commissioned representatives and distributors to extend our global reach. We expect to continue to add sales and related support personnel as we grow our business.

Our marketing team focuses on product strategy, product development, roadmap development, new product introduction processes, program management, product demand stimulation and assessment, and competitive analysis. Our marketing team also seeks to educate the market about our products by communicating the value proposition and product differentiation in direct customer interactions and presentations and at industry tradeshows and at technical conferences.

**Research and development**

We have new product development and product sustaining engineering teams in San Jose, California and Shenzhen, China. In our San Jose facilities, we conduct PIC research, development and product roadmap



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definitions. In our Shenzhen facilities, we conduct new product development, manufacturing and process engineering, quality control and continuous improvement and cost reduction relating to product manufacturing, assembly and test. We have invested and expect to continue to invest significant time and capital into our research and development operations. Research and development expenses were \$21.5 million, \$17.3 million and \$21.5 million in 2010, 2009 and 2008, respectively.

### **Intellectual property**

Our success as a company depends in part upon our ability to obtain and maintain proprietary protections for our technology and intellectual property and prevent others from infringing these proprietary rights. To accomplish this objective, we rely on a combination of intellectual property rights, including patent, trademark, copyright, trade secret, and unfair competition laws, as well as license agreements and other contractual protections.

We have filed applications for patents to protect certain of our intellectual property in the United States and in other countries, including Australia, Japan, Korea, China, Taiwan and certain countries in the European Union. Our patents will expire between 2013 and 2028.

Because our U.S. patents do not afford any intellectual property protection in China, where we have substantial operations, we also seek to secure, to the extent possible, intellectual property protections in China. 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. See Risk factors Risks related to our business If we fail to protect, or incur significant costs in defending, our intellectual property and other proprietary rights, our business and results of operation could be materially harmed.

Our portfolio of patents and patent applications covers a range of intellectual property, including without limitation PIC fabrication and design, hybrid PIC integration, large scale integration for optical circuit designs, and methods and apparatus for assembly and packaging.

We seek to protect our intellectual property rights by having our employees and independent consultants enter into a confidentiality and inventions assignment agreements when they join us. Additionally, we enter into non-disclosure agreements with other third parties who may have access to our proprietary technologies and information.

In addition, we have registered the trademark NeoPhotonics in the United States.

### **Manufacturing, assembly and test**

We have manufacturing operations in the United States and China. Our wafer fabrication operations are located in our San Jose, California facilities and include chip design, clean room fabrication, integration and related facilities for PICs. Our manufacturing, assembly and test operations are located in our Shenzhen, China facilities, and include clean room fabrication, general manufacturing and assembly and test operations utilizing production expertise and cost-effective volume capabilities. Our operations in Shenzhen have primary responsibility for dicing, testing, volume packaging and assembly of PIC-based products. We have quality control processes and quality management methods in our internal manufacturing operations. Certain of our products are designed and qualified to meet applicable Telcordia Technologies, Inc., TÜV SÜD America Inc. and Underwriters Laboratories Inc. standards. Our manufacturing facilities in Shenzhen are third-party certified to TL 9000, ISO 9001, ISO 14001 and OHSAS 18000 standards and our facilities in San Jose are certified to ISO 9001 standards.

We use suppliers from the United States, China, Japan and other locations. Although there are multiple sources for most of the component parts of our products, some components are sourced from single or, in some

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cases, limited sources. For example, various types of adhesives are sourced from various manufacturers which presently are sole sources for these particular adhesives. We typically do not have written agreements with any of these component manufacturers to guarantee the supply of the key components used in our products.

**Backlog**

Sales of our products generally are made pursuant to purchase orders, often with short lead times. These purchase orders are typically made without deposits and are often subject to revision or cancellation. The quantities actually purchased by our customers, as well as the shipment schedules, are frequently revised to reflect changes in our customers' needs and in our supply of products. Because of the possibility of changes in delivery or acceptance schedules, cancellations, modifications or price reductions with limited or no penalties, we do not believe that backlog is a reliable indicator of our future revenue and do not rely on backlog to manage our business or evaluate our performance. Changes in the amount of our backlog do not necessarily reflect a corresponding change in the level of actual or potential sales.

**Geographic Areas**

We calculate the percentage of our total revenue to specific regions based on sales to a customer location as follows:

	Year Ended December 31,		
	2010	2009	2008
% of total consolidated revenue			
China	58%	68%	54%
United States	15%	9%	13%
Japan	10%	8%	13%
Other	17%	15%	20%
Total consolidated revenue	100%	100%	100%

As of December 31, 2010 and 2009, we owned long-lived assets in China and in the United States as follows:

	December 31,	
	2010	2009
Long-lived assets:		
China	\$ 32,033	\$ 27,538
United States	11,080	7,763
Total long-lived assets	\$ 43,113	\$ 35,301

For further information, see Note 15 of Item 8, Notes to Consolidated Financial Statements.

**Competition**

The market for optical communications systems is highly competitive. While no company competes against us in all of our product areas, our competitors range from large international companies offering a wide range of products to smaller companies specializing in narrow markets. We believe the principal competitive factors in this market are:

ability to design and manufacture high quality, reliable products;

breadth of product solutions;

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price to performance characteristics;

financial stability;

ability to quickly and consistently produce in high volume and high quality;

ability to meet customers' specific requirements;

ability to meet customer lead time demands; and

depth of relationships with and proximity to key customers globally.

We believe we compete favorably with respect to these factors. We believe our principal competitors include Finisar Corporation, JDS Uniphase Corporation, NTT Electronics Corporation, Source Photonics, Inc. and Sumitomo Electric Device Innovations, Inc. We also compete with various other companies.

Our competitors may have substantially greater name recognition and technical, financial and marketing resources than we do. Many of our competitors have greater resources to develop products or pursue acquisitions, and more experience in developing or acquiring new products and technologies and in creating market awareness for these products and technologies than we do. In addition, a number of our competitors have the financial resources to offer competitive products at below market pricing levels that could prevent us from competing effectively and which could adversely affect our financial performance.

We also face competition from some of our customers who evaluate our capabilities against the merits of manufacturing products internally. These customers may have the ability to manufacture competitive products at a lower cost than we would charge as a result of their higher levels of integration. 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.

## **Employees**

As of December 31, 2010, we had 3,112 employees, of which 166 employees were based in our corporate headquarters in San Jose, California and 2,946 were based in Shenzhen, China. As of that date, we had 110 employees in sales and marketing, 321 employees in research and development, 2,543 employees in manufacturing and operations and 138 employees in general and administrative functions.

None of our employees are covered by a collective bargaining agreement. Chinese law requires that all employees be members of a union that is overseen by the People's Republic of China. We have never experienced employment-related work stoppages and we consider our employee relations to be good.

## **Environmental, health and safety matters**

Our research and development and manufacturing operations and our products are subject to a variety of environmental, health and safety laws and regulations in the jurisdictions in which we operate. These regulations govern, among other things, the discharge of pollutants to air, water, and soil; the remediation of soil and groundwater contamination; the use, handling and disposal of hazardous materials; employee health and safety; and the hazardous material content and recycling of our products. We use, store and dispose of hazardous materials in our manufacturing operations and as components in our products. We incur costs to comply with existing environmental, health and safety requirements, and any failure to comply, or the identification of contamination for which we are found liable, could cause us to incur additional costs, including cleanup costs, monetary fines, or civil or criminal penalties, or result in the curtailment of our operations. In addition, environmental, health and safety requirements have become more stringent over time, and changes to existing requirements could restrict our ability to expand our facilities, require us to acquire costly pollution control equipment, or cause us to incur other significant expenses or to modify our manufacturing processes or the contents of our products. Some jurisdictions in which we operate or sell our products have enacted requirements



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regarding the recycling of waste electronic equipment, and/or the packaging and hazardous material content of certain products. For example, jurisdictions including China and the European Union, among a growing number of jurisdictions, have placed restrictions on the use of lead, among other chemicals, in electronic products, which affects the composition and packaging of our products. The passage of such requirements in additional jurisdictions, or the tightening of standards or elimination of certain exemptions in jurisdictions where our products are already subject to such requirements, could cause us to incur significant expenditures to make our products compliant with new requirements, or could limit the markets into which we may sell our products.

Additionally, increasing efforts to control emissions of greenhouse gases, or GHG, may also impact us. For example, our semiconductor manufacturing operations in California use perfluorocarbons, which are classified as a high global warming potential greenhouse gas. 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 to reduce our perfluorocarbon emissions beginning in 2012. In the United States, the Environmental Protection Agency has announced a finding relating to GHG emissions that may result in promulgation of federal GHG air quality standards. The U.S. Congress has considered various options, including a cap and trade system which would impose a limit and a price on GHG emissions and establish a market for trading GHG credits. China has recently agreed to join the Copenhagen Climate Accord, a voluntary (and non-binding) GHG agreement. Globally, negotiations for a treaty to succeed the 1997 Kyoto Protocol Treaty are ongoing, and it is not yet known whether (or on what terms) agreement will be reached on a successor treaty. Additional restrictions, limits, taxes, or other controls on GHG emissions could significantly 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. In addition, some of our operations might be affected by the physical impacts of climate change. For example, some of our facilities are located in coastal areas that might be vulnerable to changes in sea level.

## **Corporate Information**

We were incorporated in the State of Delaware in October 1996 as NanoGram Corporation, and we changed our name to NeoPhotonics Corporation in 2002. During 2002 and 2003, we spun out two new companies, NanoGram Devices Corporation, a medical device battery company, and NanoGram Corporation, a nanomaterials applications company. NanoGram Devices was subsequently acquired by Greatbatch Inc. NanoGram Corporation was acquired by Teijin Limited in July 2010. In November 2003, we filed a petition for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Northern District of California. Our plan of reorganization was substantially consummated in March 2004, at which point we emerged from bankruptcy. In addition, we have completed several acquisitions as follows:

In March 2003, we acquired Lightwave Microsystems Corporation, a developer and fabricator of photonic integrated circuits;

In March 2006, we completed the acquisition of Photon Technology Co., Ltd. (now named NeoPhotonics (China) Co., Ltd.), a manufacturer of active optoelectronics, transceivers and modules;

In June 2006, we acquired Lightconnect, Inc., which expanded our product portfolio by adding a line of micro-electromechanical systems based optical components and modules;

In June 2006, we acquired OpTun, Inc., a developer of ROADM technology;

In August 2006, we completed an acquisition of BeamExpress, Inc., an integrator of active indium phosphide telecommunications devices in parallel optics high-speed transceivers;

In November 2006, we acquired Paxera Corporation, a developer of tunable technology for dynamically reconfigurable networks; and

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In February 2008, we acquired certain assets and intellectual property from Mitsubishi Electric Corporation relating to the manufacture of high-speed transceivers.

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Our principal offices are located at 2911 Zanker Road, San Jose CA 95134, and our telephone number is (408) 232-9200. Our website address is [www.neophotonics.com](http://www.neophotonics.com). Information found on, or accessible through, our website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

### **Available Information**

We file electronically with the United States Securities and Exchange Commission, or SEC, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended. We make available on our website at [www.neophotonics.com](http://www.neophotonics.com), free of charge, copies of these reports as soon as reasonably practicable after filing these reports with, or furnishing them to, the SEC.

### **ITEM 1A. RISK FACTORS**

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

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

We have a history of losses and we may incur additional losses in future periods. As of 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.

*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, 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 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

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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.

***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.

***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,

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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 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.

***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 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

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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.

### ***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 March 2011 earthquake and tsunami in Japan may adversely impact our revenues from customers located in Japan and/or our ability to source parts from companies located 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 manmade 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 adversely affected. We are not insured against several natural disasters, including earthquakes.

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

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

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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

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

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

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

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

In particular, we have developed new technologies and products that we believe are key components in our customers' systems for 40Gbps and 100Gbps data transmission. 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

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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.

*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,

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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 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.

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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.

***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

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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.

On January 18, 2011, we and Finisar again agreed to toll our respective claims and not to refile the originally asserted claims against each other until at least 90 days after one or more specified events occur resulting in the partial or complete resolution of litigation involving the same Finisar patents between Oplink Communications, Inc. and Finisar. At that time, Finisar will be permitted to bring a new lawsuit against us if they choose to do so. If we are unsuccessful in our defense of the Finisar patent infringement claims, a license to use the allegedly infringing technology may not be available to us at all, and if it is, it may not be available on commercially reasonable terms and therefore may limit or preclude us from competing in the market for optical transceivers in the United States, which may have a material adverse effect on our results of operations and financial condition, and otherwise materially harm our business.

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

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

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

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***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 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;

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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.***

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

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

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

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

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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;

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 diseases;

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

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

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

Negative developments in any of these areas in China or other countries could result in a reduction in demand for our products, the cancellation or delay of orders already placed, difficulties in producing and delivering our products, threats to our intellectual property, difficulty in collecting receivables, and a higher cost of doing business. In addition, although we maintain an anti-corruption compliance program throughout 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.

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***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 control laws, regulations and 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 ending December 31, 2011. Effective internal controls are necessary for us to produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and results of operations could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.

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

We have lending arrangements with several financial institutions, including a loan and security agreement with Comerica Bank in the United States, and our subsidiaries in China have several line of credit arrangements. Our U.S. loan and security agreement requires us to maintain certain financial covenants, including a liquidity

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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.

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

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

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

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

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

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,

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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 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.

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***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 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.

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

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

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

***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

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proceeds from any reduction in capital, share transfer or liquidation, to their offshore parent company, and the offshore parent company may also be prohibited from injecting additional capital into their subsidiaries in China. Moreover, failure to comply with the various foreign exchange registration requirements described above could result in liability under Chinese laws for evasion of applicable foreign exchange restrictions. We cannot provide any assurances that all of our stockholders who are Chinese residents have made or obtained, or will make or obtain, any applicable registrations or approvals required by these foreign exchange regulations. The failure or inability of our stockholders in China to comply with the required registration procedures may subject us to fines and legal sanctions, restrict our cross-border investment activities, or limit our Chinese subsidiaries' ability to distribute dividends or obtain foreign-exchange-dominated loans. Moreover, because of the uncertainties in the interpretation and implementation of these foreign exchange regulations, we cannot predict how they will affect our business operations or future strategy. For example, we may be subject to a more stringent review and approval process with respect to our foreign exchange activities, such as remittance of dividends and foreign-currency-denominated borrowings, which may adversely affect our results of operations and financial condition. In addition, if we decide to acquire a domestic company in China, we cannot assure you that we or the owners of such company, as the case may be, will be able to obtain the necessary approvals or complete the necessary filings and registrations required by these foreign exchange regulations. This may restrict our ability to implement our acquisition strategy and could adversely affect our business and prospects.

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

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

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

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***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.

***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

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

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

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

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

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

See also 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.

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***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 on conditions when an employer has to sign an employment contract with open-ended terms. If an employer fails to enter into an open-ended contract in certain circumstances, the employer must pay the employee twice their monthly wage beginning from the time the employer should have executed an open-ended contract. Additionally an employer must pay severance for nearly all terminations, including when an employer decides not to renew a fixed-term contract.

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

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

From time to time, the Chinese government has implemented requirements to increase the minimum wage for employees in China. These requirements have resulted in the past, and may result in the future, in higher employee costs for our personnel in China. For example, 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.

***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.

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### ***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 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

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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 Annual Report on Form 10-K, 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 February 28, 2011, our executive officers and directors, and entities that are affiliated with them, beneficially own an aggregate of approximately 59% 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 February 28, 2011, we had an aggregate of 24,626,001 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;

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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

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 expire on July 31, 2011, subject to potential extension in the event we release earning 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.

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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.

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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.](#)

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

Our properties consist primarily of owned and leased office and manufacturing facilities. Our corporate headquarters are located in San Jose, California and our manufacturing facilities are located in Shenzhen, China. The following schedule presents the approximate square footage of our facilities as of December 31, 2010:

Location	Square Feet	Commitment and Use
San Jose, California	63,526	Leased; 2 buildings, 24,212 square feet expiring in October 2015 and 39,314 square feet expiring in October 2019.  Used for corporate headquarters offices, wafer fabrication, and research and development.
Shenzhen, China	236,715	Owned; 1 building and 1 floor.  Used for manufacturing, research and development, and sales and marketing.
Shenzhen, China	131,816	Leased; 4 buildings, expiring on various dates ranging from July 2011 to February 2013.  Used for staff dormitory.

In addition, we lease a number of smaller offices in China for warehouse, manufacturing and other functions.

**ITEM 3. 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 Annual Report on Form 10-K, other than as described below, we are not involved in any pending legal proceedings that we believe could have a material adverse effect on our financial condition, results of operations or cash flows. However, as described below, a certain pending dispute involves a claim by a third party that our activities infringe their intellectual property rights. This and other types of intellectual property rights claims generally involve the demand by a third party that we cease the manufacture, use or sale of the allegedly infringing products, processes or technologies and/or pay substantial damages or royalties for past, present and future use of the allegedly infringing intellectual property. Claims that our products or processes infringe or misappropriate any third-party intellectual property rights (including claims arising through our contractual indemnification of our customers) often involve highly complex, technical issues, the outcome of which is inherently uncertain. Moreover, from time to time, we may pursue litigation to assert our intellectual property rights. Regardless of the merit or resolution of any such litigation, complex intellectual property litigation is generally costly and diverts the efforts and attention of our management and technical personnel which could adversely affect our business.

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

On January 5, 2010, Finisar Corporation, or Finisar, filed a complaint in the United States District Court for the Northern District of California against Source Photonics, Inc., MRV Communications, Inc., Oplink



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Communications, Inc. and us, or collectively, the co-defendants. In the complaint, Finisar alleged infringement of certain of its U.S. patents arising from the co-defendants' respective manufacture, importation, use, sale or offer to sell certain optical transceiver products in the 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.

On January 18, 2011, we and Finisar again agreed to toll our respective claims and not to refile the originally asserted claims against each other until at least 90 days after one or more specified events occur resulting in the partial or complete resolution of litigation involving the same Finisar patents between Oplink Communications, Inc. and Finisar. At that time, Finisar will be permitted to bring a new lawsuit against us if they choose to do so. If we are unsuccessful in our defense of the Finisar patent infringement claims, a license to use the allegedly infringing technology may not be available to us at all, and if it is, it may not be available on commercially reasonable terms and therefore may limit or preclude us from competing in the market for optical transceivers in the United States, which may have a material adverse effect on our results of operations and financial condition, and otherwise materially harm our business.

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

**ITEM 4. *REMOVED AND RESERVED***

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**PART II**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

On February 2, 2011, the effective date of our Registration Statement on Form S-1 (File No. 333-166096), our common stock began to trade on the New York Stock Exchange under the symbol NPTN. As of February 28, 2011, the closing price of our common stock as reported on the New York Stock Exchange was \$18.35 and there were approximately 301 holders of record of our common stock. We have not paid cash dividends on our common stock since our inception, and we do not anticipate paying any in the foreseeable future. Any future determination as to the declaration and payment of dividends, if any, will be at the discretion of our board of directors and will depend on then existing conditions, including our financial condition, operating results, contractual restrictions, capital requirements, business prospects and other factors our board of directors may deem relevant.

For equity compensation plan information refer to Item 12 of this Annual Report on Form 10-K.

In January 2010, we issued 2,401 shares of Series X preferred stock for \$2,500.00 per share and received cash proceeds of \$6.0 million. Proceeds from the sale of Series X preferred stock were utilized for working capital, continued expansion of our existing business and general corporate purposes. Shares of Series X preferred stock were convertible into shares of our common stock pursuant to our Amended and Restated Certificate of Incorporation. In connection with the closing of our initial public offering in February 2011, all of the shares of Series X preferred stock outstanding automatically converted into shares of common stock on a 400-for-1 basis. The shares of Series X preferred stock were sold to certain of our existing investors, and no underwriters were involved in this transaction. In connection with the issuance of Series X preferred, we filed a Form D, Notice of Exempt Offering of Securities with the Securities and Exchange Commission pursuant to Rule 506 of Section 4(2) of the Securities Act of 1933, as amended, and in the States of California, Colorado, Georgia, Illinois and Virginia. For further information, see Note 10 of Item 8, Notes to Consolidated Financial Statements.

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. As a result of our initial public offering, we received net proceeds of \$88.2 million before offering expenses. None of such payments were a direct or indirect payment to any of our directors or officers or their associates, to persons owning ten percent or more of our common stock or any of our other affiliates.

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).

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The following selected consolidated financial data should be read together with our consolidated financial statements and the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this Annual Report on Form 10-K. The selected consolidated financial data in this section is not intended to replace our consolidated financial statements and the related notes.

We derived the consolidated statements of operations data for the years ended December 31, 2010, 2009 and 2008 and the consolidated balance sheet data as of December 31, 2010 and 2009 from our consolidated financial statements appearing elsewhere in this Annual Report on Form 10-K. The consolidated statements of operations data for the years ended December 31, 2007 and 2006 and the consolidated balance sheet data as of December 31, 2008, 2007 and 2006 are derived from our consolidated financial statements, which are not included in this Annual Report on Form 10-K and have been revised to reflect the adoption of revised authoritative guidance relating to accounting and reporting for the noncontrolling interest in a subsidiary. Our historical results are not necessarily indicative of our future results.

Consolidated Statement of Operations Data:	Year ended December 31,				
	2010	2009	2008	2007	2006
	<i>(in thousands, except share and per share data)</i>				
Revenue	\$ 184,139	\$ 155,062	\$ 133,989	\$ 95,825	\$ 83,357
Cost of goods sold <sup>(1) (2)</sup>	128,147	114,572	109,439	83,475	71,453
Gross profit	55,992	40,490	24,550	12,350	11,904
Operating expenses:					
Research and development <sup>(1)</sup>	21,549	17,266	21,480	23,076	20,315
Sales and marketing <sup>(1)</sup>	10,176	9,587	10,435	10,123	7,753
General and administrative <sup>(1)</sup>	16,985	15,448	14,581	13,142	10,995
Acquired in-process research and development <sup>(2)</sup>					8,736
Amortization of purchased intangible assets <sup>(2)</sup>	1,144	1,136	1,665	1,826	922
Asset impairment charges <sup>(3)</sup>		1,233	4,047	6,138	
Restructuring charges			1,383		
Total operating expenses	49,854	44,670	53,591	54,305	48,721
Income (loss) from operations	6,138	(4,180)	(29,041)	(41,955)	(36,817)
Interest and other income (expense):					
Interest income	207	345	448	1,496	1,755
Interest expense	(724)	(1,046)	(1,692)	(1,249)	(747)
Other income (expense), net	(68)	(64)	432	319	(157)
Total interest and other income (expense), net	(585)	(765)	(812)	566	851
Income (loss) before income taxes	5,553	(4,945)	(29,853)	(41,389)	(35,966)
Benefit from (provision for) income taxes	(2,282)	(1,902)	1,812	(86)	241
Net income (loss)	3,271	(6,847)	(28,041)	(41,475)	(35,725)
Net loss attributable to noncontrolling interests <sup>(4)</sup>	(80)	(116)	(13)	8	22
Net income (loss) attributable to NeoPhotonics Corporation	3,191	(6,963)	(28,054)	(41,467)	(35,703)
Accretion of redeemable convertible preferred stock	(113)	(153)	(428)		
Net income (loss) attributable to NeoPhotonics Corporation common stockholders	\$ 3,078	\$ (7,116)	\$ (28,482)	\$ (41,467)	\$ (35,703)



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Consolidated Statement of Operations Data:	Year ended December 31,				
	2010	2009	2008	2007	2006
	<i>(in thousands, except share and per share data)</i>				
<b>Net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:</b>					
Basic	\$	\$ (3.72)	\$ (14.80)	\$ (22.34)	\$ (21.19)
Diluted	\$	\$ (3.72)	\$ (14.80)	\$ (22.34)	\$ (21.19)

**Weighted average shares used to compute net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:**

Basic	1,945,111	1,913,117	1,924,141	1,856,215	1,684,599
Diluted	3,035,786	1,913,117	1,924,141	1,856,215	1,684,599

Consolidated Balance Sheet Data:	Year ended December 31,				
	2010	2009	2008	2007	2006
	<i>(in thousands)</i>				
Cash and cash equivalents	\$ 25,465	\$ 43,420	\$ 28,741	\$ 13,663	\$ 50,629
Restricted cash	3,027	3,286	1,516	1,652	1,269
Short-term investments				4,112	6,006
Working capital <sup>(5)</sup>	44,129	44,167	30,583	26,012	51,417
Total assets	172,495	162,248	154,776	167,116	138,896
Long-term debt (including current portion)	8,836	8,147	17,740	13,970	2,724
Redeemable convertible preferred stock	211,541	205,450	196,430	164,789	164,789
Common stock and additional paid-in capital	93,354	91,899	91,281	90,714	89,390
Total deficit	(109,638)	(119,582)	(113,023)	(88,285)	(50,756)

- (1) These expenses include stock-based compensation expense. Stock-based compensation expense for employee stock options granted on or before December 31, 2005 was accounted for as the difference, if any, between the exercise price and the fair value of the common stock on the date of grant. Stock-based compensation expense for employee stock options granted on or after January 1, 2006 is accounted for at fair value, using the Black-Scholes option pricing model. Stock-based compensation expense is recognized over the vesting period of the stock options and was included in cost of goods sold and operating expenses as follows:

	Year ended December 31,				
	2010	2009	2008	2007	2006
	<i>(in thousands)</i>				
Cost of goods sold	\$ 106	\$ 53	\$ 125	\$ 130	\$ 128
Research and development	373	228	314	435	409
Sales and marketing	378	180	177	226	200
General and administrative	741	520	512	545	371
Total	\$ 1,598	\$ 981	\$ 1,128	\$ 1,336	\$ 1,108

- (2) In 2005, we acquired approximately 81.5% of Shenzhen Photon Technology Co., Ltd., in 2006 we acquired another 18.1% interest and in April 2010 we acquired the remaining 0.4% of outstanding shares. Also in 2005, we invested in 7.7% of the outstanding shares of BeamExpress, Inc. and, in 2006, we acquired BeamExpress, Inc. by purchasing the remaining shares. In 2006, we acquired Optun, Inc., Lightconnect, Inc. and the assets and liabilities of Paxera Corporation. These acquisitions were accounted for using the purchase method of accounting. Consideration was allocated to the assets acquired and liabilities assumed based on their fair values, including intangible assets and in-process research and development, and the residual was recorded to goodwill. In-process research and development was expensed at the date of acquisition and the intangible assets are being amortized in cost of goods sold and in operating expenses



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- over their respective useful lives. The results of operations for these acquired businesses are included in our consolidated results of operations from the date of acquisition.
- (3) In 2007, we recorded asset impairment charges relating to goodwill of \$5.9 million and intangible assets of \$0.2 million, both relating to our acquisition of BeamExpress Inc. in 2006. In 2008, we recorded asset impairment charges relating to intangible assets of \$3.3 million and property and equipment of \$0.7 million, both triggered by our decision to discontinue development of a product relating to our acquisition of Paxera Corporation in 2006. In 2009, we entered into an agreement to sell our ownership interest in Shenzhen Archcom Technology Co., Ltd, or Archcom, for less than our share of the net assets of Archcom and, as a result, we recognized an impairment charge of \$0.8 million. In 2009, we also recorded an asset impairment charge of \$0.4 million resulting from the write-off of machinery and equipment no longer in use. For further information, see Note 5 of Notes to Consolidated Financial Statements.
  - (4) Net income (loss) attributable to noncontrolling interests represents the noncontrolling shareholders' proportionate share of the results of operations of our majority-owned subsidiaries. For further information, see Note 14 of Notes to Consolidated Financial Statements.
  - (5) Working capital is defined as total current assets less total current liabilities.

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### **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*You should read the following discussion and analysis by our management of our financial condition and results of operations in conjunction with our consolidated financial statements and the accompanying notes. The following discussion contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. Our actual results could differ materially from those discussed in the forward-looking statements. Please also see the cautionary language at the beginning of Part I of this Annual Report on Form 10-K regarding forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in Risk Factors.*

#### **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.

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 worldwide to extend our global reach.

We changed our name to NeoPhotonics Corporation in 2002 after having been incorporated as NanoGram Corporation in October 1996 in the State of Delaware. During 2002 and 2003, we spun out two new companies, NanoGram Devices Corporation, a medical device battery company, and NanoGram Corporation, a nanomaterials applications company. NanoGram Devices was subsequently acquired by Greatbatch Inc. NanoGram Corporation was acquired by Teijin Limited in July 2010. In November 2003, we filed a petition for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Northern District of California. Our plan of reorganization was substantially consummated in March 2004, at which point we emerged from bankruptcy. In addition, we have completed several acquisitions as follows:

In March 2003, we acquired Lightwave Microsystems Corporation, a developer and fabricator of photonic integrated circuits;

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In March 2006, we completed the acquisition of Photon Technology Co., Ltd. (now named NeoPhotonics (China) Co., Ltd.), a manufacturer of active optoelectronics, transceivers and modules;

In June 2006, we acquired Lightconnect, Inc., which expanded our product portfolio by adding a line of micro-electromechanical systems based optical components and modules;

In June 2006, we acquired OpTun, Inc., a developer of ROADM technology;

In August 2006, we completed an acquisition of BeamExpress, Inc., an integrator of active indium phosphide telecommunications devices in parallel optics high-speed transceivers;

In November 2006, we acquired Paxera Corporation, a developer of tunable technology for dynamically reconfigurable networks; and

In February 2008, we acquired certain assets and intellectual property from Mitsubishi Electric Corporation relating to the manufacture of high-speed transceivers.

The amortization of intangible assets relative to these acquisitions is expected to be \$0.8 million, \$0.3 million and \$0.1 million for the years ending December 31, 2011, 2012 and 2013, respectively, and will continue to decline until fully amortized.

In February 2011, we completed our initial public offering of 8,625,000 shares of common stock, including the full underwriters' over-allotment option, at a public offering price of \$11.00 per share. Our initial public offering generated net proceeds of \$88.2 million before offering expenses. In connection with the closing of the initial public offering, all of the shares of our Series 1, Series 2 and Series 3 preferred stock then outstanding automatically converted into 6,639,513 shares of common stock on a 1-for-1 basis and all of the shares of our Series X preferred stock then outstanding automatically converted into 7,398,976 shares of common stock on a 400-for-1 basis.

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

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with U.S. GAAP. These principles require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, expenses and cash flow, and related disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, stock-based compensation expense, impairment analysis of goodwill and long-lived assets, valuation of inventory, warranty liabilities and accounting for income taxes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

We believe that of our significant accounting policies, which are described in Note 2 of Notes to Consolidated Financial Statements, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, we believe these are the most critical to fully understand and evaluate our financial condition and results of operations.

#### *Revenue recognition*

We recognize revenue from the sale of our products provided that persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collectability is reasonably assured. Contracts and/or customer purchase orders are used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based primarily on the creditworthiness of the customer as determined by credit checks and the customer's payment history.



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Revenue is recognized when the product is shipped and title has transferred to the buyer. We bear all costs and risks of loss or damage to the goods up to that point. On most orders, our terms of sale provide that title passes to the buyer upon shipment by us. In certain cases, our terms of sale may provide that title passes to the buyer upon delivery of the goods to the buyer. We determine payments made to third-party sales representatives are appropriately recorded to sales and marketing expense and not a reduction of revenue as the sales agent services they provide have an identifiable benefit and are made at similar rates of other sales agent service providers. Shipping and handling costs are included in the cost of goods sold. We present revenue net of sales taxes and any similar assessments.

We recognize revenue on sales to distributors, using the sell in method (i.e., when product is sold to the distributor) at the time of shipment or delivery, as our distributors do not have extended rights of return or subsequent price discounts or price protections.

*Stock-based compensation expense*

Our stock-based compensation expense was recorded as follows:

(in thousands)	Years ended December 31,		
	2010	2009	2008
Cost of goods sold	\$ 106	\$ 53	\$ 125
Research and development	373	228	314
Sales and marketing	378	180	177
General and administrative	741	520	512
	\$ 1,598	\$ 981	\$ 1,128

Effective January 1, 2006, we adopted new authoritative accounting guidance for stock-based compensation expense, which requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments, including stock options, based on the grant date fair value of the award. We adopted the new guidance using the prospective transition method. Under this transition method, beginning January 1, 2006, employee stock-based compensation expense includes: (1) compensation cost for all stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the intrinsic value method and (2) compensation cost for all stock-based awards granted or modified subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the new guidance.

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

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stock-based awards. Consequently, there is a risk that our estimates of the fair value of our stock-based awards on the grant 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. 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.

For the years ended December 31, 2010, 2009 and 2008, we calculated the fair value of stock options granted to employees using the Black-Scholes pricing model with the following assumptions:

	Years ended December 31,					
	2010		2009		2008	
Weighted-average expected term (years)	6.59		6.00		5.84	
Weighted-average volatility	73%		79%		77%	
Risk-free interest rate	2.51%	3.19%	2.15%	3.12%	2.81%	3.45%
Expected dividends	0%		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 year ended December 31, 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 year ended December 31, 2010, net of expected forfeitures, would have increased by \$263,000. 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 \$430,000 as of December 31, 2010, which would be amortized over a weighted-average period of 3.0 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.

As of December 31, 2010, we had 301,594 stock appreciation units issued and outstanding, respectively. These stock appreciation units are not exercisable by any recipient until the earliest to occur of the following: (i) the expiration of the period of time agreed to between our underwriters and certain of our stockholders selected by the underwriters in connection with a public offering of the stock, or (ii) upon the consummation of a change in control, which means a sale of all or substantially all of our assets, or a merger, consolidation or other capital reorganization or business combination transaction with or into another corporation or entity. Because neither of these events has occurred and therefore recipients are not able to exercise their units, no compensation expense has been recognized to date relative to these awards. Upon the occurrence of either of the two events, we would recognize compensation expense and corresponding liability equal to the number of vested and outstanding stock appreciation units multiplied by the fair value, calculated using the Black-Scholes option pricing model, on that date.

Stock-based compensation expense subsequent to December 31, 2010 will include an estimate of a catch-up expense for stock appreciation units previously granted to certain employees as well as the ongoing expense relating to the portion of these awards vesting after our initial public offering in February 2011. Prior to our initial public offering, no expense was recognized for these awards given their contingent nature. The expense will be calculated using the Black-Scholes option pricing model and will include the value of our common stock, which could vary significantly.

In addition, we plan to issue stock purchase rights under our 2010 Employee Stock Purchase Plan, and we may also issue additional stock-based equity awards under our 2010 Equity Incentive Plan, which will result in additional stock-based compensation expense.

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*Goodwill and long-lived assets*

Goodwill is evaluated, at a minimum, on an annual basis and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Our annual goodwill impairment testing is performed on December 31 of each year. Goodwill is reviewed for impairment utilizing a two-step process. First, impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of the reporting unit is estimated using a discounted cash flow approach. If the carrying amount of the reporting unit exceeds its fair value, a second step is performed to measure the amount of impairment loss, if any. In step two, the implied fair value of goodwill is calculated as the excess of the fair value of a reporting unit over the fair values assigned to its assets and liabilities. If the implied fair value of goodwill is less than the carrying value of the reporting unit's goodwill, the difference is recognized as an impairment loss. We did not recognize any goodwill impairment charges during the years ended December 31, 2010, 2009 or 2008.

Depreciation and amortization of the intangible assets and other long-lived assets is provided using the straight-line method over their respective estimated useful lives, reflecting the pattern of economic benefits associated with these assets. Changes in circumstances such as technological advances, changes to our business model, or changes in our capital strategy could cause the actual useful lives of intangible assets or other long-lived assets to differ from initial estimates. In those cases where we determine that the useful life of an asset should be revised, we depreciate the remaining net book value over the new estimated useful life.

These assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable based on their future cash flows. The estimated future cash flows are based upon, among other things, assumptions about expected future operating performance and may differ from actual cash flows. The assets evaluated for impairment are grouped, based on our judgment, with other assets at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. If the sum of the projected undiscounted cash flows (excluding interest) is less than the carrying value of the assets, the assets will be written down to the estimated fair value. We did not record any asset impairment charges related to finite-lived assets during the year ended December 31, 2010. During the years ended December 31, 2009 and 2008, we recorded asset impairment charges of \$1.2 million and \$4.0 million, respectively.

*Valuation of inventories*

Inventories are recorded at the lower of cost (using the first-in, first-out method) or market, after we give appropriate consideration to obsolescence and inventories in excess of anticipated future demand. In assessing the ultimate recoverability of inventories, we are required to make estimates regarding future customer demand, the timing of new product introductions, economic trends and market conditions. If the actual product demand is significantly lower than forecasted, we could be required to record additional inventory write-downs which would be charged to cost of goods sold. Any write-downs would have an adverse impact on our gross margin. During the years ended December 31, 2010, 2009 and 2008, we recorded excess and obsolete inventory charges of \$1.2 million, \$1.1 million and \$0.0 million, respectively.

*Warranty liabilities*

We provide warranties to cover defects in workmanship, materials and manufacturing of our products for a period of one to two years to meet stated functionality specifications. From time to time, we have agreed, and may agree, to warranty provisions providing for extended terms or with a greater scope. Products are tested against specified functionality requirements prior to delivery, but we nevertheless from time to time experience claims under our warranty guarantees. We accrue for estimated warranty costs under those guarantees based upon historical experience, and for specific items at the time their existence is known and the amounts are determinable. A provision for estimated future costs related to warranty activities is charged to cost of goods sold based upon historical product failure rates and historical costs incurred in correcting product failures. If we

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experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our gross margin and profitability would be adversely affected. During the years ended December 31, 2010, 2009 and 2008, we recorded warranty expense of \$0.4 million, \$0.4 million and \$0.5 million, respectively.

*Accounting for income taxes*

We record income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. In estimating future tax consequences, generally all expected future events, other than enactments or changes in tax law or rates, are considered. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized.

We operate in various tax jurisdictions and are subject to audit by various tax authorities. We provide for tax contingencies whenever it is deemed probable that a tax asset has been impaired or a tax liability has been incurred for events such as tax claims or changes in tax laws. Tax contingencies are based upon their technical merits, relevant tax law and the specific facts and circumstances as of each reporting period. Changes in facts and circumstances could result in material changes to the amounts recorded for such tax contingencies.

Tax effects of a position are recognized only if it is more likely than not to be sustained based solely on its technical merits as of the reporting date. At December 31, 2010, we had \$5.1 million of unrecognized tax benefits, \$169,000 of which would affect our effective tax rate if recognized.

As part of the process of preparing our consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions in which we operate. We estimate actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets.

At December 31, 2010, we had total net deferred tax assets of \$56.9 million, primarily comprised of U.S. federal and state NOL carryforwards, and a related valuation allowance of \$56.4 million, primarily against our U.S. net deferred tax assets, as we believe that sufficient uncertainty exists regarding the realizability of these deferred tax assets. Our net deferred tax assets consist primarily of NOL carryforwards generated in the United States. Realizability of deferred tax assets is deemed appropriate when realization of such assets is more likely than not. Based upon the weight of available evidence, which includes our historical operating performance and the recorded U.S. cumulative net losses, we have provided a full valuation allowance against our U.S. deferred tax assets. We intend to maintain valuation allowances until sufficient evidence exists to support the reversal of the valuation allowances. Under certain conditions related to our future profitability and other business factors, we believe it is possible our results will yield sufficient positive evidence to support the conclusion that it is more likely than not that we will realize the tax benefit of our NOL carryforwards. If that is the case, subject to review of other qualitative factors and uncertainties, we would reverse the remaining deferred tax asset valuation allowance as a reduction of tax expense. For the periods following the recognition of this tax benefit and to the extent we are profitable, we will record a tax provision for which the actual payment may be offset against our accumulated NOL carryforwards. However, our tax rate may significantly increase in future periods.

We make estimates and judgments about our future taxable income that are based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted. Any adjustment to the deferred tax asset valuation allowance would be recorded in the consolidated statement of operations in the period that the adjustment is determined to be required.

We pay withholding taxes on royalty income from foreign sources. In 2010, these payments were offset by a refund from a favorable tax ruling in China and resulted in net impact of zero to our income tax expense. Although there is a U.S. foreign tax credit for foreign income taxes paid, we do not record a benefit from these foreign tax credits, due to our full valuation allowance on our U.S. deferred tax assets.

**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 RMB or U.S. dollars. For the year ended December 31, 2010, 58% of our sales were derived from our China-based subsidiaries, the majority of which were denominated in RMB. Revenue is driven by the volume of shipments and may be impacted by pricing pressures. We have generated most of our revenue from a limited number of customers. Given the high concentration of network equipment vendors in our industry, our top ten customers represented 89%, 83% and 71% of our revenue in 2010, 2009 and 2008, respectively.

(in thousands)	Years ended December 31,		
	2010	2009	2008
Total revenue	\$ 184,139	\$ 155,062	\$ 133,989

Total revenue increased by \$29.1 million in 2010 compared to 2009, representing a 19% increase. The increase in revenue was primarily attributable to an increase in demand for our speed and agility products, as customers began to deploy more sophisticated product offerings, plus additional design wins and overall market expansion. Although sales increased on a global basis, the increase was primarily realized in China and the United States.

Total revenue increased by \$21.1 million in 2009 compared to 2008, representing a 16% increase. The increase in revenue was primarily attributable to a \$33.5 million increase in revenue from our customers in China. The increase in revenue from customers in China was primarily due to increased demand for our speed, agility and access products resulting from the 3G wireless buildout, partially relating to the economic stimulus program in China, as well as our launch of new products in 2009. The increase in revenue from customers in China was partially offset by lower revenue from other regions of the world, primarily due to a decrease in revenue in the United States and Japan of \$7.9 million from 2008 to 2009. The lower demand in the United States and Japan was primarily driven by lower capital spending by service providers given recessionary economic conditions in 2009.

We expect that our revenue for 2011 will be higher than our revenue for 2010. We also expect that a significant portion of our revenue will continue to be derived from a limited number of customers, as a result of growth in purchases by our key China, U.S. and European customers. We expect a significant portion of our sales to be denominated in foreign currencies in the future, and therefore may be effected by changes in foreign exchange rates.

*Cost of goods sold and gross margin*

Our cost of goods sold consists primarily of the cost to produce wafers and to manufacture and test our products. We have a global set of suppliers to help balance considerations related to product availability, quality and cost. Components of our cost of goods sold are denominated primarily in RMB. Our manufacturing process extends from wafer fabrication through final module and subsystem assembly and test. The cost of our manufacturing, assembly and test processes includes the cost of personnel and the cost of our manufacturing equipment and facilities. Our cost of goods sold is impacted by manufacturing variances such as assembly and test yields and production volume. We typically experience lower yields and higher associated costs on new products. In general, our cost of goods sold associated with a particular product declines over time as a result of decreases in wafer costs associated with the increase in the volume of wafers produced, as well as yield improvements and assembly and test enhancements. Additionally, our cost of goods sold includes reserves for excess and obsolete inventory, royalty payments, amortization of certain purchased intangible assets, warranty, shipping and allocated facilities costs.

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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, changes in the cost and volumes of materials purchased from our suppliers, changes in labor costs, changes in overhead costs or requirements, any reserves for excess and obsolete inventories and changes in the average selling prices of our products. Our newer and more advanced products typically have higher average selling prices and higher gross margins. Average selling prices by product typically decline as a result of periodic negotiations with our customers and competitive pressures. We strive to increase our gross margin as we seek to manage the costs of our supply chain and increase productivity in our manufacturing processes.

(in thousands, except percentages)	Years ended December 31,					
	2010		2009		2008	
	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue
Cost of goods sold	\$ 128,147	70%	\$ 114,572	74%	\$ 109,439	82%

Gross margin	Years ended December 31,		
	2010	2009	2008
	30%	26%	18%

Cost of goods sold increased by \$13.6 million in 2010 compared to 2009, representing a 12% increase. Cost of goods sold increased primarily from higher sales volumes and additional direct labor and overhead costs, offset by lower material costs and improved manufacturing utilization in 2010, and a decrease in amortization of purchased intangible assets, as these assets became fully amortized. Gross margin was 30% for 2010, compared to 26% for 2009. The improvement in gross margin primarily resulted from the increase in sales of our higher-margin agility products in 2010, combined with higher cost leveraging and lower material costs resulting from manufacturing cost reductions.

Cost of goods sold increased by \$5.1 million in 2009 compared to 2008, representing a 5% increase. Cost of goods sold increased primarily due to an increase in sales volumes and higher sales of our higher cost PIC products, offset by efficiencies obtained in the manufacturing process, including higher wafer yields due to design improvements, reduced testing needed for more mature product offerings and improved manufacturing utilization. In addition, expense related to excess and obsolete inventories increased by \$1.1 million in 2009 compared to 2008, primarily as a result of integrating our cable television portfolio during 2009. Similarly, the improvement in gross margin is primarily attributable to these impacts.

We expect that our gross margins are likely to continue to fluctuate as our revenues change over time due to a number of factors, including those mentioned above. In addition, we periodically negotiate pricing with certain customers which can cause our gross margins to fluctuate particularly in the quarter in which the negotiations occurred. Also, effective December 2010, our China subsidiaries incurred an additional 5% increase in payroll taxes in accordance with the new housing fund requirement issued by Shenzhen municipal government. Subsequent to our initial public offering in February 2011, the stock-based compensation expense estimate will include an estimate of a catch-up expense for stock appreciation units previously granted to certain employees as well as the ongoing expense relating to the portion of these awards vesting after our initial public offering in February 2011. This expense will be based in part on our stock price at the relevant period end and thus can vary materially from estimates. Due to the fact that the compensation costs for many of our China-based employees are included in cost of goods sold, the added housing fund payroll tax and higher stock-based compensation expense as a result of vesting of stock appreciation rights is expected to adversely affect gross margin in future periods.

*Operating expenses*

Our operating expenses consist of research and development, sales and marketing, general and administrative, amortization of purchased intangible assets, asset impairment charges and restructuring charges.

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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)	Years ended December 31,					
	2010		2009		2008	
	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue
Research and development	\$ 21,549	12%	\$ 17,266	11%	\$ 21,480	16%
Sales and marketing	10,176	5	9,587	6	10,435	8
General and administrative	16,985	9	15,448	10	14,581	11
Amortization of purchased intangible assets	1,144	1	1,136	1	1,665	1
Asset impairment charges			1,233	1	4,047	3
Restructuring charges					1,383	1
<b>Total operating expenses</b>	<b>\$ 49,854</b>	<b>27%</b>	<b>\$ 44,670</b>	<b>29%</b>	<b>\$ 53,591</b>	<b>40%</b>

*Research and development*

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

Research and development expense increased by \$4.3 million in 2010 compared to 2009, representing a 25% increase. This increase was primarily due to a \$2.5 million increase in additional payroll and employee-related cost in conjunction with increased number of research and development professionals in 2010 and a \$2.1 million increase in material usage, project management and design services, and prototype expenses in 2010 as we invested in additional resources to support future anticipated demand, partially offset by a \$0.3 million decrease in depreciation as part of our assets were fully depreciated and new assets were placed into service later in 2010.

Research and development expense decreased by \$4.2 million in 2009 compared to 2008, representing a 20% decrease. This was primarily due to several factors, such as strategic reductions in spending, including a \$2.0 million reduction in employee costs. This reduction in employee costs resulted from our reduction in workforce implemented at the end of 2008. In addition, the decrease was due to a reduction in development and prototype expenses of \$1.3 million, redeployment of resources from research and development to manufacturing of \$0.5 million and lower depreciation charges of \$0.4 million during 2009.

We expect research and development expense to increase as we enhance and expand our product offerings and higher stock-based compensation expense as a result of vesting and remeasurement of stock appreciation rights. As a percentage of total revenues, our research and development expense may vary as our revenue changes over time.

*Sales and marketing*

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

Sales and marketing expense increased by \$0.6 million in 2010 compared to 2009, representing a 6% increase. The increase was primarily due to a \$1.0 million increase in employee-related costs and sales commissions, partially offset by a \$0.3 million decrease in bad debt expense as a result of improved collections.

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Sales and marketing expense decreased by \$0.8 million in 2009 compared to 2008, representing an 8% decrease. This decrease was primarily due to \$0.6 million in lower external sales commissions expense and a \$0.3 million reduction in employee costs resulting from our reduction in workforce implemented at the end of 2008, partially offset by an increase in bad debt expense of \$0.2 million due to higher defaults of regional foreign cable TV customers in 2009.

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

### *General and administrative*

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

General and administrative expense increased by \$1.5 million in 2010 compared to 2009, representing a 10% increase. This increase was primarily due to increases in legal costs of \$1.0 million, personnel costs of \$0.4 million, and increases in accounting and tax related costs of \$0.5 million, partially offset by lower facilities-related costs of \$0.2 million.

General and administrative expense increased by \$0.9 million in 2009 compared to 2008, representing a 6% increase. This was primarily due to an increase in accounting, consulting and advisory costs of \$0.4 million and an increase in employee expenses of \$0.3 million, due to an increase in incentive-based compensation expense, partially offset by reduced salary-related expense resulting from our reduction in workforce implemented at the end of 2008.

We expect general and administrative expense to increase in the short term, as we develop infrastructure necessary to operate as a public company, including increased accounting and legal fees, costs to comply with the Sarbanes-Oxley Act and the rules and regulations applicable to companies listed on a national stock exchange, as well as investor relations expense and higher insurance premiums. As a percentage of total revenue, our general and administrative expense may vary as our revenue changes over time.

### *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 2010 compared to 2009, as we continue to amortize intangible assets associated with business acquisitions made prior to 2007.

Amortization of purchased intangible assets decreased by \$0.5 million in 2009 compared to 2008 due to the impairment of intangible assets recognized in 2008 as a result of our decision to discontinue development of a product relating to our acquisition of Paxera Corporation. The impairment resulted in lower amortization of purchased intangible assets in 2009.

We expect amortization of purchased intangible assets to decrease as some of our purchased intangible assets were fully amortized in 2010.

### *Asset impairment charges*

We record asset impairment charges when it is determined that the carrying value of our assets is not recoverable.

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We did not incur any asset impairment charges in 2010 compared to \$1.2 million in 2009 and \$4.0 million in 2008.

In 2009, we entered into an agreement to sell our 55% ownership interest in Shenzhen Archcom Technology Co., Ltd., or Archcom, for \$1.1 million, which was less than our share of the value in the net assets of Archcom. This transaction was completed as of March 31, 2010. As a result, we recognized an impairment charge of \$0.8 million in the year ended December 31, 2009, of which \$0.2 million was related to tangible fixed assets and the remaining \$0.6 million was recorded as an accrual for the expected loss on sale. In addition, in 2009, we recorded an impairment charge of \$0.4 million resulting from the write-off of machinery and equipment no longer in use.

In 2008, we discontinued the development of a tunable laser product based on recognized operating losses and the projection of future losses relative to that product. As a result of the discontinuance, we concluded that certain asset groups associated with the product were impaired and an asset impairment charge of \$4.0 million was recognized in the year ended December 31, 2008, of which \$3.3 million was related to purchased intangible assets and \$0.7 million was related to tangible fixed assets.

Asset impairment charges are based on individual facts and circumstances and are not otherwise considered a recurring expense. Although we have recognized impairment charges in 2009 and 2008, this is not necessarily indicative of future periods.

*Restructuring charges*

We did not incur any restructuring charges in 2010 and 2009.

During the third quarter of 2008, we initiated a restructuring plan as part of a companywide cost saving initiative aimed to reduce operating costs by moving manufacturing operations from the United States to our primary subsidiary in China. We recorded \$1.3 million of expense for severance costs resulting from involuntary termination of employees located in the United States and China and \$0.1 million of expense related to a facility closure.

The cost savings resulting from our restructuring plans have been fully reflected in the financial statements presented and we do not anticipate any incremental cost savings in the future as a result of the restructuring plan implemented in 2008.

*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)	Years ended December 31,		
	2010	2009	2008
Interest income	\$ 207	\$ 345	\$ 448
Interest expense	(724)	(1,046)	(1,692)
Other income (expense), net	(68)	(64)	432
Total	\$ (585)	\$ (765)	\$ (812)

Total interest and other income (expense), net decreased by \$0.2 million in 2010 compared to 2009, representing a 24% decrease. The decrease was primarily related to a reduction in interest expense associated with lower outstanding debt in 2010 and lower foreign exchange loss. The decrease was partially offset by a

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reduction in interest income, primarily due to lower cash balances. Other income (expense), net remained flat in 2010 compared to 2009 primarily due to a \$0.6 million share of loss of unconsolidated investee, partially offset by a \$0.3 million increase in government subsidies received by our China subsidiaries and a \$0.2 million decrease in other non-operating material sales in 2010.

Total interest and other income (expense), net remained flat in 2009 compared to 2008. Interest income decreased by \$0.1 million in 2009 compared to 2008. While we maintained higher cash balances in 2009, our cash was invested in money market funds with lower interest rates in 2009, but was invested in higher yielding short-term investments for part of 2008. Interest expense decreased by \$0.6 million in 2009 compared to 2008 primarily as a result of paying off one of our term loans in 2008, amortization of debt issuance costs on our U.S. term loans and a lower average balance outstanding under our lines of credit in China in 2009, as compared to 2008. Other income (expense), net changed by \$0.5 million in 2009 compared to 2008 primarily due to our subsidiaries in China realizing more foreign currency transaction gains on transactions denominated in U.S. dollars in 2008 when the RMB appreciated against the U.S. dollar.

In the future, interest income will depend on our average cash balances and our investment decisions. We expect interest income to increase in 2011 as a result of proceeds from our initial public offering completed in February 2011. We expect interest expense to vary based on outstanding debt obligations.

*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. In China, one of our subsidiaries has qualified for a preferential 15% tax rate available for 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 rate will remain at 15% for 2011, 2012 and 2013, otherwise, the rate will be 24% for 2011 and 25% thereafter. In 2009, our cash tax liability in China was partially offset by the utilization of NOL carryforwards. In future periods, we expect that our operations in China will not have sufficient NOL carryforwards to offset any future cash tax obligation in China.

(in thousands, except percentages)	Years ended December 31,		
	2010	2009	2008
Benefit from (provision for) income taxes	\$ (2,282)	\$ (1,902)	\$ 1,812
Effective tax rate	41%	(39)%	6%

Our effective tax rate was 41% in 2010, compared with an effective tax rate of negative 39% in 2009. Our operating income is subject to varying rates of tax in the United States and foreign subsidiaries. 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. In 2010, our tax expense incurred was primarily related to the earnings generated by our foreign subsidiaries. Our withholding taxes on royalty income from foreign sources were offset by a refund from a favorable tax ruling in China and resulted in net impact of zero to our income tax expense in 2010. In 2009, we incurred tax expense despite a consolidated loss before income taxes, primarily due to foreign income taxes paid based on earnings generated by our foreign subsidiaries of \$1.2 million and withholding taxes on royalties received from our foreign subsidiaries of \$0.8 million.

The effective tax rate was negative 39% in 2009, compared with an effective tax rate of 6% in 2008. The income tax benefit for 2008 primarily resulted from amortization of a deferred tax liability of \$1.3 million relating to intangible assets in a foreign subsidiary and the recognition of refundable U.S. research and development credits of \$0.2 million.

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**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 December 31, 2010, our cash and cash equivalents totaled \$25.5 million. Cash and cash equivalents were held for working capital purposes and were invested primarily in money market funds. We do not enter into investments for trading or speculative purposes. 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 December 31, 2010, our restricted cash totaled \$3.0 million.

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

As of December 31, 2010, 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 December 31, 2010, we had outstanding \$3.0 million under the revolving line of credit and a \$5.0 million letter of credit supporting our China line of credit facility. The \$3.0 million outstanding under the line of credit is due in December 2011. As of December 31, 2010, \$0.0 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 December 31, 2010, \$5.8 million was outstanding and is due and payable in equal monthly payments of principal and interest through June 2013. The capacity for future borrowing is limited by specified maximum amounts. As of December 31, 2010, \$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 December 31, 2010, we were in compliance with all covenants contained in this agreement.

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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 December 31, 2010, we had repaid the \$5.0 million line of credit in full, 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 December 31, 2010 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 December 31, 2010, 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)	Years ended December 31,		
	2010	2009	2008
Net cash provided by (used in) operating activities	\$ 11,141	\$ 11,762	\$ (15,260)
Net cash used in investing activities	(24,690)	(6,037)	(6,674)
Net cash provided by (used in) financing activities	(4,862)	9,010	36,648
Effect of exchange rates on cash and cash equivalents	456	(56)	364
Net increase (decrease) in cash and cash equivalents	\$ (17,955)	\$ 14,679	\$ 15,078

In February 2011, we completed an initial public offering of common stock, raising net proceeds of \$88.2 million before offering expenses. 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.

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. We may also use a portion of our net proceeds to repay a portion of our outstanding indebtedness.

*Operating activities*

In 2010, net cash provided by operating activities was \$11.1 million. Cash provided by operating activities was primarily related to cash receipts from customers in excess of cash payments to our employees and suppliers. During the year ended December 31, 2010, we recognized net income of \$3.3 million. However, that net income incorporated non-cash charges, including depreciation and amortization of \$12.1 million, stock-based compensation expenses of \$1.6 million and non-cash increases to our asset reserve accounts of \$1.6 million. These amounts were partially offset as we spent an additional \$6.0 million to increase our inventories to meet customer demands of seasonally higher sales volumes in the second and third quarter of the year and for future sales and a \$5.6 million increase in prepaid expenses, primarily associated with our initial public offering. However, not all of the inventory purchases were paid for during the year ended December 31, 2010, due to extended payment terms with certain suppliers, as evidenced by our net increase in accounts payable and accrued liabilities of \$4.1 million during the period.

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In 2009, net cash provided by operating activities was \$11.8 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 year ended December 31, 2009, we recognized a net loss of \$6.8 million. However, that net loss incorporated non-cash charges, including depreciation and amortization of \$13.6 million, asset impairment charges of \$1.2 million and stock-based compensation expense of \$1.0 million and we recorded non-cash increases to our asset reserve accounts of \$1.9 million. Furthermore, we experienced increase in revenues and higher collections. Our uses of cash were partially offset by reduced inventories resulting from continued improvement in our inventory turns and extended payment terms to suppliers as evidenced by an increase in our accounts payable and accrued and other liabilities.

In 2008, net cash used in operating activities was \$15.3 million. Cash used in operating activities primarily related to payments to suppliers and employees in excess of cash received from our customers from the sale of our products. Although we experienced a 39.8% increase in revenue from 2007 to 2008, our accounts receivables increased by 50.9%, or \$15.3 million, primarily due to growth in our international receivables, which typically have longer payment terms. During the year ended December 31, 2008, we recognized a net loss of \$28.0 million. However, that net loss incorporated non-cash charges, including depreciation and amortization of \$13.5 million, asset impairment charges of \$4.0 million and stock-based compensation expense of \$1.1 million. Our uses of cash were partially offset by reduced inventories resulting from improved inventory turns and extended payment terms to suppliers, as evidenced by an increase in our accounts payable and accrued and other liabilities.

### *Investing activities*

Our investing activities consisted primarily of capital expenditures and in 2010, included purchases of equity securities.

In 2010, net cash used for investing activities was \$24.7 million. We purchased \$15.8 million of capital equipment and invested \$8.1 million in shares of a non-U.S. publicly listed company. 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.

In 2009, we used \$6.0 million of cash for investing activities, comprised of \$4.6 million of capital expenditures associated with the purchase of machinery and equipment and software to enhance and support our manufacturing operations, an increase of \$1.8 million in restricted cash associated with our notes payable in China, partially offset by \$1.0 million of cash provided by the sale of property, plant and equipment and the expected sale of Archcom.

In 2008, we used \$6.7 million of cash for investing activities. We used \$11.1 million of cash for the purchase of property and equipment, primarily associated with expansion of our manufacturing operations in China, partially offset by \$4.1 million of cash provided by the sales and maturities of short-term investments.

### *Financing activities*

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

In 2010, net cash used for financing activities was \$4.9 million. We repaid \$9.6 million, net of our bank loans, repaid \$1.3 million, net of our notes payable, and received \$6.0 million in cash from the issuance of preferred stock.

In 2009, our financing activities provided \$9.0 million in cash, primarily resulting from \$8.9 million of cash proceeds from the issuance of preferred stock and \$5.2 million of net proceeds from notes payable. Our proceeds were offset by \$5.1 million of net payments on our outstanding bank loans.

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In 2008, our financing activities provided \$36.6 million in cash, primarily resulting from \$31.1 million of cash from the issuance of preferred stock and \$5.8 million in cash from net borrowings associated with our bank loans.

**Contractual obligations and commitments**

The following summarizes our contractual obligations as of December 31, 2010:

(in thousands)	Total	Payments due by period			More than 5 Years
		Less than 1 Year	1-3 Years	3-5 Years	
Short-term loans and notes payable <sup>(1)</sup>	\$ 17,205	\$ 17,205	\$	\$	\$
Debt obligations <sup>(2)</sup>	8,836	5,924	2,912		
Operating leases <sup>(3)</sup>	7,479	1,786	2,329	1,416	1,948
Purchase commitments <sup>(4)</sup>	25,159	25,159			
Asset retirement obligations <sup>(5)</sup>	1,000				1,000
	59,679	50,074	5,241	1,416	2,948
Expected interest payments <sup>(6)</sup>	610	519	91		
Total commitments	\$ 60,289	\$ 50,593	\$ 5,332	\$ 1,416	\$ 2,948

- (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 December 31, 2010 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 several loan and security agreements in the United States that provide various credit facilities, including lines of credit and term loans. The amount presented in the table represents the principal portion of the obligations. The debt obligations outstanding as of December 31, 2010 bear interest at rates ranging from 3.01% to 4.50%. All of the outstanding debt was subject to fluctuations in interest rates. Interest is paid monthly over the term of the debt arrangement.
- (3) We have entered into various non-cancelable operating lease agreements for our offices in China and the United States.
- (4) We are obligated to make payments under various arrangements with suppliers for the procurement of goods and services.
- (5) 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.
- (6) We calculate the expected interest payments based on our outstanding short-term loans and debt obligations at prevailing interest rates as of December 31, 2010.

**Off-balance sheet arrangements**

During the years ended December 31, 2010, 2009 and 2008, we did not have any significant off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K.

**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

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one unit of accounting, and how the arrangement consideration should be allocated among the separate units of accounting. The new accounting guidance is effective for the Company beginning January 1, 2011 and may be applied retrospectively or prospectively for new or materially modified arrangements. In addition, early adoption is permitted. We do not expect that the adoption of the guidance will 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. Accordingly, the Company adopted this amendment for year ended December 31, 2010, except for the additional Level 3 requirements which will be adopted in 2011. 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. We do not expect the adoption of the guidance to have a material impact on our consolidated financial statements.

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 in fiscal years and interim periods within those fiscal years, beginning on or after June 15, 2010. Early adoption is permitted. We do not expect the adoption of the guidance to have a material impact on our consolidated financial statements.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

*Interest rate fluctuation risk*

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 December 31, 2010, 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 December 31, 2010, a portion of our U.S. debt was based on floating rates of interest and is subject to fluctuations in interest rates. As of December 31, 2010, we had not hedged our interest rate risk.

As of December 31, 2010, we had \$8.8 million outstanding under our U.S. credit facilities, which was subject to fluctuations in interest rates. As of December 31, 2010, the weighted average interest rate on the \$8.8 million of outstanding principal subject to interest rate fluctuations was 4.34%. A hypothetical 10% increase in the interest rate could result in approximately \$38,000 of additional annual interest expense. A hypothetical 10% increase in the interest rate could result in approximately \$10,000 of additional annual interest expense. The hypothetical changes and assumptions made above will be different from what actually occurs in the future. Furthermore, the computations do not anticipate actions that may be taken by our management should the hypothetical market changes actually occur over time. As a result, actual impacts on our results of operations in the future will differ from those quantified above.

*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

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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 years ended December 31, 2010 and 2009, we recognized foreign currency transaction losses of \$0.1 million and \$0.1 million, 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 year ended December 31, 2010, a 10% depreciation in RMB against the U.S. dollar would have resulted in a \$10.6 million decrease in our revenue and a \$1.3 million decrease in our net income for the period. Comparatively, for the year ended December 31, 2009, a 10% depreciation in RMB against the U.S. dollar would have resulted in an \$11.8 million decrease in our revenue and a \$1.2 million increase in our net loss in 2009.

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

*Inflation risk*

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

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

NeoPhotonics Corporation

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, consolidated statements of redeemable convertible preferred stock, deficit and comprehensive income (loss) and consolidated statements of cash flows present fairly, in all material respects, the financial position of NeoPhotonics Corporation and its subsidiaries (the Company) at December 31, 2010 and December 31, 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 of Notes to Consolidated Financial Statements, the Company changed the manner in which it accounts for noncontrolling interests effective January 1, 2009.

/s/ PricewaterhouseCoopers LLP

San Jose, California

March 28, 2011

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**NEOPHOTONICS CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share and per share data)	December 31,	
	2010	2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 25,465	\$ 43,420
Restricted cash	3,027	3,286
Accounts receivable, net of allowance for doubtful accounts of \$2,270 and \$2,311 at December 31, 2010 and 2009, respectively	54,374	52,561
Inventories	19,426	14,155
Prepaid expenses and other current assets	7,665	2,867
<b>Total current assets</b>	<b>109,957</b>	<b>116,289</b>
Property, plant and equipment, net	43,113	35,301
Goodwill	4,323	4,323
Other intangible assets, net	2,146	5,475
Other long-term assets	12,956	860
<b>Total assets</b>	<b>\$ 172,495</b>	<b>\$ 162,248</b>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 29,653	\$ 22,210
Short-term loans and notes payable	17,205	28,341
Current portion of long-term debt	5,924	6,035
Accrued and other current liabilities	13,046	15,536
<b>Total current liabilities</b>	<b>65,828</b>	<b>72,122</b>
Long-term debt, net of current portion	2,912	2,112
Deferred income tax liabilities	536	768
Other noncurrent liabilities	1,316	1,378
<b>Total liabilities</b>	<b>70,592</b>	<b>76,380</b>
Commitments and contingencies (Note 9)		
Redeemable convertible preferred stock:		
Series X redeemable convertible preferred stock, \$0.0025 par value		
Authorized 20,000 shares at December 31, 2010 and 2009; Issued and outstanding 18,497 and 16,096 shares at December 31, 2010 and 2009, respectively; Maximum liquidation preference \$92,487 and \$80,482 at December 31, 2010 and 2009, respectively	46,180	40,140
Series 1, 2 and 3 redeemable convertible preferred stock, \$0.0025 par value		
Authorized 7,400,000 shares at December 31, 2010 and 2009; Issued and outstanding 6,639,513 shares at December 31, 2010 and 2009; Liquidation preference \$177,960 at December 31, 2010 and 2009	165,361	165,310
	<b>211,541</b>	<b>205,450</b>
Deficit:		
Common stock, \$0.0025 par value		
Authorized 14,000,000 shares at December 31, 2010 and 2009; Issued and outstanding 1,955,280 and 1,924,627 shares at December 31, 2010 and 2009, respectively	5	5
Additional paid-in capital	93,349	91,894

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Accumulated other comprehensive income	12,807	6,000
Accumulated deficit	(215,799)	(218,990)
Total NeoPhotonics Corporation stockholders' deficit	(109,638)	(121,091)
Noncontrolling interests		1,509
Total deficit	(109,638)	(119,582)
Total liabilities, redeemable convertible preferred stock and deficit	\$ 172,495	\$ 162,248

*See accompanying Notes to Consolidated Financial Statements.*

**Table of Contents****NEOPHOTONICS CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except share and per share data)	Years ended December 31,		
	2010	2009	2008
Revenue	\$ 184,139	\$ 155,062	\$ 133,989
Cost of goods sold	128,147	114,572	109,439
Gross profit	55,992	40,490	24,550
Operating expenses:			
Research and development	21,549	17,266	21,480
Sales and marketing	10,176	9,587	10,435
General and administrative	16,985	15,448	14,581
Amortization of purchased intangible assets	1,144	1,136	1,665
Asset impairment charges		1,233	4,047
Restructuring charges			1,383
Total operating expenses	49,854	44,670	53,591
Income (loss) from operations	6,138	(4,180)	(29,041)
Interest income	207	345	448
Interest expense	(724)	(1,046)	(1,692)
Other expense, net	(68)	(64)	432
Total interest and other expense, net	(585)	(765)	(812)
Income (loss) before income taxes	5,553	(4,945)	(29,853)
Benefit from (provision for) income taxes	(2,282)	(1,902)	1,812
Net income (loss)	3,271	(6,847)	(28,041)
Net income attributable to noncontrolling interests			
	(80)	(116)	(13)
Net income (loss) attributable to NeoPhotonics Corporation	3,191	(6,963)	(28,054)
Accretion of redeemable convertible preferred stock	(113)	(153)	(428)
Net income (loss) attributable to NeoPhotonics Corporation common stockholders	\$ 3,078	\$ (7,116)	\$ (28,482)
Net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:			
Basic	\$	\$ (3.72)	\$ (14.80)
Diluted	\$	\$ (3.72)	\$ (14.80)
Weighted average shares used to compute net income (loss) per share attributable to NeoPhotonics Corporation common stockholders:			
Basic	1,945,111	1,913,117	1,924,141

Diluted	3,035,786	1,913,117	1,924,141
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*See accompanying Notes to Consolidated Financial Statements.*

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## NEOPHOTONICS CORPORATION

**CONSOLIDATED STATEMENT OF REDEEMABLE CONVERTIBLE PREFERRED STOCK,  
DEFICIT AND COMPREHENSIVE INCOME (LOSS)**

(In thousands, except share data)	Redeemable convertible preferred stock		Common stock		Additional paid-in capital	Deferred compensation	Accumulated other comprehensive income	Accumulated deficit	NeoPhotonics Corporation stockholders' deficit	Noncontrolling interests	Total deficit
	Shares	Amount	Shares	Amount							
<b>Balances at December 31, 2007</b>	6,639,513	\$ 164,789	1,922,057	\$ 5	\$ 90,803	\$ (201)	\$ 3,416	\$ (183,973)	\$ (89,950)	\$ 1,665	\$ (88,285)
Comprehensive loss											
Net loss attributable to NeoPhotonics Corporation								(28,054)	(28,054)		(28,054)
Foreign currency translation adjustment							2,555		2,555	102	2,657
Net income attributable to noncontrolling interests										13	13
<b>Total comprehensive loss</b>									(25,499)	115	(25,384)
Issuance of Series X preferred stock for cash, net of issuance costs of \$137	12,491	31,090									
Issuance of Series X preferred stock in exchange for shares of the Company's common stock	49	123	(11,352)		(123)				(123)		(123)
Accretion of preferred stock to redemption value		428			(428)				(428)		(428)
Exercise of stock options			15,736		69				69		69
Repurchases of common stock			(11,094)		(98)				(98)		(98)
Vesting of early exercised stock options					98				98		98
Amortization of deferred stock-based compensation						146			146		146
Stock-based compensation expense					982				982		982
Forfeiture of stock options due to terminations					(27)	27					
<b>Balances at December 31, 2008</b>	6,652,053	196,430	1,915,347	5	91,276	(28)	5,971	(212,027)	(114,803)	1,780	(113,023)
Comprehensive loss											
Net loss attributable to NeoPhotonics Corporation								(6,963)	(6,963)		(6,963)
Foreign currency translation adjustment							29		29		29
Net income attributable to noncontrolling interests										116	116
<b>Total comprehensive loss</b>									(6,934)	116	(6,818)
Issuance of Series X preferred stock for cash, net of issuance costs of \$24	3,556	8,867									
Accretion of preferred stock to redemption value		153			(153)				(153)		(153)
Acquisition of noncontrolling interest					(268)				(268)	(387)	(655)
Exercise of stock options			9,470		40				40		40
Exercise of warrants			10,009		40				40		40
Repurchases of common stock			(10,199)		(37)				(37)		(37)
Vesting of early exercised stock options					43				43		43

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Amortization of deferred stock-based compensation						28				28		28
Stock-based compensation expense						953				953		953
<b>Balances at December 31, 2009</b>	6,655,609	\$ 205,450	1,924,627	\$ 5	\$ 91,894	\$	\$ 6,000	\$ (218,990)	\$ (121,091)	\$ 1,509	\$	(119,582)

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## NEOPHOTONICS CORPORATION

## CONSOLIDATED STATEMENT OF REDEEMABLE CONVERTIBLE PREFERRED STOCK,

## DEFICIT AND COMPREHENSIVE INCOME (LOSS) (Continued)

(In thousands, except share data)	Redeemable convertible preferred stock		Common stock		Additional paid-in capital	Deferred compensation	Accumulated other comprehensive income	Accumulated deficit	NeoPhotonics Corporation stockholders' deficit	Noncontrolling interests	Total deficit
	Shares	Amount	Shares	Amount							
<b>Balances at December 31, 2009</b>	6,655,609	\$ 205,450	1,924,627	\$ 5	\$ 91,894	\$	\$ 6,000	\$ (218,990)	\$ (121,091)	\$ 1,509	\$ (119,582)
Comprehensive income											
Net income attributable to NeoPhotonics Corporation								3,191	3,191		3,191
Unrealized gain on cost method investments						4,412			4,412		4,412
Foreign currency translation adjustment						2,395			2,395		2,395
Net income attributable to noncontrolling interests										80	80
<b>Total comprehensive income</b>									9,998	80	10,078
Issuance of Series X preferred stock for cash, net of issuance costs of \$24	2,401	5,978									
Accretion of preferred stock to redemption value		113				(113)			(113)		(113)
Acquisition of noncontrolling interest						(199)			(199)	95	(104)