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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2019

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-36083

Applied Optoelectronics, Inc.

(Exact name of registrant as specified in its charter)

Delaware

76-0533927

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

13139 Jess Pirtle Blvd.

Sugar Land, TX 77478

(Address of principal executive offices)

(281) 295-1800

(Registrant's telephone number)

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

Title of each class	Trading Symbol(s)	Trading Name of each exchange on which registered
Common Stock, Par value \$0.001	AAOI	NASDAQ Global Market

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 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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes  No

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

If an emerging growth company, indicate by check mark whether the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of June 30, 2019, the aggregate market value of the common stock held by non-affiliates of the Registrant was \$160,183,854 based upon the closing sales price of the Registrant's common stock as reported on the NASDAQ Global Markets on June 28, 2019 of \$10.28 per

share. Shares of common stock held by officers, directors and holders of more than ten percent of the outstanding common stock have been excluded from this calculation because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 20, 2020, the Registrant had 20,231,435 outstanding shares of Common Stock.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement for the Registrant's 2020 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, 2019.

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## **Forward-Looking Information**

This Annual Report on Form 10-K ("Form 10-K") contains forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management, including statements appearing under the heading, "Management's Discussion and Analysis of Financial Condition and Results of Operations". The statements contained in this Form 10-K that are not purely historical are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "strategy," "future," "likely," or "would" or by other similar expressions that convey uncertainty of future events or outcomes. These forward-looking statements involve risks and uncertainties, as well as assumptions and current expectations, which could cause the Company's actual results to differ materially from those anticipated in such forward-looking statements. These risks and uncertainties include but are not limited to: reduction in the size or quantity of customer orders; change in demand for the company's products due to industry conditions; our ability to maintain sufficient liquidity; changes in manufacturing operations; volatility in manufacturing costs; delays in shipments of products; disruptions in the supply chain; change in the rate of design wins or the rate of customer acceptance of new products; the company's reliance on a small number of customers for a substantial portion of its revenues; pricing pressure; a decline in demand for our customers' products or their rate of deployment of their products; general conditions in the internet data center, cable television or CATV, telecommunications or telecom and fiber-to-the-home or FTTH; changes in the world economy (particularly in the United States and China); the negative effects of seasonality; impact of the Tax Cuts and Jobs Act of 2017, including impact on deferred tax assets ; realization of deferred tax assets; and other risks and uncertainties described more fully under the heading "Risk Factors" in this Form 10-K and those discussed in the Company's other documents filed with or furnished to the Securities and Exchange Commission. You should not rely on forward-looking statements as predictions of future events. All forward-looking statements in this Form 10-K are based upon information available to us as of the date hereof, and qualified in their entirety by this cautionary statement. Except as required by law, we assume no obligation to update forward-looking statements for any reason after the date of this report to conform these statements to actual results or to changes in the company's expectations.

## **PART I**

### **Item 1. Business**

#### **BUSINESS**

##### **Overview**

Applied Optoelectronics, Inc. (the "Company" or "AOI") is a leading, vertically integrated provider of fiber-optic networking products, primarily for four networking end-markets: internet data center, cable television, ("CATV"), telecommunications, ("telecom"), and fiber-to-the-home ("FTTH"). We design and manufacture a range of optical communications products at varying levels of integration, from components, subassemblies and modules to complete turn-key equipment.

In designing products for our customers, we begin with the fundamental building blocks of lasers and laser components. From these foundational products, we design and manufacture a wide range of products to meet our customers' needs and specifications, and such products differ from each other by their end market, intended use and level of integration. We are primarily focused on the higher-performance segments within all four of our target markets, which increasingly demand faster connectivity and innovation.

The four end markets we target are all driven by significant bandwidth demand fueled by the growth of network-connected devices, video traffic, cloud computing and online social networking. To address this increased bandwidth demand, CATV and telecom service providers are competing directly against each other by providing bundles of voice, video and data services to their subscribers and investing to enhance the capacity, reliability and capability of their networks. The trend of rising bandwidth consumption also impacts the internet data center market, as reflected in the shift to higher speed server connections. As a result of these trends, fiber-optic networking technology is becoming essential in all four of our target markets, as it is often the only economical way to deliver the desired bandwidth.

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The internet data center market is our largest and fastest growing market. Our customers in this market are generally large internet-based ("Web 2.0") data center operators, to whom we supply optical transceivers that plug into switches and servers within the data center and allow these network devices to send and receive data over fiber-optic cables. The majority of the data center optical transceivers that we sell utilize our own lasers and subassemblies (we refer to the transceivers subassemblies as "light engines"), and we believe that our in-house technology and manufacturing capability for these lasers and subassemblies gives us an advantage over many of our competitors who often lack either development or manufacturing capabilities for these advanced optical modules.

The CATV market is our most established market, for which we supply a broad array of products, including lasers, transmitters and transceivers, and turn-key equipment. Sales of headend, node and distribution equipment have contributed significantly to our revenue in recent years as a result of our ability to meet the needs of CATV equipment vendors who have continued to outsource both the design and manufacturing of this equipment. As the complexity of CATV networks has increased over the years, equipment vendors, many of whom are our customers, have been under pressure to supply a wider variety of increasingly complex equipment to CATV multiple system operators ("MSOs"). In order to meet these demands, many equipment vendors have looked to engage with suppliers like AOI who have the capability to design and manufacture various network equipment or subassemblies, rather than always developing these devices themselves. This outsourcing trend has been a significant contributor to the revenue we derive from the CATV market. We believe that our extensive high-speed optical, mixed-signal semiconductor and mechanical engineering capabilities position us well to continue to benefit from these industry dynamics.

Our vertically integrated manufacturing model provides us several advantages, including rapid product development, fast response times to customer requests and control over product quality and manufacturing costs. We design, manufacture and integrate our own analog and digital lasers using a combination of Metal Organic Chemical Vapor Deposition, or MOCVD, and our proprietary Molecular Beam Epitaxy, or MBE, fabrication process, which we believe is unique in our industry. We manufacture the majority of the laser chips and optical components that are used in our products. The lasers we manufacture are tested extensively to enable reliable operation over time and our devices are often highly tolerant of changes in temperature and humidity, making them well-suited to the CATV and FTTH markets where networking equipment is often installed outdoors.

In 2019, 2018 and 2017, our revenue was \$190.9 million, \$267.5 million, and \$382.3 million and our gross margin was 24.2%, 32.8%, and 43.5%. 2019 In the years ended December 31, 2019, 2018 and 2017, we had net income (loss) of \$(66.0) million, \$(2.1) million, and \$74.0 million, respectively. At December 31, 2019 and 2018, our retained earnings (accumulated deficit) were \$(30.1) million and \$36.0 million, respectively. In 2019, we earned 75.2% of our total revenue from the internet data center market and 19.6% of our total revenue from the CATV market. In 2019, our key customers in the data center market included Microsoft Corp (Microsoft), Amazon.com (Amazon) and Facebook, Inc. (Facebook). In 2019, 2018, and 2017, Microsoft accounted for 32.2%, 22.1%, and 13.8% of our revenue, Amazon accounted for 24.0%, 12.1%, and 35.4% of our revenue and Facebook accounted for 10.9%, 38.3%, and 28.6% of our revenue, respectively. In 2019, our key customers in the CATV market included Cisco Systems, Inc. (Cisco), CommScope (which in 2019 acquired Arris, who had previously acquired the Motorola Home Business in 2013 and Pace Plc in 2016), and a US-based public company who provides CATV equipment. In 2019, 2018 and 2017, Cisco accounted for 10.0%, 9.9%, and 4.8% of our revenue, CommScope accounted for 3.7%, 2.1%, and 3.2% of our revenue, and the US-based public company who provides CATV equipment accounted for 1.6%, 0.8% and 0.8% of our revenue, respectively.

## Industry Background

During 2019, our four target markets, internet data center, CATV, telecom and FTTH, experienced a significant growth in bandwidth consumption and the corresponding need for network infrastructure improvement to support this growth.

The prevailing trends in our target markets include:

- **Trends in the Internet Data Center Market.** To support the substantial increase in bandwidth consumption, internet data center operators are increasing the scale of their internet data centers and deploying infrastructure capable of data transmission rates. As a result, there is an ongoing transition from the use of copper cable, typically at speeds of up to 1 gigabit per second ("Gbps"), to optical fiber as a transport medium, typically providing speeds from 10 Gbps to 400 Gbps. In recent years, a number of leading internet companies have adopted more open internet data center architectures, using a mix of systems and components from a variety of vendors, and in some cases designing their own equipment. For these companies, compatibility of new networking equipment with legacy infrastructure is not as important, and consequently, these companies are more willing to work with non-traditional equipment vendors, which we believe creates an opportunity for optical device vendors. Moreover, transmission speeds have continued to increase among the companies who have previously transitioned from copper-based to fiber-based infrastructure, resulting in opportunities for optical device vendors to supply new optical transceivers capable of operating at these higher data rates.

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- **Trends in the CATV Market.** In recent years, CATV service providers have invested extensively to support high speed, two-way communications and we expect that they will continue to do so. In North America, in particular, CATV service providers have upgraded their networks with new technologies like DOCSIS 3.1, which enables them to offer higher speed connections to their customers. In order to increase available bandwidth for their customers beyond the bandwidth possible with the introduction of DOCSIS 3.1, cable MSOs have been reducing the number of customers that are connected to a single node. By reducing the number of "homes per node," the average bandwidth available to each customer is increased. Other new technologies, such as Converged Cable Access Platform ("CCAP") and Remote-PHY are under development by cable equipment suppliers. These technologies are being developed to be a cost-effective

solution to provide higher available bandwidth to CATV customers. AOI has developed a unique Remote-PHY product portfolio which started to generate revenue in 2018. We believe this product is well positioned in the marketplace and we expect continued deployments in 2020.

As the complexity of CATV networks has increased over the years, equipment vendors, many of whom are our customers, have been under pressure to supply a wider variety of increasingly complex equipment to CATV MSOs. In order to meet these demands, many equipment vendors have looked to engage with suppliers like AOI, who have the capability to design and manufacture various network equipment or subassemblies, rather than always developing these devices themselves. This outsourcing trend has been a significant contributor to the revenue we derive from the CATV market.

- **Trends in the Telecom Market.** The telecom market is composed of customers who deploy wireline optical networks, other than Passive Optical Networks, or PONs, for telecom access networks, including for backhaul of cellular telephone signals. As demand for mobile internet connectivity has increased in recent years, reliable and high-speed optical networks have become increasingly important. In particular, the use of wavelength division multiplexing ("WDM") to expand the capacity of mobile networks has led to increased demand for WDM components (including lasers and transceivers) by telecom equipment manufacturers. In coming years, we believe that the deployment of advanced 5G networks will result in increased demand for optical components, especially those used in connecting between antennas and base stations, as well as for backhaul as mentioned above.
- **Trends in the FTTH Market.** The FTTH market generally refers to the PONs that telecom service providers deploy. The most commonly deployed PON technology is Gigabit PON, or GPON, which delivers up to 2.5 Gbps of data, but due to the splitting of the bandwidth among multiple users, the actual bandwidth delivered to an individual subscriber is far less than 2.5 Gbps. One approach that does support true 1 Gbps service to the home is wavelength division multiplexing PON, or WDM-PON, a technology that enables the transmission of multiple wavelengths of data over a single fiber-optic strand. We also see opportunities for 10 Gbps EPON and higher data rate PON networks in the future.

## Our Solutions

We experience certain challenges within our target markets, including continuous pressure to innovate and deliver highly integrated products that perform reliably in harsh, demanding environments and to produce high-quality devices in large volumes at competitive prices.

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By addressing the challenges in our target markets, we provide the following benefits to our customers:

- **Enable customers to deliver innovative products.** We leverage our extensive expertise in high-speed optical, mixed-signal semiconductor and mechanical engineering, and MOCVD and our proprietary MBE laser fabrication process to deliver technologically advanced products to our customers.
- **Enhance efficiency and cost effectiveness of our customers' supply chains.** We design and sell products at the level of integration desired by a customer, from components to turn-key equipment, providing our customers a dependable, cost-effective and simplified supply chain.
- **Deliver high quality, reliable products in high volume.** As a vertically integrated supplier, we are able to monitor and maintain quality control throughout the production process, using our internally produced components, where possible, for our final products. With manufacturing facilities in the U.S., Taiwan and China, we can support high volume production and timely delivery for our customers around the world.
- **Provide sophisticated design solutions to our customers.** We believe our in-house expertise in both analog and digital optical engineering enables us to design comprehensive solutions that meet many of the different network architectures and protocols used by our customers.

## Our Strengths

Our key competitive strengths include the following:

- **Proprietary technological expertise and track record of innovation.** We continue to develop innovative products by leveraging our technological expertise, including our proprietary MBE and MOCVD laser fabrication process.
- **Innovative light engine design and manufacturing.** High-speed data center interconnect transceivers increasingly rely on multiple parallel optical signals. Our expertise in designing and manufacturing light engines, which combine lasers and photodiodes, and in some cases, driver electronics and/or signal amplifiers, with channel

multiplexing and de-multiplexing elements, gives us the ability to quickly develop new products for our data center customers.

- **Proven system design capabilities.** We have extensive expertise and proven design capabilities in high-speed optical, mixed-signal semiconductor and mechanical engineering, which we believe position us to take advantage of the continuing shift to outsourced design and manufacturing among CATV equipment vendors.
- **Industry-leading position in the CATV market.** We have continued to be awarded new design and manufacturing opportunities for CATV components and equipment. We serve a majority of the largest CATV equipment manufacturers in the world and our knowledge of both their requirements and the needs of their customers (the CATV network operators) allows us to access these new opportunities.
- **Vertically integrated, geographically distributed manufacturing model.** Our vertically integrated design and manufacturing process encompasses various steps from laser design and fabrication to complete optical system design and assembly. Furthermore, we have geographically distributed our manufacturing by strategically locating our operations in the U.S., China and Taiwan to reduce development time and production costs, to better support our customers and to help protect our intellectual property.

## Our Strategy

We seek to be the leading global provider of optical components, modules and equipment for each of our four target markets: internet data centers, CATV, telecom and FTTH. Our strategy includes the following key elements:

- **Continue to penetrate the internet data center market.** In the internet data center market, we primarily target internet data center operators who have adopted an open system architecture—one in which the optical connectivity solutions can be provided by a different vendor than the vendor which provides their servers and switches.

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- **Extend our leadership in CATV networking.** We intend to maintain our position as a leading producer of optical components used in CATV networks, and to capture an increasing share of the CATV equipment market as the major equipment vendors continue to outsource the design and manufacturing of such products.
- **Develop new products for the Telecom market.** Our addressable telecom market has often been limited by our relatively small portfolio of products for this market. In many cases, our telecom product offerings are identical or nearly identical to products that we sell in other markets (for example, CATV or internet data center). As we continue to develop new technological capabilities, we intend to develop products specifically for telecom markets.
- **Continue to penetrate the FTTH market.** We believe our WDM-PON technology is a cost-effective solution for delivering 1 Gbps bandwidth to a home. We intend to capture an increasing share of the FTTH market by delivering optical modules enabling 1 Gbps synchronous service to the home through our customers, who are either internet service providers or manufacturers of networking equipment supplying internet service providers. Besides WDM-PON, we also believe that PON networks operating at 10 Gbps or higher will be in demand by certain customers in the future and we intend to develop components for these networks.
- **Continue to invest in our capabilities and infrastructure.** We intend to continue to invest in new products, new technology and our production infrastructure and facilities to maintain and strengthen our competitive position. We engage in an active research and development program to develop new products and enhance existing products.
- **Selectively pursue other opportunities that leverage our existing expertise.** Our expertise in designing and manufacturing outdoor equipment for the CATV industry positions us well to pursue applications that are also characterized by having varying and demanding environments, including wireless and wireline telecom infrastructure, industrial robotics, aerospace and defense, and oil and gas exploration.
- **Pursue complementary acquisition and strategic alliance opportunities.** We evaluate and selectively pursue acquisition opportunities or strategic alliances that we believe will enhance or complement our current product offerings, augment our technology roadmap, or diversify our revenue base.

## Our Technology

We believe that we have technology leadership in four key areas: semiconductor laser manufacturing, electronic technologies that enhance the performance of our lasers, optical hybrid integration and mixed-signal semiconductor design.

- **Differentiated semiconductor laser manufacturing.** We use a combination of MBE and MOCVD processes in the fabrication of our lasers. We believe that the combination of these two epitaxial processes allows our products to benefit from the advantages afforded by each of these techniques. Among the differentiators of MBE relative to MOCVD fabrication are a lower process temperature and the use of solid phase materials rather than gaseous sources to grow wafers and the growth of more highly strained crystals. These factors contribute to longer operating lives of our lasers, improved laser efficiency and threshold current, and other performance attributes that make them well-suited to our target markets. While we believe that these advantages of MBE are important, MBE does have disadvantages including the inability to use certain dopant materials (for example, Iron), difficulty in certain types of regrowth, and the necessity to maintain complex ultra-high vacuum equipment. By utilizing MOCVD in a portion of our production process, we are able to ameliorate some of these disadvantages. However, the epitaxial and processing steps required in the fabrication of our devices are very complex, with numerous critical steps requiring highly precise control. As a result of some of these challenges, production yields and the performance attributes of laser devices are highly variable and optimizing these characteristics requires numerous enhancements and modifications to standard MBE equipment and the MBE process. To our knowledge, we are unique in incorporating MBE processes in the production of communications lasers in high volume, and believe it would be difficult and time-consuming for other vendors to replicate our production technology.

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- **Laser enhancement technology.** Certain properties of the semiconductor lasers predominantly used in traditional communications devices, such as chirp and wavelength drift, negatively affect their ability to transmit signals over long fiber distances or prevent them from transmitting signals with acceptable fidelity in certain applications. We have developed laser enhancement circuitry that can correct many of these deficiencies. We believe that our technology will become more essential with wider deployment of higher capacity CATV and FTTH systems, which place more stringent demands on laser performance.
- **Optical hybrid-integration technology.** Reducing the size, power consumption and complexity of optical devices is essential for achieving the price and performance targets of our customers. Our ability to integrate multiple optical networking functions into a single device and to co-package multiple devices into smaller form factors helps us meet customer requirements, which we believe can also create new opportunities. For instance, the transmission speed between network elements (switches and servers, for example) within the data center has continued to increase. However, the rate at which this data can be converted from electrical signals to optical signals by laser diodes has not increased at the same pace. Therefore, to achieve data rates of 40 Gbps and above, many customers utilize multiple lower data rate lasers co-packaged together into a single optical module, which we refer to as a light engine. The technology required to cost-effectively and reliably co-package these lasers and the associated electronic control circuitry is complex. Our extensive experience with the processes and the manufacturing technologies required to produce these devices gives us a competitive advantage.

Similarly, in FTTH and telecom networks, installing new fiber-optic cable is expensive and difficult, and in some situations prohibitively so for a network service provider. As a consequence, network operators seek to maximize the utilization of their installed fiber plant. In long-haul and metropolitan networks, the number of service providers who deployed WDM technology as fiber utilization rose. Fiber utilization in access networks has risen, but the use of WDM technology in the access segment has been problematic due to the relatively high cost and power consumption of the requisite optical devices. We have developed proprietary miniaturized optical packaging, electronic control circuitry and testing algorithms to create a hybrid WDM-PON solution that addresses these historical impediments that we believe will make WDM-PON a cost-effective alternative for deployment.

- **Mixed-signal design.** As CATV providers continue to evolve from primarily broadcast-video content providers to a mixture of HD video content together with data-connectivity providers, the networks they utilize to offer these services must evolve as well. Older analog networks are giving way to hybrid networks that incorporate both analog and digital signals. For example, many newer networks are being designed with “digital return-path” capabilities, and certain MSOs have begun to deploy “Remote-PHY” technologies. Both of these technologies involve transporting certain network signals in digital format, and then converting these signals to and from analog signals at various points in the MSO’s network. This combination of analog and digital signaling creates unique design challenges. Our engineers have many years of experience in developing equipment, modules and components that are well suited to these sorts of mixed-signal architectures. We believe that having deep experience in both digital and analog signaling allows us to offer superior solutions to our customers, compared with companies who have expertise in only one of these signal types.

## **Our Products**

Our products include an array of optical communications solutions at varying levels of integration. We begin from the fundamental building blocks of lasers and laser components. From these foundational products, we design and manufacture a

wide range of products from optical modules to complete turn-key equipment. We design our products to target customers in our identified markets to meet their needs and specifications.

Our components often incorporate one or more of our optical laser chips inside a precision housing that provides mechanical protection as well as standardized electrical contacts. More complex optical components may also include optical filters (for example, for use in WDM) or other optical elements by which optical signals are routed internally within the component. These more advanced components may also include coolers, heaters and sensors that allow the temperature of the laser chip to be measured and controlled. We manufacture the majority of the laser chips and optical components that are used in our own products.

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At the next level of integration, our module or sub-assembly products typically contain one or more of our optical components and some additional control circuitry. Examples of modules include our transceiver line primarily used in internet data center markets, telecom markets, and FTTH markets.

At the highest level of integration and complexity, our equipment products typically contain one or more optical components, modules and additional electronic control circuitry required to enable these subsystems to operate independently. For example, our CATV transmitter equipment requires utilization of our optical components and assembly onto a circuit board and to an external housing. Examples of equipment include our CATV transmitter and CATV nodes.

#### **Intellectual Property**

We rely on a combination of patent, copyright, trademark, trade secret laws and unfair competition laws, as well as confidentiality and licensing arrangements, to establish and protect our intellectual property. We employ various methods to protect these intellectual property rights, including maintaining a technological infrastructure with significant security measures, limiting disclosure and restricting access to only those individuals with an operational need for such information, and having employees, consultants and suppliers execute confidentiality agreements with us. While we expect our intellectual property to provide competitive advantages, we also find meaningful value from unpatented proprietary process knowledge, know-how and trade secrets.

##### *Patents*

As of December 31, 2019, we owned a total of 149 U.S. issued patents and 142 patents issued in China and Taiwan, plus a number of pending U.S. and foreign/international patent applications. Our issued U.S. and foreign patents will expire between 2020 and 2040. While our patents are an important element of our success, our business as a whole is not dependent on any one patent or group of patents. We do not anticipate any material effect on our business due to any patents expiring in 2020, and we continue to obtain new patents through our ongoing research and development.

Our portfolio of patents and patent applications covers several different technology families including:

- laser structure and design;
- optical signal conditioning and laser control;
- laser fabrication;
- photodiode and optical receiver design and fabrication;
- optical device and module designs;
- optical device packaging equipment and techniques; and
- optical network enhancements.

##### *Trademarks*

We have registered the trademarks APPLIED OPTOELECTRONICS, INC., AOI and our logo with the U.S. Patent and Trademark Office on the Principal Register. These marks are also registered in, or have applications for registration pending in, various foreign trademark offices.

#### **Research and Development**

To maintain our growth and competitiveness, we engage in an active research and development program to develop new products and enhance existing products. As a result of these efforts, we anticipate releasing various new or enhanced products over the next several years. Our research and development expenses were approximately \$43.4 million, \$49.9 million, and \$35.4 million for the years 2019, 2018 and 2017, respectively.

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As of December 31, 2019, we had a total of 306 employees working in the R&D department, including 16 with Ph.D. degrees. We continue to recruit talented engineers to further enhance our research and development capabilities. We have research and development departments in our facilities in Texas, Georgia, China and Taiwan. Our research and development teams collaborate on joint projects, and by co-locating with our manufacturing operations enable us to achieve an efficient cost structure and improve our time to market.

A key factor in our research and development success is our highly collaborative process for new product development. Particularly in our equipment and module businesses, we often collaborate very closely with our customers from a very early stage in product development. By purposefully fostering this close collaboration, we believe that we can more rapidly develop leading solutions meeting the needs of our customers.

## **Manufacturing and Operations**

We have three manufacturing sites: Sugar Land, Texas, Ningbo, China and Taipei, Taiwan. Our research and development functions are generally partnered with our manufacturing locations, and we have an additional research and development facility in Duluth, Georgia. In our Sugar Land facility, we manufacture laser chips (utilizing our MBE and MOCVD processes), subassemblies and components. The subassemblies are used in the manufacture of components by our other manufacturing facilities or sold to third parties as modules. We manufacture our laser chips only within our Sugar Land facility, where our laser design team is located. In our Taiwan location, we manufacture optical components, such as our butterfly lasers, which incorporate laser chips, subassemblies and components manufactured within our Sugar Land facility. In addition, in our Taiwan location, we manufacture transceivers for the internet data center, telecom, FTTH and other markets. In our China facility, we take advantage of lower labor costs and manufacture certain more labor intensive components and optical equipment systems, such as optical subassemblies and transceivers for the internet data center market, CATV transmitters (at the headend) and CATV outdoor equipment (at the node). Each manufacturing facility conducts testing on the components, modules or subsystems it manufactures and each facility is certified to ISO 9001:2015. Our facilities in Ningbo, China, Taipei, Taiwan, and Sugar Land, Texas are all certified to ISO 14001:2015.

We sell our products to customers worldwide, and in addition to these external customer sales many of our products are used internally in the production of transceivers and equipment that we manufacture. With a vertically integrated manufacturing process, we produce many of our own laser chips and other parts required to manufacture our optical components. Through this model, we are able to reduce development time and product costs as well as actively monitor and control product quality. We incorporate our own components into our transceivers, subsystems and equipment products wherever possible. In instances where we do not produce components ourselves, we source them from external suppliers and regularly evaluate these relationships in an attempt to reduce risk and lower cost.

We depend on a limited number of suppliers, including in some cases our own internal supply, for certain raw materials and components used in our products. We regularly review our vendor relationships in an attempt to mitigate risks and lower costs, especially where we depend on one or two vendors for critical components or raw materials. While maintaining inventories that we believe are sufficient to meet our near-term needs, we strive not to carry significant inventories of externally sourced raw materials. Accordingly, we maintain ongoing communications with our vendors in order to help prevent any interruptions in supply, and have implemented a supply-chain management program to maintain quality and lower purchase prices through standardized purchasing efficiencies and design requirements.

## **Customers**

Our customers are primarily internet data center operators, CATV and telecom equipment manufacturers, and internet service providers. We generally employ a direct sales model in North America and in the rest of the world we use both direct and indirect sales channels. In 2019, 2018 and 2017, we obtained 98.0%, 96.4%, and 97.0% of our revenue, respectively, through our direct sales efforts and the remainder of our revenue through our indirect sales channels. Our sales channel partners provide logistical services and day-to-day customer support. Where we sell through an indirect sales channel, we work with the end customer to establish technological specifications for our products. Our equipment customers typically offer our equipment under their brand-name and our equipment is often customized with unique design or performance criteria by each of these customers. We also from time to time offer design or manufacturing services to customers to assist them in more effectively using our products and realizing time-to-market advantages.

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In the last three years, we have taken several actions to increase the diversity of our customer base. These actions include hiring sales staff to improve our ability to serve new customers and introduction of new products that we believe will appeal to new customers. Furthermore, we have developed additional original design manufacturer, or ODM, relationships with customers in each of our target markets which should enable us to diversify our revenue base.

In 2019, the three customers who contributed most to our data center revenue were Microsoft, Amazon, and Facebook. Our CATV products were used by three large CATV original equipment manufacturers, or OEMs, consisting of Cisco; CommScope (which in 2019 acquired Arris, who had previously acquired the Motorola Home Business in 2013 and Pace Plc in 2016); and a US-based public company who provides CATV equipment. In 2019, revenue from the internet data center market, CATV market, telecom market, FTTH market and other markets provided 75.2%, 19.6%, 4.4%, 0.1% and 0.7% of our revenue, respectively, compared to 74.9%, 19.3%, 4.9%, 0.3% and 0.6% , respectively, in 2018.

In our telecom market, we manufacture and sell optical products which include transceivers designed to transmit signals used in 5th Generation ("5G") mobile networks, and various products targeted at the metro-scale telecom networking market. We have various other products designed for diverse applications, both inside and outside of communications technology, which generally are derivatives of products developed for our four target markets.

We support our sales efforts by attendance at industry trade shows, technical conferences, advertising in various trade journals and magazines and other promotional efforts. These efforts are aimed at attracting new customers and enhancing our existing customer relationships.

## **Backlog**

We generally make sales pursuant to short-term purchase orders without deposits and subject to rescheduling, revision or cancellation on short notice. We accordingly believe that purchase orders are not an accurate indicator of our future sales and any backlog of purchase orders is not a reliable indicator of our future revenue.

## **Additional Financial Information**

For certain financial information regarding our business, see "Item 6. Selected Financial Data."

## **Competition**

The optical networking market is intensely competitive. Because of the broad nature of our product offerings, we do not believe that we face a single major competitor across all of our markets. We do, however, experience intense competition in each product area from a number of manufacturers and we anticipate that competition will increase. Our major competitors in one or more of our markets include EMCORE Corporation, Finisar Corporation, Foxconn Interconnect Technology Ltd., InnoLight Technology (Suzhou) Ltd., Intel Corporation, Lumentum Holdings, Inc., Mitsubishi, Molex, LLC, Source Photonics, Inc. and Sumitomo Electric Industries, Ltd.

Many of our competitors are larger than we are and have significantly greater financial, marketing and other resources.

In addition, several of our competitors have large market capitalizations or cash reserves and are much better positioned to acquire other companies to gain new technologies or products that may displace our products. Network equipment providers, who are our customers, and network service providers, who are supplied by our customers, may decide to manufacture the optical subsystems incorporated into their network systems in-house. We also encounter potential customers that, because of existing relationships, are committed to the products offered by these competitors.

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We believe the principal competitive factors in our target markets include the following:

- use of internally manufactured components;
- product breadth and functionality;
- timing and pace of new product development;
- breadth of customer base;
- technological expertise;
- reliability of products;

- product pricing; and
- manufacturing efficiency.

We believe that we compete favorably with respect to the above factors based on our MBE and MOCVD processes, our vertically integrated model, the performance and reliability of our product offerings, and our technical expertise in light engine design and manufacture.

## **Seasonality**

See Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Seasonality,” regarding seasonality of certain of the Company’s products.

## **Employees**

As of December 31, 2019, we employed 3,115 full-time employees, of which 42 held Ph.D. degrees in a science or engineering field. Of our employees, 417 are located in the U.S., 920 are located in Taiwan and 1,778 are located in China. None of our employees are represented by any collective bargaining agreement, but certain employees of our China subsidiary are members of a trade union. We have never suffered any work stoppage as a result of an employment related strike or any employee related dispute and believe that we have satisfactory relations with our employees.

## **Environmental Matters**

Our research and development and manufacturing operations and our products are subject to a variety of federal, state, local and foreign environmental, health and safety laws and regulations, including those governing discharges of pollutants to air and water, the use, storage, handling and disposal of hazardous materials and solid wastes, employee health and safety, and the hazardous material content in our products. Our environmental management systems in our facilities in Sugar Land, Texas, Ningbo, China and Taipei, Taiwan are all certified to meet the requirements of ISO14001:2015. However, there can be no assurance that violations of applicable laws at any of our facilities will not occur in the future as a result of human error, accident, equipment failure or other causes. We use, store and dispose of hazardous materials and solid wastes in our manufacturing operations and hazardous materials are present in our products. We incur costs to comply with 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 substantial costs, including cleanup costs, natural resource damages, monetary fines, or administrative, civil or criminal penalties, and subject us to property damage and personal injury claims, and result in injunctive relief including the suspension of production, alteration or upgrades of our manufacturing processes, redesign of our products, or curtailment of sales, and could result in adverse publicity. Liability under environmental, health and safety laws can be joint and several and without regard to fault or negligence. For example, pursuant to environmental laws and regulations, including but not limited to the Comprehensive Environmental Response Compensation and Liability Act, or CERCLA, we may be liable for the full amount of any remediation-related costs at properties we currently own or operate or formerly owned, such as our currently owned Sugar Land, Texas facility, or at properties at which we previously operated, as well as at properties we will own or operate in the future, and properties to which we have sent hazardous substances, whether or not we caused the contamination.

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We expect that our operations and products will be affected by new environmental requirements on an ongoing basis. 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, requires us to obtain additional permits for our activities, or cause us to incur other significant expenses or to modify our manufacturing processes or the hazardous material content of our products. Identification of presently unidentified environmental conditions, more vigorous enforcement by a governmental authority, enactment of more stringent legal requirements or other unanticipated events could give rise to adverse publicity, restrict our operations, affect the design or marketability of our products or otherwise cause us to incur material environmental costs or delays in planned activities.

We face increasing complexity in our product design and procurement operations as we adjust to new and upcoming requirements relating to the materials composition of our products. Some jurisdictions in which our products are sold have enacted requirements regarding the hazardous material content of certain products. For example, member states of the European Union and China are among a growing number of jurisdictions that have placed restrictions on the use of lead, among other chemicals, in electronic products, which affect 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. Other governmental regulations may require us to reengineer our products to use components that are more environmentally compatible, resulting in additional costs to us.

## **Sources of Raw Materials**

We depend on a limited number of suppliers for certain raw materials, components, and equipment used in our products. We continually review our supplier relationships to mitigate risks and lower costs, especially where we depend on one or two suppliers for critical components or raw materials. While maintaining inventories that we believe are sufficient to meet our near-term needs, we strive not to carry significant inventories of raw materials. Accordingly, we maintain ongoing communications with our suppliers in order to prevent any interruptions in supply, and have implemented a supply-chain management program to maintain quality and lower purchase prices through standardized purchasing efficiencies and design requirements. To date, we generally have been able to obtain sufficient quantities of critical supplies in a timely manner.

We are subject to rules promulgated by the SEC pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding the use of "conflict minerals". These rules have imposed and will continue to impose additional costs and may introduce new risks related to our ability to verify the origin of any "conflict minerals" used in our products.

## **Export Regulations**

The Bureau of Industry and Security (BIS) of the U.S. Department of Commerce is responsible for regulating the export of most commercial items that are classified as dual-use goods that may have both commercial and military applications. Our products are classified under Export Control Classification Numbers, or ECCNs, 5A991 and 6A995. Export Control Classification requirements are dependent upon an item's technical characteristics, the destination, the end-use, and the end-user, and other activities of the end-user. Should the ECCN change, then the export of our products to certain countries would be restricted. However, we currently do not export our products to any countries on the restricted list, and therefore a change in the ECCN would not materially impact our business.

## **Corporate Information**

We were incorporated in the State of Texas in 1997. In March 2013, Applied Optoelectronics, Inc., a Texas corporation, converted into a Delaware corporation. Prime World International Holdings, Ltd. ("Prime World") is a wholly-owned subsidiary of the Company incorporated in the British Virgin Islands on January 13, 2006. Prime World is the parent company of Global Technology, Inc. ("Global"). Global was established in June 2002 in the People's Republic of China ("PRC") and was acquired by Prime World on March 30, 2006. Prime World also operates a division in Taiwan, which is qualified to do business in Taiwan and primarily manufactures transceivers and performs research and development activities.

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Our principal executive offices are located at 13139 Jess Pirtle Blvd., Sugar Land, TX 77478, and our telephone number is (281) 295-1800. Our website address is [www.ao-inc.com](http://www.ao-inc.com). Information contained on our website is not incorporated by reference into this 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.ao-inc.com](http://www.ao-inc.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**

*Investing in our common stock involves a high degree of risk. You should carefully consider the following risk factors and all other information contained in our Form 10-K, including our consolidated financial statements and related notes. If any of the following risks actually occur, we may be unable to conduct our business as currently planned and our financial condition and results of operations could be seriously harmed. In addition, the trading price of our common stock could decline due to the occurrence of any of these risks and you may lose all or part of your investment.*

## **Risks Inherent in Our Business**

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

We generate much of our revenue from a limited number of customers. For each year ended 2019, 2018 and 2017, our top ten customers represented 88.1%, 92.9%, and 94.9% of our revenue, respectively. In 2019, Microsoft represented 32.2% of our revenue, Amazon represented 24.0% of our revenue, Facebook represented 10.9% of our revenue, and Cisco represented 10.0% of our revenue. As a result, the loss of, or a significant reduction in orders from any of our key customers would

materially and adversely affect our revenue and results of operations. We typically do not have long-term contracts with our customers and instead rely on recurring purchase orders. However, many of our current revenue expectations and forecasts reflect significant anticipated orders from a limited number of key customers. If our key customers do not continue to purchase our existing products or fail to purchase additional products from us, our revenue would decline and our results of operations would be adversely affected.

Adverse events affecting our key customers could also negatively affect our ability to retain their business and obtain new purchase orders, which could adversely affect our revenue and results of operations. For example, in recent years, there has been consolidation among various network equipment manufacturers and this trend is expected to continue. We are unable to predict the impact that industry consolidation would have on our existing or potential customers. We may not be able to offset any potential decline in revenue arising from the consolidation of our existing customers with revenue from new customers or additional revenue from the merged company.

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***Customer demand is difficult to forecast accurately and, as a result, we may be unable to 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 product demand and customer requirements. Our products are typically purchased pursuant to individual purchase orders. While our customers may provide us with their demand forecasts, they are typically not contractually committed to buy any quantity of products beyond firm purchase orders. Furthermore, many of our customers may increase, decrease, cancel or delay purchase orders already in place without significant penalty. The short-term nature of commitments by 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 more onerous 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. If any of our major customers decrease, stop or delay purchasing our products for any reason, we will likely have excess manufacturing capacity or inventory and our business and results of operations would be harmed.

***If our customers do not qualify our products for use on a timely basis, our results of operations may suffer.***

Prior to the sale of new products, our customers typically require us to “qualify” our products for use in their applications. At the successful completion of this qualification process, we refer to the resulting sales opportunity as a “design win.” Additionally, new customers often audit our manufacturing facilities and perform other evaluations during this qualification 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 accurately predict the amount of time required to qualify our products with customers, or are unable to qualify our products with certain customers at all, then our ability to generate revenue could be delayed or our revenue would be lower than expected and we may not be able to recover the costs associated with the qualification process or with our product development efforts, which would have an adverse effect on our results of operations.

In addition, due to rapid 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. Some of these unrecoverable expenses for cancelled or unutilized custom design projects may be significant. 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.

Our ability to successfully qualify and scale capacity for new technologies and products is important to our ability to grow our business and market presence, and we may invest a significant amount to scale our capacity to meet potential demand from customers for our new technologies and products. If we are unable to qualify and sell any of our new 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 markets into which we sell our products are highly competitive. Our competitors range from large, international companies offering a wide range of products to smaller companies specializing in niche markets. Current and potential competitors may have substantially greater name recognition, financial, marketing, research and manufacturing resources than we do, and there can be no assurance that our current and future competitors will not be more successful than us in specific product lines or markets. Some of our competitors may also have better-established relationships with our current or potential

customers. Some of our competitors have more resources to develop or acquire new products and technologies and create market awareness for their products and technologies. 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. In recent years, there has been consolidation in our industry and we expect such consolidation to continue. Consolidation involving our competitors could result in even more intense competition. Network equipment manufacturers, who are our customers, and network service providers may decide to manufacture the optical subsystems incorporated into their network systems in-house instead of outsourcing such products to companies such as us. We also encounter potential customers that, because of existing relationships with our competitors, are committed to the products offered by our competitors.

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***We must continually develop successful new products and enhance existing products, and if we fail to do so or if our release of new or enhanced products is delayed, 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. 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.

In addition, due to the costs and length of research, development and manufacturing process cycles, we may not recognize revenue from new products until long after such expenditures, if at all, and our margins may decrease if our costs are higher than expected, adversely affecting our financial condition and results of operations.

Although the length of our product development cycle varies widely by product and customer, it may take 18 months or longer before we receive our first order. As a result, we may incur significant expenses long before customers accept and purchase our products.

Product development delays may result from numerous factors, including:

- modification of product specifications and customer requirements;
- unanticipated engineering complexities;
- difficulties in reallocating engineering resources and overcoming resource limitations; and
- rapidly changing technology or competitive product requirements.

The introduction of new products by us or our competitors and other changes in our customer's demands could result in a slowdown in demand for our existing products and could result in a write-down in the value of our inventory. We have in the past experienced periodic fluctuations in demand for existing products and delays in new product development, and such fluctuations will likely occur in the future. To the extent we fail to qualify our products and obtain their approval for use, which we refer to as a design win, or experience product development delays for any reason, our competitive position would be adversely affected and our ability to grow our revenue would be impaired.

Furthermore, our ability to enter a market with new products in a timely manner can be critical to our success because it is difficult to displace an existing supplier for a particular type of product once a customer has chosen a supplier, even if a later-to-market product provides better performance or cost efficiency.

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 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 revenues, growth rates and operating results are likely to fluctuate significantly as a result of factors that are outside our control, which could adversely impact our operating results.***

Our revenues, growth rates and operating results are likely to fluctuate significantly in the future as a result of factors that are outside our control. We may not achieve similar revenues, growth rates or operating results in future periods. Our revenues, growth rates and operating results for any prior quarterly or annual period should not be relied upon as any indication

of our future revenues, growth rates or operating results. The timing of order placement, size of orders and satisfaction of contractual customer acceptance criteria, changes in the pricing of our products due to competitive pressures as well as order or shipment delays or deferrals, with respect to our products, may cause material fluctuations in revenues. Our lengthy sales cycle, which may extend to more than one year, may cause our revenues and operating results to vary from period to period and it may be difficult to predict the timing and amount of any variation. Delays or deferrals in purchasing decisions by our customers may increase as we develop new or enhanced products for existing and new markets, including automotive and biotechnology markets. Our current and anticipated future dependence on a small number of customers increases the revenue impact of each such customer's decision to delay or defer purchases from us, or decision not to purchase products from us. Our expense levels in the future will be based, in large part, on our expectations regarding future revenue sources and, as a result, operating results for any quarterly period in which anticipated material orders fail to occur, or are delayed or deferred, could be significantly harmed.

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***Continued tension in U.S.-China trade relations may adversely impact our business and operating results.***

The U.S. government has made statements and amended its U.S. trade policies, resulting in tariffs that affect imported products manufactured in China, by our Chinese subsidiary. In addition, the Chinese government has imposed reciprocal tariffs that affect products manufactured by our U.S. operations. The additional tariffs have increased our cost of goods sold, however we believe that the negative impact of these tariffs has not been material to our financial results. Although we cannot predict the impact of any future tariffs, we intend to continue to adjust our manufacturing processes, supplier lists, and manufacturing locations in order to minimize the impact of any tariffs on both AOI and our customers.

It is unknown whether and to what extent additional new tariffs (or other new laws or regulations) will be adopted that increase the cost of importing and/or exporting products to or from the United States, or from China to the United States. Furthermore, it is unknown what effect that any such new tariffs or retaliatory actions would have on us or our industry and customers. As additional new tariffs, legislation and/or regulations are implemented, or if existing trade agreements are renegotiated or if China or other affected countries take retaliatory trade actions, such changes could have a material adverse effect on our business, financial condition, results of operations or cash flows.

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

In each of our target markets, including the CATV market, our sales depend on 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. 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 these cyclical fluctuations, and we may experience substantial period to period fluctuations in our future results of operations. Any future downturn in any of the markets in which we compete could significantly reduce the demand for our products and therefore may result in a significant reduction in our revenue. 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 any of the markets utilizing our products. We may not be able to accurately predict these cyclical fluctuations and the impact that these fluctuations may have on our revenue and operating results.

***If we encounter manufacturing problems, we may lose sales and damage our customer relationships.***

We may experience delays, disruptions or quality control problems in our manufacturing operations. These and other factors may cause less than acceptable yields at our facility. Manufacturing yields depend on a number of factors, including the quality of available raw materials, the degradation or change in equipment calibration and the rate and timing of the introduction of new products. Changes in manufacturing processes required as a result of changes in product specifications, changing customer needs and the introduction of new product lines may significantly reduce our manufacturing yields, resulting in low or negative margins on those products. In addition, we use our Molecular Beam Epitaxy, or MBE, fabrication process to make our lasers, in addition to Metal Organic Chemical Vapor Deposition, or MOCVD, the technique most commonly used in optical manufacturing by communications optics vendors, and our MBE fabrication process relies on custom-manufactured equipment. If our MBE or MOCVD fabrication facility in Sugar Land, Texas were to be damaged or destroyed for any reason, our manufacturing process would be severely disrupted. Any such manufacturing problems would likely delay product shipments to our customers. For example, shipments of certain of our 100 Gbps transceiver products to one of our customers decreased during the three months ended September 30, 2018 due to customer concerns about failures of similar products shipped previously. Although we conducted extensive testing of our products to demonstrate that any potentially affected units could be nearly eliminated from future shipments, and we subsequently resumed shipments with the customer's agreement, we did incur additional testing costs and costs to enhance the ongoing monitoring of product quality which adversely affected the results of our operations. It is unclear the extent to which our reputation with this customer, or other customers, may have been affected.

Manufacturing problems and any such delays would negatively affect our sales and revenue and could negatively affect our competitive position and reputation. We may also experience delays in production, typically in February, during the Lunar New Year holiday when our facilities in China and Taiwan are closed.

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***Given the high fixed costs associated with our vertically integrated business, a reduction in demand for our products will likely adversely impact our gross profits and our results of operations.***

We have a high fixed cost base due to our vertically integrated business model, including the fact that 2,719 of our employees as of December 31, 2019 were employed in manufacturing and research and development operations. We may not be able to adjust these fixed costs quickly to adapt to rapidly changing market conditions. Our gross profit and gross margin are greatly affected by our sales volume and volatility on a quarterly basis and the corresponding absorption of fixed manufacturing overhead expenses. In addition, because we are a vertically integrated manufacturer, insufficient demand for our products may subject us to the risk of high inventory carrying costs and increased inventory obsolescence. Given our vertical integration, the rate at which we turn inventory has historically been low when compared to our cost of sales. We do not expect this to change significantly in the future and believe that we will have to maintain a relatively high level of inventory compared to our cost of sales. As a result, we continue to expect to have a significant amount of working capital invested in inventory. We may be required to write down inventory costs in the future and our high inventory costs may have an adverse effect on our gross profits and our results of operations.

***Increasing costs and shifts in product mix may adversely impact our gross margins.***

Our gross margins on individual products and among products fluctuate over each product's life cycle. Our overall gross margins have fluctuated from period to period as a result of shifts in product mix, the introduction of new products, decreases in average selling prices and our ability to reduce product costs, and these fluctuations are expected to continue in the future. We may not be able to accurately predict our product mix from period to period, and as a result we may not be able to forecast accurately our overall gross margins. The rate of increase in our costs and expenses may exceed the rate of increase in our revenue, either of which would materially and adversely affect our business, our results of operations and our financial condition.

***If the CATV market does not continue to develop as we expect, or if there is any downturn in this market, our business would be adversely affected.***

Historically, we have generated much of our revenue from the CATV market. In 2019, 2018 and 2017, the CATV market represented 19.6%, 19.3%, and 15.9% of our revenue, respectively. In the CATV market, we are relying on expected increasing demand for bandwidth-intensive services and applications such as on-demand television programs, high-definition television channels, or HDTV, social media, peer-to-peer file sharing and online video creation and viewing from network service providers. Without network and bandwidth growth, the need for our products will not increase and may decline, adversely affecting our financial condition and results of operations. Although demand for broadband access is increasing, network and bandwidth growth may be limited by several factors, including an uncertain regulatory environment, high infrastructure costs to purchase and install equipment and uncertainty as to which competing content delivery solution, such as telecom, wireless or satellite, will gain the most widespread acceptance. If the trend of outsourcing for the design and manufacture of CATV equipment does not continue, or continues at a slower pace than currently expected, our customers' demand for our design and manufacturing services may not grow as quickly as expected. If expectations for the growth of the CATV market are not realized, our financial condition and results of operations will be adversely affected. In addition, if the CATV market is adversely impacted, whether due to competitive pressure from telecom service providers, regulatory changes, or otherwise, our business would be adversely affected. We may not be able to offset any potential decline in revenue from the CATV market with revenue from new customers in other markets.

***We have limited operating history in the telecom and FTTH markets, and our business could be harmed if these markets do not develop as we expect.***

For 2019 and 2018, respectively, we generated 4.4% and 4.9% of our revenue from the telecom market and 0.1% and 0.3% of our revenue from the FTTH market. In the telecom market, we generally have sold products that were originally designed for other markets (such as internet data center or FTTH) or are variations of such products. As we gain experience in this market, we have begun to develop products specifically designed for telecom customers. Given our limited experience in this market, the products that we develop may prove to be unsuitable for customer use, or we may be unable to derive profit margins from this market that are similar to what we derive from our other markets. The products that we offer in the FTTH market are relatively new and have not yet gained widespread customer acceptance. For example, our WDM-PON products

designed for the FTTH market, have not, and may never, gain widespread acceptance by large internet service providers. Our business in this market is dependent on the deployment of our optical components, modules and subassemblies. We are relying on increasing demand for bandwidth-intensive services and telecom service providers' acceptance and deployment of WDM-PON as a technology supporting 1 Gbps service to the home. Without network and bandwidth growth and adoption of our solutions by operators in these markets, we will not be able to sell our products in these markets in high volume or at our targeted margins, which would adversely affect our financial condition and results of operations. For example, WDM-PON technology may not be adopted by equipment and service providers in the FTTH market as rapidly as we expect or in the volumes we need to achieve acceptable margins. Network and bandwidth growth may be limited by several factors, including an uncertain regulatory environment, high infrastructure costs to purchase and install equipment and uncertainty as to which competing content delivery solution, such as CATV, will gain the most widespread acceptance. In addition, as we enter new markets or expand our product offerings in existing markets, our margins may be adversely affected due to competition in those markets and commoditization of competing products. If our expectations for the growth of these markets are not realized, our financial condition and results of operations will be adversely affected.

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***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 operating results have varied in the past and will likely 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:

- the timing, size and mix of sales of our products;
- fluctuations in demand for our products, including the increase, decrease, rescheduling or cancellation of significant customer orders;
- our ability to design, manufacture and deliver products which meet customer requirements in a timely and cost-effective manner;
- new product introductions and enhancements by us or our competitors;
- the gain or loss of key customers;
- the rate at which our present and potential customers and end users adopt our technologies;
- changes in our pricing and sales policies or the pricing and sales policies of our competitors;
- seasonality of certain of our products and manufacturing capabilities;
- quality control or yield problems in our manufacturing operations;
- supply disruption for certain raw materials and components used in our products;
- capacity constraints of our outside contract manufacturers for a portion of the manufacturing process for some of our products;
- length and variability of the sales cycles of our products;
- unanticipated increases in costs or expenses;
- the loss of key employees;
- different capital expenditure and budget cycles for our customers, affecting the timing of their spending for our products;
- political stability in the areas of the world in which we operate;
- fluctuations in foreign currency exchange rates;
- changes in accounting rules;

- changes in or limitations imposed by trade protection laws or other regulatory orders or requirements in the United States or in other countries, including tariffs, sanctions, or other costs, restrictions, or requirements which may affect our ability to import or export our products to or from various countries;
- trade-related government actions that impose barriers or restrictions that would impact our ability to sell or ship products to Huawei or other customers;
- the evolving and unpredictable nature of the markets for products incorporating our solutions; and
- general economic conditions and changes in such conditions specific to our target markets.

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The foregoing factors are difficult to forecast, and these, as well as other factors, could materially adversely affect our quarterly and annual operating results. 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. For these reasons, you should not rely on quarter-to-quarter comparisons of our results of operations as an indicator of future performance. Moreover, our operating results 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 indebtedness and liabilities could limit the cash flow available for our operations, expose us to risks that could adversely affect our business, financial condition and results of operations and impair our ability to satisfy our obligations under our indebtedness.***

As of December 31, 2019, we had approximately \$133.3 million of consolidated indebtedness. We may also incur additional indebtedness to meet future financing needs. Our indebtedness could have significant negative consequences for our security holders and our business, results of operations and financial condition by, among other things:

- increasing our vulnerability to adverse economic and industry conditions;
- limiting our ability to obtain additional financing;
- requiring the dedication of a substantial portion of our cash flow from operations to service our indebtedness, which will reduce the amount of cash available for other purposes;
- limiting our flexibility to plan for, or react to, changes in our business;
- diluting the interests of our existing stockholders as a result of issuing shares of our common stock upon conversion of the Notes; and
- placing us at a possible competitive disadvantage with competitors that are less leveraged than us or have better access to capital.

Our business may not generate sufficient funds, and we may otherwise be unable to maintain sufficient cash reserves, to pay amounts due under our indebtedness, including the Notes, and our cash needs may increase in the future. In addition, our existing Credit Facility with Branch Banking and Trust, contains, and any future indebtedness that we may incur may contain, financial and other restrictive covenants that limit our ability to operate our business, raise capital or make payments under our other indebtedness. If we fail to comply with these covenants or to make payments under our indebtedness when due, then we would be in default under that indebtedness, which could, in turn, result in that and our other indebtedness becoming immediately payable in full.

***We depend on key personnel to develop and maintain our technology and manage our business in a rapidly changing market.***

The continued services of our executive officers and other key engineering, sales, marketing, manufacturing and support personnel is essential to our success. For example, our ability to achieve new design wins depends upon the experience and expertise of our engineers. Any of our key employees, including our Chief Executive Officer, Chief Financial Officer, Senior Vice President and North America General Manager and Senior Vice President and Asia General Manager, may resign at any time. We do not have key person life insurance policies covering any of our employees.

To implement our business plan, we also intend to hire additional employees, particularly in the areas of engineering, manufacturing and sales. Our ability to continue to attract and retain highly skilled employees is a critical factor in our success.

Competition for highly skilled personnel is intense. We may not be successful in attracting, assimilating or retaining qualified personnel to satisfy our current or future needs. Our ability to develop, manufacture and sell our products, and thus our financial condition and results of operations, would be adversely affected if we are unable to retain existing personnel or hire additional qualified personnel.

***Epidemic diseases, or the perception of their effects, could have a material adverse effect on our business, financial condition, results of operation, or cash flows.***

Outbreaks of epidemic, pandemic, or contagious diseases, such as the recent novel coronavirus or, historically, the Ebola virus, Middle East Respiratory Syndrome, Severe Acute Respiratory Syndrome, or the H1N1 virus, could divert medical resources and priorities towards the treatment of that disease. Business disruptions could include disruptions or restrictions on our ability to travel or to distribute our products, as well as temporary closures of our facilities or the facilities of our suppliers and their contract manufacturers. Any disruption of our suppliers and their contract manufacturers or our customers would likely impact our sales and operating results. In addition, a significant outbreak of epidemic, pandemic, or contagious diseases in the human population could result in a widespread health crisis that could adversely affect the economies and financial markets of many countries, resulting in an economic downturn that could affect demand for our products. Any of these events could have a material adverse effect on our business, financial condition, results of operations, or cash flows. For example, as a result of the extension of the Lunar New Year holidays due to the recent outbreak of novel coronavirus originating in Wuhan, China, certain of our product shipments from China have been delayed. Although we are monitoring the situation on a daily basis, it is currently unknown whether the outbreak will continue to disrupt our product shipments or impact manufacturing in the region over a prolonged period. If such disruption were to extend over a prolonged period, it could have a material impact on our revenues and our business. Any disruption resulting from similar events on a larger scale or over a prolonged period could cause significant delays in shipments of our products until we are able to resume such shipments, or shift our manufacturing, assembly, or test from the affected contractor to another third-party vendor, if needed. There can be no assurance that alternative capacity could be obtained on favorable terms, if at all.

***We depend on a limited number of suppliers and any supply interruption could have an adverse effect on our business.***

We depend on a limited number of suppliers for certain raw materials and components used in our products. Some of these suppliers could disrupt our business if they stop, decrease or delay shipments or if the materials or components they ship have quality or reliability issues. Some of the raw materials and components we use in our products are available only from a sole source or have been qualified only from a single supplier. Furthermore, other than our current suppliers, there are a limited number of entities from whom we could obtain certain materials and components. We may also face shortages if we experience increased demand for materials or components beyond what our qualified suppliers can deliver. Our inability to obtain sufficient quantities of critical materials or components could adversely affect our ability to meet demand for our products, adversely affecting our financial condition and results of operations.

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We typically have not entered into long-term agreements with our suppliers and, therefore, our suppliers could stop supplying materials and components to us at any time or fail to supply adequate quantities of materials or components to us on a timely basis. It is difficult, costly, time consuming and, on short notice, sometimes impossible for us to identify and qualify new suppliers. Our customers generally restrict our ability to change the components in our products. For more critical components, any changes may require repeating the entire qualification process. Our reliance on a limited number of suppliers or a single qualified vendor may result in delivery and quality problems, and reduced control over product pricing, reliability and performance.

***We depend upon outside contract manufacturers for a portion of the manufacturing process for some of our products.***

Almost all of our products are manufactured internally. However we also rely upon manufacturers in China, Taiwan and other Asia locations to provide back-end manufacturing and produce the finished portion of a few of our products. Our reliance on a contract manufacturer for these products makes us vulnerable to possible capacity constraints and reduced control over delivery schedules, manufacturing yields, manufacturing quality/controls and costs. If one or more of our contract manufacturers is unable to meet our customer demand in a timely fashion, this could have a material adverse effect on the revenue from our products. If one or more contract manufacturers for one of our products was unable or unwilling to manufacture such product in required volumes and at high quality levels or to continue our existing supply arrangement, we would have to identify, qualify and select an acceptable alternative contract manufacturer or move these manufacturing operations to our internal manufacturing facilities. An alternative contract manufacturer may not be available to us when needed or may not be in a position to satisfy our quality or production requirements on commercially reasonable terms, including price. Any significant interruption in manufacturing our products would require us to reduce our supply of products to our customers, which in turn, would reduce our revenue, harm our relationships with the customer of these products and cause us to forego potential revenue opportunities.

***Our products could contain defects that may cause us to incur significant costs or result in a loss of customers.***

Our products are complex and undergo quality testing as well as formal qualification by our customers. 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. Any such failures could delay product shipments to our customers or result in a loss of customers. For example, shipments of certain of our 100 Gbps transceiver products to one of our customers decreased during the three months ended September 30, 2018 due to customer concerns about failures of similar products shipped previously. As a result, we could incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. 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. We face this risk because our products are widely deployed in many demanding environments and applications worldwide. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty to maintain customer relationships. Any significant product failure could result in litigation, damages, repair costs and lost future sales of the affected product and other products, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems, all of which would harm our business. Although we carry product liability insurance, this insurance may not adequately cover our costs arising from defects in our products or otherwise.

***Our loan agreements contain restrictive covenants that may adversely affect our ability to conduct our business.***

We have lending arrangements with several financial institutions, including loan agreements with Branch Banking and Trust (BB&T) Bank in the U.S., credit facilities with Taishin International Bank and Far Eastern International Bank, Co., and equipment finance agreements with Chailease Finance Co., Ltd. in Taiwan and credit facilities with China Merchants Bank Co. Ltd., Shanghai Pudong Development Bank Co., Ltd and China Zheshang Bank Co., Ltd. in China. Our loan agreements governing our long-term debt obligations in the U.S. and Asia contain certain financial and operating covenants that limit our management's discretion with respect to certain business matters. Among other things, these covenants require us to maintain certain financial ratios and restrict our ability to incur additional debt, create liens or other encumbrances, change the nature of our business, sell or otherwise dispose of assets and merge or consolidate with other entities. In addition, the Indenture governing the Notes contains covenants that limit our ability and the ability of our subsidiaries to, among other things: (i) incur or guarantee additional indebtedness or issue disqualified stock; and (ii) create or incur liens.

These restrictions may limit our flexibility in responding to business opportunities, competitive developments and adverse economic or industry conditions. Any failure by us or our subsidiaries to comply with these agreements could harm our business, financial condition and operating results. In addition, our obligations under our loan agreements with BB&T are secured by our accounts receivable, inventory, intellectual property, and all business assets including real estate and equipment. Our credit facilities with Shanghai Pudong Development Bank Co., Ltd. and China Zheshang Bank Co., Ltd. are secured by real estate. A breach of any of covenants under our loan agreements, 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.

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***We may not be able to obtain additional capital when desired, on favorable terms or at all.***

We operate in a market that makes our prospects difficult to evaluate and, to remain competitive, we will be required to make continued investments in capital equipment, facilities and technological improvements. We expect that substantial capital will be required to expand our manufacturing capacity and fund working capital for anticipated growth. If we do not generate sufficient cash flow from operations or otherwise have the capital resources to meet our future capital needs, we may need additional financing to implement our business strategy, which includes:

- expansion of research and development;
- expansion of manufacturing capabilities;
- hiring of additional technical, sales and other personnel; and
- acquisitions of complementary businesses.

If we raise additional funds through the issuance of our common stock or convertible securities, the ownership interests of our stockholders could be significantly diluted. These newly issued securities may have rights, preferences or privileges senior to those of existing stockholders. Additional financing may not, however, be available on terms favorable to us, or at all, if and when needed, and our ability to fund our operations, take advantage of unanticipated opportunities, develop or enhance our infrastructure or respond to competitive pressures could be significantly limited. If we cannot raise required capital when needed, including under our Registration Statement filed with the SEC in October 2020, we may be unable to meet the demands

of existing and prospective customers, adversely affecting our sales and market opportunities and consequently our business, financial condition and results of operations.

***Data breaches and cyberattacks could compromise our operations, our customers' operations, or the operations of our contract manufacturers upon whom we rely, and cause significant damage to our business and reputation.***

Cyberattacks have become more prevalent and much harder to detect and defend against. Companies, including companies in our industry, have been increasingly subject to a wide variety of security incidents, cyberattacks and other attempts to gain unauthorized access to their systems or to deny access and disrupt their systems and operations. These threats can come from a variety of sources, ranging in sophistication from an individual hacker to a state-sponsored attack. Cyber threats may be generic, or they may be custom-crafted against our information systems.

In the ordinary course of our business, we and our data center customers maintain sensitive data on our respective networks, including intellectual property, employee personal information and proprietary or confidential business information relating to our business and that of our customers and business partners. The secure maintenance of this information is critical to our business and reputation. Despite our implementation of network security measures, our network and storage applications have been subject to computer viruses, ransomware and other forms of cyber terrorism.

Also, despite our implementation of security measures, we are not able to guarantee that we can prevent unauthorized access by hackers or breaches due to operator error, malfeasance or other system disruptions. Our customers' network and storage applications may be subject to similar disruptions. It is often difficult to anticipate or immediately detect such incidents and the damage caused by such incidents. Data breaches and any unauthorized access or disclosure of our information, employee information or intellectual property could compromise our business, trade secrets and other sensitive business information, any of which could result in legal action against us, exposure of our intellectual property to our competitors, damages, fines and other adverse effects. A data security breach could also lead to public exposure of personal information of our employees, customers and others. Any such theft, loss or misuse of personal data collected, used, stored or transferred by us to run our business could result in significantly increased security costs or costs related to defending legal claims. Cyberattacks, such as computer viruses or other forms of cyber terrorism, have disrupted access to some of our network or storage applications. In past incidents we have been able to recover quickly without material financial impact, however such disruptions in the future may result in delays or cancellations of customer orders or delays or additional costs to produce and ship our products. Data security breaches involving our data center customers could affect their financial condition and ability to continue to purchase our products. Further, cyberattacks may cause us to incur significant remediation costs, result in product development delays, disrupt key business operations and divert attention of management and key information technology resources. These incidents could also subject us to liability, expose us to significant expense and cause significant harm to our reputation and business.

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***Changes in U.S. and international trade policies, particularly with regard to China, may materially and adversely impact our business and operating results.***

The U.S. government has made statements and taken certain actions that have led and may lead to further changes to U.S. and international trade policies, including recently-imposed tariffs affecting certain products manufactured in China. Since the beginning of 2018, there has been increasing rhetoric, in some cases coupled with legislative or executive action, from several U.S. and foreign leaders regarding the possibility of instituting tariffs on the foreign imports of certain materials. Four rounds of U.S. tariffs on imports from China (respectively the "U.S. Tariffs on China Imports") went into effect on July 2018, August 2018, and September 2019. A limited number of our products that have are of Chinese country of origin are currently subject to the U.S. Tariffs on China Imports.

It is unknown whether and to what extent new tariffs (or other new laws or regulations) will be adopted, or the effect that any such actions would have on us or our industry. A significant portion of our manufacturing operations are based in Ningbo, China; therefore, there could be material adverse effects on our business, financial condition, and/or cash flow if any new tariffs, legislation and/or regulations are implemented, or if existing trade agreements are renegotiated or if China or other affected countries take further retaliatory trade actions.

Furthermore, the implementation of trade tariffs both globally and between the U.S. and China specifically carries the risk of negatively impacting China's overall economic condition, which could have negative repercussions on our business. Bilateral tariffs could cause a decrease in the sales of our products to customers located in China or other customers selling to Chinese end users, further impacting our business.

Significant changes to existing international trade agreements could also lead to sourcing or logistics disruption resulting from import delays or the imposition of increased tariffs on our sourcing partners. For example, the Chinese government could, among other things, require the use of local suppliers, compel companies that do business in China to partner with local companies, and otherwise provide government incentives or subsidies to government-backed local customers to buy

from local suppliers. Changes in, and responses to, U.S. trade policy could reduce the competitiveness of our products and thus cause our sales and revenues to drop, which could materially and adversely impact our business and results of operations.

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

We currently derive, and expect to continue to derive, a significant portion of our revenue from sales to international customers. In 2019, 2018 and 2017, 18.8%, 23.1%, and 22.7% of our revenue was derived from sales that occurred outside of North America, respectively. In addition, a significant portion of our manufacturing operations is based in Ningbo, China and Taipei, Taiwan.

Trade-related government actions, by China or other countries that impose barriers or restrictions that would impact our ability to sell or ship products to customers or potential customers may have a negative impact on our financial condition and results of operations. We cannot predict the actions government entities may take in this context and may be unable to quickly offset or effectively react to government actions that restrict our ability to sell to certain customers or in certain jurisdictions. Government actions that affect our customers' ability to sell products or access critical elements of their supply chains may result in a decreased demand for their products, which may consequently reduce their demand for our products.

Our international revenue and operations are subject to a number of material risks, including:

- 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, including the adoption or expansion of governmental trade tariffs;
- 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;

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- trade and travel restrictions;
- domestic and international economic or political changes, hostilities and other disruptions in regions where we currently operate or may operate in the future;
- difficulties and increased expenses in complying with a variety of U.S. and foreign laws, regulations and trade standards, including the Foreign Corrupt Practices Act; and
- different and changing legal and regulatory requirements in the jurisdictions in which we currently operate or may operate in the future.

Negative developments in any of these factors in China or Taiwan 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. Although we maintain certain compliance programs throughout the Company, violations of U.S. and foreign laws and regulations 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.

Our business operations conducted in China and Taiwan are important to our success. A substantial portion of our property, plant and equipment is located in China and Taiwan. We expect to make further investments in China and Taiwan in the future. Therefore, our business, financial condition, results of operations and prospects are subject to economic, political, legal, and social events and developments in China and Taiwan. Factors affecting military, political or economic conditions in China and Taiwan could have a material adverse effect on our financial condition and results of operations, as well as the market price and the liquidity of our common shares.

***In some instances, we rely on third parties to assist in selling our products, and the failure of those parties to perform as expected could reduce our future revenue.***

Although we primarily sell our products through direct sales, we also sell our products to some of our customers through third party sales representatives and distributors. Many of such third parties also market and sell 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.

***Changes in our effective tax rate may adversely affect our results of operation and our business.***

We are subject to income taxes in the U.S. and other foreign jurisdictions, including China and Taiwan. In addition, we are subject to various state taxes in states where we have nexus. We base our tax position on the anticipated nature and conduct of our business and our understanding of the tax laws of the countries and states in which we have assets or conduct activities. Our tax position may be reviewed or challenged by tax authorities. Moreover, the tax laws currently in effect may change, and such changes may have retroactive effect, such as the U.S. tax reform legislation commonly referred to as the U.S. Tax Cuts and Jobs Act of 2017 (the “Tax Act”). We have inter-company arrangements in place providing for administrative and financing services and transfer pricing, which involve a significant degree of judgment and are often subject to close review by tax authorities. The tax authorities may challenge our positions related to these agreements. If the tax authorities successfully challenge our positions, our effective tax rate may increase, adversely affecting our results of operation and our business.

The Tax Act made broad and complex changes to the U.S. tax code, including, but not limited to, (1) reducing the U.S. federal corporate tax rate from 35 percent to 21 percent; (2) requiring companies to pay a one-time transition tax (“Transition Tax”) on certain unrepatriated earnings of foreign subsidiaries; (3) generally eliminating U.S. federal income taxes on dividends from foreign subsidiaries; (4) a new provision designed to tax global intangible low-taxed income (“GILTI”); (5) eliminating the corporate alternative minimum tax (“AMT”) and changing how existing AMT credits can be realized; (6) creating the base erosion anti-abuse tax (“BEAT”), a new minimum tax; (7) creating a new limitation on deductible interest expense; and (8) a limitation of the deduction for net operating losses generated after December 31, 2017 to 80% of current year taxable income and the elimination of net operating loss carrybacks.

As a result, the Tax Act significantly changed how the U.S. taxes corporations. The Tax Act requires complex computations to be performed that were not previously required in U.S. tax law, significant judgments to be made in interpretation of the provisions of the Tax Act and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury Department, the IRS, and other standard-setting bodies could interpret or issue guidance on how provisions of the Tax Act will be applied or otherwise administered that is different from our interpretation. As we interpret any additional guidance, we may make adjustments to amounts that we have recorded that may materially impact our provision for income taxes in the period in which the adjustments are made.

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***Failure to manage our growth effectively may adversely affect our financial condition and results of operations.***

Successful implementation of our business plan in our target markets requires effective planning and management. Production volumes for some of our products are increasing and we have announced plans to increase our production capacity in response to demand for certain of our current and future products, including adding personnel in some of our locations as well as expanding our physical manufacturing facilities. We currently operate facilities in Sugar Land, Texas, Ningbo, China, Taipei, Taiwan, and Duluth, Georgia. We currently manufacture our lasers using a proprietary process and customized equipment located only in our Sugar Land, Texas facility, and it will be costly to duplicate that facility, to scale our laser manufacturing capacity or to mitigate the risks associated with operating a single facility. The challenges of managing our geographically dispersed operations have increased and will continue to increase the demand on our management systems and resources. Moreover, we are continuing to improve our financial and managerial controls, reporting systems and procedures. Any failure to manage our expansion and the resulting demands on our management systems and resources effectively may adversely affect our financial condition and results of operations.

***Future acquisitions may adversely affect our financial condition and results of operations.***

As part of our business strategy, we may pursue acquisitions of companies that we believe could enhance or complement our current product portfolio, augment our technology roadmap or diversify our revenue base. Acquisitions involve numerous risks, any of which could harm our business, including:

- difficulties integrating the acquired business;
- unanticipated costs, capital expenditures or liabilities or changes related to research in progress and product development;

- diversion of financial and management resources from our existing business;
- difficulties integrating the business relationships with suppliers and customers of the acquired business with our existing business relationships;
- risks associated with entering markets in which we have little or no prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

Acquisitions may also result in the recording of goodwill and other intangible assets subject to potential impairment in the future, adversely affecting our operating results. We may not achieve the anticipated benefits of an acquisition if we fail to evaluate it properly, and we may incur costs in excess of what we anticipate. A failure to evaluate and execute an acquisition appropriately or otherwise adequately address these risks may adversely affect our financial condition and results of operations.

***We may be subject to disruptions or failures in information technology systems and network infrastructures that could have a material adverse effect on our business and financial condition.***

We rely on the efficient and uninterrupted operation of complex information technology systems and network infrastructures to operate our business. A disruption, infiltration or failure of our information technology systems as a result of software or hardware malfunctions, system implementations or upgrades, computer viruses, third-party security breaches, employee error, theft or misuse, malfeasance, power disruptions, natural disasters or accidents could cause a breach of data security, loss of intellectual property and critical data and the release and misappropriation of sensitive competitive information and partner, customer, and employee personal data. Any of these events could harm our competitive position, result in a loss of customer confidence, cause us to incur significant costs to remedy any damages and ultimately materially adversely affect our business and financial condition.

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***Our future results of operations may be subject to volatility as a result of exposure to fluctuations in currency exchange rates.***

We have significant foreign currency exposure and are affected by fluctuations among the U.S. dollar, the Chinese Renminbi, or RMB, and the New Taiwan dollar, or NT dollar, because a substantial portion of our business is conducted in China and Taiwan. Our sales, raw materials, components and capital expenditures are denominated in U.S. dollars, RMB and NT dollars in varying amounts.

Foreign currency fluctuations may adversely affect our revenue and our costs and expenses, and hence our results of operations. The value of the NT dollar or the RMB against the U.S. dollar and other currencies may fluctuate and be affected by, among other things, changes in political and economic conditions. The RMB currency is no longer being pegged solely to the value of 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. In addition, our currency exchange variations may be magnified by Chinese exchange control regulations that restrict our ability to convert RMB into foreign currency.

Our sales in Europe are denominated in U.S. dollars and fluctuations in the Euro or our customers' other local currencies relative to the U.S. dollar may impact our customers and affect our financial performance. If our customers' local currencies weaken against the U.S. dollar, we may need to lower our prices to remain competitive in our international markets which could have a material adverse effect on our margins. If our customers' local currencies strengthen against the U.S. dollar and if the local sales prices cannot be raised due to competitive pressures, we will experience a deterioration of our margins.

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.

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

Our operations in the U.S., China and Taiwan could be subject to significant risk of natural disasters, including earthquakes, hurricanes, typhoons, flooding and tornadoes, as well as other catastrophic events, such as epidemics, terrorist attacks or wars. For example, our corporate headquarters and wafer fabrication facility in Sugar Land, Texas is located near the Gulf of Mexico, an area that is susceptible to hurricanes. We use a proprietary MBE laser manufacturing process that requires customized equipment, and this process is currently conducted and located solely at our wafer fabrication facility in Sugar Land, Texas, such that a natural disaster, terrorist attack or other catastrophic event that affects that facility would materially harm our operations. In addition, our manufacturing facility in Taipei, Taiwan, is susceptible to typhoons and earthquakes, and

our manufacturing facility in Ningbo, China, has from time to time, suffered electrical outages. Any disruption in our manufacturing facilities arising from these and other natural disasters or other catastrophic events could cause significant delays in the production or shipment of our products until we are able to shift production to different facilities or arrange for third parties to manufacture our products. We may not be able to obtain alternate capacity on favorable terms or at all. Our property insurance coverage with respect to natural disaster is limited and is subject to deductible and coverage limits. Such coverage may not be adequate or continue to be available at commercially reasonable rates and terms. The occurrence of any of these circumstances may adversely affect our financial condition and results of operation.

***Our business could be negatively impacted as a result of shareholder activism.***

In recent years, shareholder activists have become involved in numerous public companies. Shareholder activists frequently propose to involve themselves in the governance, strategic direction, and operations of the Company. We may in the future become subject to such shareholder activity and demands. Such demands may disrupt our business and divert the attention of our management and employees, and any perceived uncertainties as to our future direction resulting from such a situation could result in the loss of potential business opportunities, be exploited by our competitors, cause concern to our current or potential customers, and make it more difficult to attract and retain qualified personnel and business partners, all of which could adversely affect our business. In addition, actions of activist shareholders may cause significant fluctuations in our stock price based on temporary or speculative market perceptions or other factors that do not necessarily reflect the underlying fundamentals and prospects of our business.

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***The unfavorable outcome of any pending or future litigation or administrative action and expenses incurred in connection with litigation could result in financial losses or harm to our business.***

We are, and in the future may be, subject to legal actions in the ordinary course of our operations, both domestically and internationally. There can be no assurances as to the favorable outcome of any litigation. In addition it can be costly to defend litigation and these costs could negatively impact our financial results. As disclosed in "Item 3. Legal Proceedings," on August 5, 2017, we and certain of our officers are currently subject to class action litigation related to allegations that we made materially false and misleading statements or failed to disclose material facts. Such litigation includes requests for damages and other relief. As further described in that section, subsequent derivative actions and securities class actions have since been filed. This litigation and any other such litigation could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm 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 operations could be materially harmed.***

Our success depends 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 patents in the U.S. and in other foreign countries, some of which have been issued. In addition, we have registered certain trademarks in the U.S. We cannot guarantee that our pending applications will be approved by the applicable governmental authorities. Moreover, our existing and future patents and trademarks may not be sufficiently broad to protect our proprietary rights or may be held invalid or unenforceable in court. A failure to obtain patents or trademark registrations or a successful challenge to our patents and trademark registrations in the U.S. or other foreign countries may limit our ability to protect the intellectual property rights that these patent and trademark 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. We may seek to secure comparable intellectual property protections in other countries. However, the level of protection afforded by patent and other laws in other countries may not be comparable to that afforded in the U.S.

We also 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 end their employment, 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, misappropriated or duplicated, 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. We may not prevail in such proceedings, and an adverse outcome may adversely impact our competitive advantage or otherwise harm our financial condition and our business.

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***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. While we have a policy in place that is designed to reduce the risk of infringement of intellectual property rights of others and we have conducted a limited review of other companies' relevant patents, there can be no assurance that third parties will not assert infringement claims against us. We cannot be certain that our products would not be found infringing on the 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. Intellectual property claims against us could force us to do one or more of the following:

- obtain from a third party claiming infringement a license to 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.

In any potential intellectual property dispute, our customers could also become the target of litigation. Because we often indemnify our customers for intellectual property claims made against them with respect to our products, any claims against our customers could trigger indemnification claims against us. These obligations could result in substantial expenses such as legal expenses, damages for past infringement or royalties for future use. Any indemnity claim could also adversely affect our relationships with our customers and result in substantial costs to us.

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

From time to time we may choose to or be required to license technology or intellectual property from third parties in connection with the development of our products. We cannot assure you that third party licenses will be available to us on commercially reasonable terms, if at all. Generally, a license, if granted, would include payments of up-front fees, ongoing royalties or both. These payments or other terms could have a significant adverse impact on our results of operations. Our 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, any 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.

***If we fail to maintain an effective system of disclosure controls and internal control over financial reporting, 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. The Sarbanes-Oxley Act requires, among other things, that as a publicly-traded company we disclose whether our internal control over financial reporting and disclosure controls and procedures are effective.

We have implemented a system of disclosure and internal controls that we believe provide reasonable assurance that we will be able to timely report our financial results and avoid accounting errors or material weaknesses in future periods. However, our internal controls cannot guarantee that no accounting errors exist or that all accounting errors, no matter how immaterial, will be detected because a control system, no matter how well designed and operated, can provide only reasonable, but not absolute assurance that the control system's objectives will be met. If we are unable to implement and maintain an effective system of disclosure controls and internal control over financial reporting, our ability to accurately and timely report our financial results could be adversely impacted. This could result in late filings of our annual and quarterly reports under the Exchange Act, restatements of our consolidated financial statements, a decline in our stock price, suspension or delisting of our common stock by NASDAQ, or other material adverse effects on our business, reputation, results of operations or financial condition.

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***Our ability to use our net operating losses and certain other tax attributes may be limited.***

As of December 31, 2019, we had U.S. accumulated net operating losses, or NOLs, of approximately \$75.9 million, federal and state research and development credits ("R&D credits") of \$8.3 million, interest expense of \$0.8 million and foreign tax credits of \$4.6 million for U.S. federal income tax purposes. Our ability to use our net operating losses, or NOLs, to offset future taxable income may be subject to certain limitations which could subject our business to higher tax liability. We may be limited in the portion of NOL carryforwards that we can use in the future to offset taxable income for U.S. federal and state income tax purposes, and federal tax credits to offset federal tax liabilities. Sections 382 and 383 of the Internal Revenue Code of 1986, as amended, limit the use of NOLs and tax credits after a cumulative change in corporate ownership of more than 50% occurs within a three-year period. The statutes place a formula limit on how much NOLs and tax credits a corporation can use in a tax year after a change in ownership. Avoiding an ownership change is generally beyond our control. Although the ownership changes we experienced in the past and in the year ended December 31, 2019 had not prevented us from using all NOLs and tax credits accumulated before such ownership changes, we could experience another ownership change that might limit our use of NOLs and tax credits in the future. Under the Tax Cuts and Jobs Act of 2017, or Tax Act, NOLs from tax years that began after December 31, 2017 do not expire, but NOLs from tax years that began before January 1, 2018 expire after 20 years. Further, under the Tax Act, although the treatment of tax losses generated in taxable years ending before December 31, 2017 has generally not changed, tax losses generated in taxable years beginning after December 31, 2017 may offset no more than 80% of taxable income annually. Accordingly, if we generate NOLs after the tax year ended December 31, 2017, we might have to pay more federal income taxes in a subsequent year as a result of the 80% taxable income limitation than we would have had to pay under the law in effect before the Tax Act.

***Our manufacturing operations are subject to environmental regulation that could limit our growth or impose substantial costs, adversely affecting our financial condition and results of operations.***

Our properties, operations and products are subject to the environmental laws and regulations of the jurisdictions in which we operate and sell products. These laws and regulations govern, among other things, air emissions, wastewater discharges, the management and disposal of hazardous materials and solid wastes, the contamination of soil and groundwater, employee health and safety and the content, performance, packaging and disposal of products. Our failure to comply with current and future environmental laws and regulations, or the identification of contamination for which we are liable, could subject us to substantial costs, including fines, clean-up costs, natural resource damages, third-party property damages or personal injury claims, administrative, civil or criminal penalties and could result in injunctive relief requiring us to make significant investments to upgrade our facilities, redesign or change our manufacturing processes, redesign our products, or curtail our operations. Liability under environmental, health and safety laws can be joint and several and without regard to fault or negligence. For example, pursuant to environmental laws and regulations, including but not limited to the Comprehensive Environmental Response Compensation and Liability Act, or CERCLA, we may be liable for the full amount of any remediation-related costs at properties we currently own or formerly owned, such as our currently owned Sugar Land, Texas facility, or at properties at which we previously operated, as well as at properties we will own or operate in the future, and properties to which we have sent hazardous substances, whether or not we caused the contamination. Identification of presently unidentified environmental conditions, more vigorous enforcement by a governmental authority, enactment of more stringent legal requirements or other unanticipated events could give rise to adverse publicity, restrict our operations, affect the design or marketability of our products or otherwise cause us to incur material environmental costs, adversely affecting our financial condition and results of operations.

***We are exposed to increased expenses and business risk as a result of Restriction on Hazardous Substances, or RoHS directives.***

Following the lead of the European Union, or EU, various governmental agencies have either already put into place or are planning to introduce regulations that regulate the permissible levels of hazardous substances in products sold in various regions of the world. For example, the RoHS directive for EU took effect on July 1, 2006. The labeling provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU have required their suppliers to be compliant with the new directive. Many of our customers have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort in planning and executing

our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such events, we could experience the following consequences: loss of revenue, damaged reputation, diversion of resources, monetary penalties, and legal action.

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***Failure to comply with the U.S. Foreign Corrupt Practices Act could subject us to penalties and other adverse consequences.***

We are subject to the U.S. Foreign Corrupt Practices Act which generally prohibits U.S. companies from engaging in bribery or other prohibited payments to foreign officials for the purpose of obtaining or retaining business. In addition, we are required to maintain records that accurately and fairly represent our transactions and have an adequate system of internal accounting controls. Foreign companies, including some that may compete with us, may not be subject to these prohibitions, and therefore may have a competitive advantage over us. If we are not successful in implementing and maintaining adequate preventative measures, we may be responsible for acts of our employees or other agents engaging in such conduct. We could suffer severe penalties and other consequences that may have a material adverse effect on our financial condition and results of operations.

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

We are subject to export and import control laws, trade regulations and other trade requirements that limit which products we sell and where and to whom we sell our products. Specifically, the Bureau of Industry and Security of the U.S. Department of Commerce is responsible for regulating the export of most commercial items that are so called dual-use goods that may have both commercial and military applications. Our products are classified under Export Control Classification Numbers, or ECCNs, 5A991 and 6A995. Export Control Classification requirements are dependent upon an item's technical characteristics, the destination, the end-use, the end-user, and other activities of the end-user. Should the regulations applicable to our products change, or the restrictions applicable to countries to which we ship our products change, then the export of our products to such countries could be restricted. As a result, our ability to export or sell our products to certain countries could be restricted, which could adversely affect our business, financial condition and results of operations.

Changes in our products or 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 delayed or decreased sales of our products to existing or potential customers. In such event, our business and results of operations could be adversely affected.

***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 applicable to our products. 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.

***Compliance with regulations related to conflict minerals could increase costs and affect the manufacturing and sale of our products.***

Public companies are required to disclose the use of tin, tantalum, tungsten and gold (collectively, "conflict minerals") mined from the Democratic Republic of the Congo and adjoining countries (the "covered countries") if a conflict mineral(s) is necessary to the functionality of a product manufactured, or contracted to be manufactured, by the Company. We filed our latest conflict minerals report on Form SD on May 29, 2019. We have previously determined, as part of our compliance efforts, that certain products or components we obtain from our suppliers contain conflict minerals. Based on our Reasonable Country of Origin Inquiry on the source of our conflict minerals for the year ended December 31, 2018, we had reason to believe that certain of such conflict minerals likely originated in covered countries. If we are unable to conclude in the future that all our products are free from conflict minerals originating from covered countries, this could have a negative impact on our business, reputation and/or results of operations. We may also encounter challenges to satisfy customers who require that our products be certified as conflict free, which could place us at a competitive disadvantage if we are unable to substantiate such a claim. Compliance with these rules could also affect the sourcing and availability of some of the minerals used in the manufacture of products or components we obtain from our suppliers, including our ability to obtain products or components in sufficient quantities and/or at competitive prices. Certain of our customers are requiring additional information from us regarding the

origin of our raw materials, and complying with these customer requirements may cause us to incur additional costs, such as costs related to determining the origin of any minerals used in our products. Our supply chain is complex and we may be unable to verify the origins for all metals used in our products. We may also encounter challenges with our customers and stockholders if we are unable to certify that our products are conflict free.

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***Some provisions of our named executive officers' agreements regarding change of control or separation of service contain obligations for us to make separation payments to them upon their termination.***

Certain provisions contained in our employment agreements with our named executive officers regarding change of control or separation of service may obligate us to make lump sum severance payments and related payments upon the termination of their employment with us, other than such executive officer's resignation without good reason or our termination of their employment as a result of their disability or for cause. In the event we are required to make these separation payments, it could have a material adverse effect on our results of operations for the fiscal period in which such payments are made.

**Risks Related to Our Operations in China**

Our business operations conducted in China are critical to our success. A total of \$83.3 million, \$143.1 million, and \$122.3 million or 43.6%, 53.6%, and 32.0% , of our revenue in the years ended December 31, 2019, 2018 and 2017 was attributable to our product manufactured at our plant in China, respectively. Additionally, a substantial portion of our property, plant and equipment, 37.1%, 36.8%, and 29.9% as of December 31, 2019, 2018 and 2017, was located in China, respectively. 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.

In addition, the laws, regulations and legal requirements in China, including the laws that apply to foreign-invested enterprises, or FIEs, are subject to frequent changes. The interpretation and enforcement of such laws is uncertain. Protections of intellectual property rights and confidentiality in China may not be as effective as in the U.S. or other countries or regions with more developed legal systems. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention. Any adverse changes to these laws, regulations and legal requirements 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 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 China subsidiary 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 FIEs, 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 China subsidiary may be subject to the uniform income tax rate of 25% unless we are able to qualify for preferential status. Since calendar year 2008, we have qualified for a

preferential 15% tax rate that is available for state-encouraged new high technology enterprises. In order to retain this preferential tax rate, we must meet certain operating conditions, satisfy certain product requirements, meet certain headcount requirements and maintain certain levels of research expenditures. In November 2017, we received approval from the Chinese government to extend this preferential tax treatment for an additional three years, ending November 2020. If we fail to continue to qualify for this preferential rate in the future, we may incur higher tax rates on our income in China. Any future increase in the enterprise income tax rate applicable to us or the expiration or other limitation of preferential tax rates available to us could increase our tax liabilities and reduce our net income.

***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 extremely high and retention of such personnel is a challenge to companies located in or with operations in China. Although direct labor costs do 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.

***Chinese regulation of loans to and direct investment by offshore holding companies in China entities may delay or prevent us from making loans or additional capital contributions to our China subsidiary.***

Any loans that we wish to make to our China subsidiary are subject to Chinese regulations and approvals. For example, any loans to our China subsidiary to finance their activities cannot exceed statutory limits, must be registered with State Administration of Foreign Exchange, or SAFE, or its local counterpart, and must be approved by the relevant government authorities. Any capital contributions to our China subsidiary must be approved by the Ministry of Commerce or its local counterpart. In addition, under Circular 142, our China subsidiary, as a FIE, 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 subsidiary. If we fail to receive such registrations or approvals, our ability to capitalize our China subsidiary may be negatively affected, which could materially and adversely affect our liquidity and ability to fund and expand our business.

***Our China subsidiary is subject to Chinese labor laws and regulations, and Chinese labor laws may increase our operating costs in China.***

Chinese labor laws and regulations provide certain protections for our employees located in China, and changes to those labor laws and regulations may increase our costs and reduce our flexibility. The China Labor Contract Law, which went into effect in 2008, together with its implementing rules, provides increased rights to Chinese employees compared to prior employment laws in China. Under the rules under the China Labor Contract Law, 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 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. Any further changes to these laws may increase our costs and reduce our flexibility.

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***An increase in our labor costs in China may adversely affect our business and our profitability.***

A significant portion of our workforce is located in China. Labor costs in China have been increasing recently due to labor unrest, strikes and changes in employment laws. If labor costs in China continue to increase, our costs will increase. If we are not able to pass these increases on to our customers, our business, profitability and results of operations may be adversely affected.

***We may have difficulty establishing and maintaining adequate management and financial controls over our China operations.***

Businesses in China 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. Moreover, familiarity with U.S. GAAP principles and reporting procedures is less common in China. As a consequence, we may have difficulty finding accounting personnel experienced with U.S. GAAP, and we may have difficulty training and integrating our China-based accounting staff with our U.S.-based finance organization. As a result of these factors, we may

experience difficulty in establishing and maintaining management and financial controls over our China operations. These difficulties include 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.

## Risks Related to Our Common Stock

### ***Our stock price has been and is likely to be volatile.***

The market price of our common stock has been and is likely to be subject to wide fluctuations in response to, among other things, the risk factors described in this section of this 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. For example, announcements made by competitors regarding factors influencing their business may cause fluctuations in the valuation of companies throughout our industry, including fluctuations in the valuation of our stock.

Furthermore, 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 have been and may become the target of this type of litigation in the future. For example, on August 3, 2017 we provided guidance for the third quarter of 2017, and on August 4, 2017 the market price of our stock decreased significantly. As disclosed in “Item 3. Legal Proceedings,” on August 5, 2017, a class action lawsuit was filed against us and two of our officers. The complaint in this matter alleges that we made materially false and misleading statements or failed to disclose material facts and requests damages and other relief. On August 7, 2018, a derivative class action lawsuit was filed against our chief executive officer, chief financial officer and board of directors. The allegations are substantially similar to those under the August 5, 2017 lawsuit. On October 1, 2018, another class action lawsuit was filed in the U.S. District Court for the Southern District of Texas against us and two of our officers. The complaint in this matter alleges that we made materially false and misleading statements or failed to disclose material facts and a related action was filed on October 10, 2018. These lawsuits and any other such litigation could result in substantial costs and divert our management’s attention from other business concerns, which could seriously harm our business.

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### ***We have incurred and will continue to incur significant increased expenses and administrative burdens as a public company, which could have a material adverse effect on our operations and financial results.***

We face increased legal, accounting, administrative and other costs and expenses as a public company that we did not incur as a private company, and greater expenditures may be necessary in the future with the advent of new laws, regulations and stock exchange listing requirements pertaining to public companies. These increased costs will require us to divert a significant amount of money that we could otherwise use to expand our business and achieve our strategic objectives. The Sarbanes-Oxley Act, including the requirements of Section 404, as well as rules and regulations subsequently implemented by the SEC, the Public Company Accounting Oversight Board and the NASDAQ Global Market, impose additional reporting and other obligations on public companies. Compliance with public company requirements has increased our costs and made some activities more time-consuming. For example, we have created board committees and adopted internal controls and disclosure controls and procedures. In addition, we have incurred and will continue to incur additional expenses associated with our SEC reporting requirements. Furthermore, if we identify any issues in complying with those requirements (for example, if we or our auditors identify a material weakness or significant deficiency in our internal control over financial reporting), we could incur additional costs rectifying those issues, and the existence of those issues could adversely affect us, our reputation or investor perceptions of us. Advocacy efforts by stockholders and third parties may also prompt additional changes in governance and reporting requirements, which could further increase our costs. Legal, accounting, administrative and other costs and expenses may increase in the future as we continue to incur both increased external audit fees as well as additional spending to ensure continued regulatory compliance.

### ***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 or pay dividends on shares of our common stock in the foreseeable future. Consequently, your only opportunity to achieve a return on any shares of our common stock that you may acquire 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 in the market will ever exceed the price that you pay.

**Our charter documents, stock incentive plans 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 and our stock incentive plans 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;
- requiring advance notification of stockholder nominations and proposals; and
- change of control provisions in our stock incentive plans, and the individual stock option agreements, which provide that a change of control may accelerate the vesting of the stock options and equity awards issued under such plans.

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In addition, we are governed by the provisions of Section 203 of the Delaware General Corporate Law. 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 the approval of substantially all of our stockholders for a certain period of time.

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

***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 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 common 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 stock could decrease, which could cause our stock price or trading volume to decline.

#### **Item 1B. Unresolved Staff Comments**

Not Applicable.

#### **Item 2. Properties**

We maintain manufacturing, research and development, sales and administrative offices in the U.S., China and Taiwan. Our corporate headquarters is located at our facility in Sugar Land, Texas. The table below provides information regarding our facilities.

Location	Owned or Lease Expiration Date	Approximate Square Footage	Use
Sugar Land, Texas	Owned (1) December 31, 2022	139,450	Administration, sales, manufacturing, research and development
Duluth, Georgia	(2)	6,253	Research and development
Ningbo, China	Owned (3)	458,849	Administration, sales, manufacturing, research and development
Taipei, Taiwan	May 31, 2029 (4)	268,797	Administration, sales, manufacturing, research and development

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- (1) We manufacture laser chips (utilizing our MBE and MOCVD process), subassemblies and components in our Sugar Land, Texas facility.
  - (2) The lease covering the Georgia office commenced on December 1, 2015 and expires on December 31, 2022.
  - (3) In our China facility, we manufacture certain more labor intensive components and optical equipment systems, such as optical subassemblies and transceivers for the internet data center market, CATV transmitters (at the headend) and CATV outdoor equipment (at the node). Our China subsidiary acquired the land use rights to the real property on which our current facility is located from the Chinese government. Such land use rights expire on October 7, 2054. Our China subsidiary owns the facility located on such real property. Our China subsidiary also obtained from the Chinese government the land use rights to a second real property located within a close proximity to our current facility. We have begun construction on a new manufacturing facility on the second real property. The land use rights for the second real property expire on December 28, 2067.
  - (4) In our Taiwan location, we manufacture optical components, such as our butterfly lasers, which incorporate laser chips, subassemblies and components manufactured within our Sugar Land facility. In addition, in our Taiwan location, we manufacture transceivers for the internet data center market, telecom, FTTH and other markets. Our Taiwan subsidiary relocated its entire operation to this facility in November 2014. The lease covering the new facility commenced on June 1, 2014 and expires on May 31, 2029.

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### **Item 3. Legal Proceedings**

From time to time, we may be subject to legal proceedings and litigation arising in the ordinary course of business, including, but not limited to, inquiries, investigations, audits and other regulatory proceedings, such as described below. Except for the lawsuit described below, we believe that there are no claims or actions pending or threatened against us, the ultimate disposition of which would have a material adverse effect on us.

On August 5, 2017, a lawsuit was filed in the U.S. District Court for the Southern District of Texas against the Company and two of its officers in *Mona Abouzied v. Applied Optoelectronics, Inc., Chih-Hsiang (Thompson) Lin, and Stefan J. Murry, et al.*, Case No. 4:17-cv-02399. The complaint in this matter seeks class action status on behalf of the Company's shareholders, alleging violations of Sections 10(b) and 20(a) of the Exchange Act against the Company, its chief executive officer, and its chief financial officer, arising out of its announcement on August 3, 2017 that "we see softer than expected demand for our 40G solutions with one of our large customers that will offset the sequential growth and increased demand we expect in 100G." A second, related action was filed by Plaintiff Chad Ludwig on August 16, 2017 (Case No. 4:17-cv-02512) in the Southern District of Texas. The two cases were consolidated before Judge Vanessa D. Gilmore. On January 22, 2018, the court appointed Lawrence Rougier as Lead Plaintiff and Levi & Korsinsky LLP as Lead Counsel. Lead Plaintiff filed an amended consolidated class action complaint on March 6, 2018. The amended complaint requests unspecified damages and other relief. The Company filed a motion to dismiss on April 4, 2018, which was denied on March 28, 2019. The Company disputes the allegations, and intends to continue to vigorously defend against these claims. On May 15, 2019, Lead Plaintiff filed a motion for leave to amend the consolidated class action complaint for the purpose of adding named Plaintiffs Richard Hamilton, Kenneth X. Luthy, Roy H. Cetlin, and John Kugel (together with Lead Plaintiff Lawrence Rougier, "Plaintiffs") to the case. The court granted the motion on May 16, 2019. The substantive allegations in the Plaintiffs' operative second amended consolidated class action complaint remain unchanged. On May 28, 2019, Plaintiffs filed a motion seeking to certify the case as a class action pursuant to Federal Rule of Civil Procedure 23 and seeking appointment of Plaintiffs as class representatives and Levi & Korsinsky as class counsel. On July 12, 2019, the Company filed a response in opposition to the motion for class certification, and on August 26, 2019, Plaintiffs filed their Reply Brief. The Court has not yet ruled on the pending motion for class certification. On November 13, 2019, the Magistrate Judge issued a Memorandum and Recommendation recommending that the Plaintiffs' motion for class certification be granted, to which Defendants filed written objections on November 27, 2019. On December 11, 2019, Plaintiffs filed a response in opposition to Defendants' objections, and on December 16, 2019, Defendants filed their reply brief. The court entered an order adopting the Magistrate Judge's Memorandum and Recommendation over Defendants' objections on December 20, 2019. Thereafter, on January 3, 2020, Defendants filed a petition for permission to appeal the class certification order to the Fifth Circuit Court of Appeals. Plaintiffs filed an answer in opposition to Defendants' petition on January 13, 2020, and Defendants filed a reply brief in further support of the petition for permission to appeal on January 21, 2020. On January 23, 2020, Defendants filed an unopposed motion in the Fifth Circuit requesting that the court stay further proceedings for 90 days to allow the parties to conduct settlement negotiations. The Fifth Circuit entered an order granting the motion on January 24, 2020. The case is currently in the discovery phase, and fact discovery is scheduled to be completed by June 1, 2020. At this stage, we are not yet able to determine the likelihood of loss, if any, arising from this matter.

On August 7, 2018, Plaintiff Lei Jin filed a purported derivative action on behalf of nominal defendant Applied Optoelectronics, Inc. in the U.S. District Court for the Southern District of Texas against the Company's chief executive officer, chief financial officer and board of directors (Case No. 4:18-cv-02713). This case was consolidated with a later filed derivative

lawsuit filed by Plaintiff Yiu Kwong Ng in the U.S. District Court for the Southern District of Texas (Case No. 4:18-cv-4751). The allegations in the consolidated derivative complaints are substantially similar to those underlying the *Abouzied* securities class action and the *Taneja* securities class action discussed below. The consolidated derivative action is stayed pending a ruling on defendants' forthcoming motion to dismiss in the *Taneja* securities class action. We dispute the allegations and intend to vigorously contest the matter.

On October 1, 2018, a lawsuit was filed in the U.S. District Court for the Southern District of Texas against the Company and two of its officers in *Gaurav Taneja v. Applied Optoelectronics, Inc., Thompson Lin, and Stefan Murry*, Case No. 4:18-cv-03544. The complaint in this matter seeks class action status on behalf of the Company's shareholders, alleging violations of Sections 10(b) and 20(a) of the Exchange Act against the Company, its chief executive officer, and its chief financial officer, arising out of its announcement on September 28, 2018 that it was revising its third quarter revenue guidance due to "an issue with a small percentage of 25G lasers within a specific customer environment." This case was consolidated with two identical cases styled *Davin Pokoik v. Applied Optoelectronics, Inc., Chih-Hsiang Lin, and Stefan J. Murry*, Case No. 4:18-cv-3722 and *Stephen McGrath v. Applied Optoelectronics, Inc., Chih-Hsiang Lin, and Stefan J. Murry*. Mark Naglich was appointed as Lead Plaintiff on the consolidated matter on January 4, 2019. Lead Plaintiff filed an amended consolidated complaint on March 5, 2019, and the Company filed a motion to dismiss the amended consolidated complaint on May 6, 2019. On July 5, 2019, Plaintiff filed a response in opposition to the motion to dismiss, and the Company filed its reply brief in further support of the motion on August 5, 2019. On January 29, 2020, the district court entered an order granting Defendants' motion to dismiss and dismissing the amended consolidated complaint with prejudice. The court also entered an order denying Lead Plaintiff's request for leave to further amend the complaint, and entered a final judgment terminating the case. An appeal by Lead Plaintiff, if any, must be filed with the Fifth Circuit by February 28, 2020. We continue to dispute the allegations and intends to vigorously contest the matter should an appeal be filed.

**Item 4. Mine Safety Disclosure**

Not Applicable.

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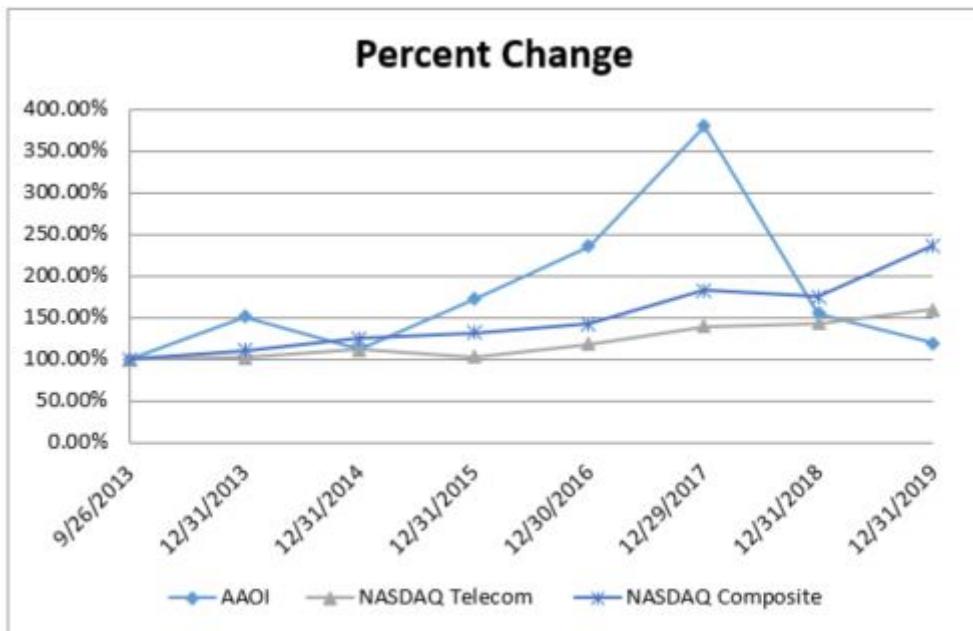
**PART II**

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

On September 26, 2013, our common stock began to trade on the NASDAQ Global Market under the symbol "AAOI". Prior to that time, there was no public market for our common stock. As of February 20, 2020 there were 36 holders of record of our common stock (not including beneficial holders of our common stock holding in street name). The following table sets forth, for the periods indicated, the high and low sales prices of our common stock as reported by the NASDAQ Global Market.

	<b>Low</b>	<b>High</b>
<b>Fiscal Year 2018:</b>		
First Quarter	\$ 23.65	\$ 38.89
Second Quarter	\$ 24.00	\$ 47.04
Third Quarter	\$ 24.66	\$ 48.80
Fourth Quarter	\$ 13.84	\$ 24.91
<b>Fiscal Year 2019:</b>		
First Quarter	\$ 12.19	\$ 17.79
Second Quarter	\$ 8.66	\$ 13.09
Third Quarter	\$ 8.50	\$ 11.70
Fourth Quarter	\$ 9.36	\$ 12.15

The graph below shows the cumulative total stockholder return of an investment of \$100 (and the reinvestment of any dividends thereafter) on September 26, 2013 (the first trading day of our common stock) in (i) our common stock, (ii) the NASDAQ Composite Index and (iii) the NASDAQ Telecommunications Index. Our stock price performance shown in the graph below is not indicative of future stock price performance. The following graph and related information is being "furnished" and shall not be deemed "soliciting material" or be deemed to be "filed" with the SEC, nor shall such information be incorporated by reference into any future filing, except to the extent that we specifically state that such graph and related information are incorporated by reference into such filing.



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### PERCENT CHANGE

Date	AAOI	NASDAQ Telecom	NASDAQ Composite
9/26/2013	100.00%	100.00%	100.00%
12/31/2013	150.70%	102.48%	110.28%
12/31/2014	112.65%	111.61%	125.05%
12/31/2015	172.29%	103.25%	132.21%
12/31/2016	235.34%	118.59%	142.13%
12/29/2017	379.72%	139.28%	182.27%
12/31/2018	251.61%	146.03%	186.50%
12/31/2019	119.28%	159.83%	236.90%

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

## Dividend Policy

We have never declared or paid any cash dividends on our capital stock, and we do not anticipate paying any cash dividends on our common stock for the foreseeable future. We currently intend to retain all available funds and future earnings for use in the operation and expansion of our business. Any future determination to pay cash dividends will be at the discretion of our board of directors and will depend upon our financial condition, results of operations, terms of financing arrangements, applicable Delaware law, capital requirements and such other factors as our board of directors deems relevant. In addition, the terms of our loan agreements governing our long-term debt obligations restricts us from paying dividends.

## Unregistered Sales of Equity Securities

Not applicable.

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## Item 6. Selected Financial Data

The selected consolidated financial data in this section is not intended to replace our consolidated financial statements and the related notes. You should read this summary consolidated financial data together with the sections titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our audited consolidated financial statements and related notes, all included elsewhere in this Form 10-K. We derived the consolidated statements of operations data for the years ended December 31, 2019, 2018 and 2017 and the consolidated balance sheet data as of December 31, 2019 and 2018 from our consolidated financial statements appearing elsewhere in this Form 10-K. The consolidated statement of operations data for the years ended December 31, 2016 and 2015 and the consolidated balance sheet data as of December 31, 2017, 2016 and 2015 are derived from our audited consolidated financial statements that have previously been filed with the SEC. Our

historical results are not necessarily indicative of the results to be expected in the future and results of interim periods are not necessarily indicative of results for the entire year.

The following table sets forth our consolidated results of operations for the periods presented (in thousands, except share and per share data):

	Years ended December 31,				
	2019	2018	2017	2016	2015
<b>Consolidated Statements of Operations Data:</b>					
Revenue	\$ 190,872	\$ 267,465	\$ 382,329	\$ 260,713	\$ 189,903
Cost of goods sold (1)	144,671	179,692	216,049	173,759	129,450
Gross profit	46,201	87,773	166,280	86,954	60,453
Operating expenses:					
Research and development (1)	43,399	49,903	35,365	31,780	20,852
Sales and marketing (1)	10,060	9,141	8,702	6,627	6,381
General and administrative (1)	41,489	39,497	35,262	25,527	19,771
Total operating expenses	94,948	98,541	79,329	63,934	47,004
Income (loss) from operations	(48,747)	(10,768)	86,951	23,020	13,449
Interest and other income (expense), net:					
Interest income	925	282	221	247	328
Interest expense	(5,405)	(1,106)	(858)	(1,717)	(1,018)
Other income (expense), net	1,840	1,814	(1,788)	(547)	(1,591)
Total interest and other income (expense), net	(2,640)	990	(2,425)	(2,017)	(2,281)
Income (loss) before income taxes	(51,387)	(9,778)	84,526	21,003	11,168
Income tax (expense) benefit	(14,662)	7,632	(10,575)	10,231	(375)
Net income (loss) attributable to common stockholders	\$ (66,049)	\$ (2,146)	\$ 73,951	\$ 31,234	\$ 10,793
Net income (loss) per share attributable to common stockholders:					
Basic	\$ (3.31)	\$ (0.11)	\$ 3.87	\$ 1.82	\$ 0.69
Diluted	\$ (3.31)	\$ (0.11)	\$ 3.76	\$ 1.76	\$ 0.65
Weighted average shares used to compute net income (loss) per share attributable to common stockholders:					
Basic	19,982,363	19,646,646	19,097,355	17,201,731	15,626,753
Diluted	19,982,363	19,646,646	20,139,105	17,712,928	16,532,850

- (1) These expenses include share-based compensation expense. Share-based compensation expense is accounted for at fair value, using the Black-Scholes option-pricing model for stock options and at the fair market value based on quoted market prices of the Company's stock as of the grant date for restricted stock units and restricted stock awards. Share-based compensation expense is recognized over the vesting period of the awards and was included in cost of goods sold and operating expenses as follows:

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The following table provides share-based compensation expense for the periods presented (in thousands):

	Years ended December 31,		
	2019	2018	2017
Cost of goods sold	\$ 772	\$ 795	\$ 461
Research and development	2,557	2,419	1,496
Sales and marketing	1,070	925	481
General and administrative	7,405	6,981	5,357
Total share-based compensation expense	\$ 11,804	\$ 11,120	\$ 7,795

The following table provides selected balance sheet data for the periods presented (in thousands):

	As of December 31,				
	2019	2018	2017	2016	2015
<b>Consolidated balance sheet data:</b>					
Total cash, restricted cash, cash equivalents and short-term investments	\$ 67,028	\$ 58,004	\$ 83,984	\$ 52,008	\$ 40,679
Working capital (1)	101,449	116,857	158,953	97,579	79,848
Total assets	466,825	466,840	452,948	322,318	273,475

Short-term obligations (2)	40,663	28,217	559	8,172	33,906
Long-term obligations (3)	101,676	60,328	48,964	34,961	33,997
Common stock and additional paid-in-capital	303,421	292,500	285,395	265,282	233,353
Total retained earnings (deficit)	\$ (30,057)	\$ 35,992	\$ 38,138	\$ (37,013)	\$ (68,247)

- (1) Working capital is defined as total current assets less total current liabilities.
- (2) Short-term obligations are defined as short-term loans, operating and financing leases, notes payable and bank acceptance payable.
- (3) Long-term obligations are defined as long-term loans, operating and financing leases, notes payable and convertible senior notes.

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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 of our financial condition and results of operations in conjunction with our consolidated financial statements and the accompanying notes appearing elsewhere in this Form 10-K. This discussion and other parts of this Form 10-K contain 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. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in "Risk Factors."*

#### **Overview**

We are a leading, vertically integrated provider of fiber-optic networking products. We target four networking end-markets: internet data centers, CATV, telecom and FTTH. We design and manufacture a range of optical communications products at varying levels of integration, from components, subassemblies and modules to complete turn-key equipment. In designing products for our customers, we begin with the fundamental building blocks of lasers and laser components. From these foundational products, we design and manufacture a wide range of products to meet our customers' needs and specifications, and such products differ from each other by their end market, intended use and level of integration. We are primarily focused on the higher-performance segments within the internet data center, CATV, telecom and FTTH markets which increasingly demand faster connectivity and innovation. Our vertically integrated manufacturing model provides us several advantages, including rapid product development, fast response times to customer requests and control over product quality and manufacturing costs.

The four end markets we target are all driven by significant bandwidth demand fueled by the growth of network-connected devices, video traffic, cloud computing and online social networking. Within the internet data center market, we benefit from the increasing use of higher-capacity optical networking technology as a replacement for copper cables, particularly as speeds reach 10 Gbps and above, as well as the movement to open internet data center architectures and the increasing use of in-house equipment design among leading internet companies. Within the CATV market, we benefit from a number of ongoing trends including the move to higher bandwidth networks among CATV service providers and the outsourcing of system design among CATV networking equipment companies. In the FTTH market, we benefit from continuing PON deployments and system upgrades among telecom service providers. In the telecom market, we benefit from deployment of new high-speed fiber-optic networks by telecom network operators, including 5G networks.

In 2019, 2018 and 2017, our revenue was \$190.9 million, \$267.5 million, and \$382.3 million and our gross margin was 24.2%, 32.8%, and 43.5%. We have grown our annual revenue at a compound annual growth rate, or CAGR, of 18.8% between 2010 and 2019. In the years ended December 31, 2019, 2018 and 2017, we had net income (loss) of \$(66.0) million, \$(2.1) million, and \$74.0 million, respectively. At December 31, 2019 and 2018, our retained earnings (accumulated deficit) was \$(30.1) million and \$36.0 million, respectively. In 2019, we earned 75.2% of our total revenue from the internet data center market, and 19.6% of our total revenue from the CATV market.

We sell our products to leading OEMs in the CATV, telecom, and FTTH markets as well as internet data center operators. In 2019, revenue from the internet data center market, CATV market, telecom market and FTTH markets provided 75.2%, 19.6%, 4.4%, and 0.1% of our revenue, respectively, compared to 74.9%, 19.3%, 4.9%, and 0.3% of our 2018 revenue, respectively. In 2019, our key customers in the data center market included, Microsoft Corp (Microsoft), Amazon.com (Amazon) and Facebook, Inc. (Facebook). In 2019, 2018, and 2017, Microsoft accounted for 32.2%, 22.1%, and 13.8% of our revenue, Amazon accounted for 24.0%, 12.1%, and 35.4% of our revenue, and Facebook accounted for 10.9%, 38.3%, and 28.6% of our revenue, respectively. In 2019, our key customers in the CATV market included Cisco Systems, Inc. (Cisco), CommScope, and a US-based public company who provides CATV equipment. In 2019, 2018 and 2017, Cisco accounted for 10.0%, 9.9%, and 4.8% of our revenue, respectively; CommScope accounted for 3.7%, 2.1%, and 3.2% of our revenue, respectively; and the US-based public company who provides CATV equipment accounted for 1.6%, 0.8% and 0.8% of our revenue, respectively.

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In 2019, our revenue decrease of 28.6% over the prior-year was driven primarily by decreased demand for our 40 Gbps and 100 Gbps transceivers. The decrease in 100 Gbps demand was mostly from one major customer, this decrease was partially offset by growth in 100 Gbps transceivers from another of our major customers. We believe that the decrease in 40 Gbps transceiver sales is related to a broad industry trend of reducing 40 Gbps infrastructure in favor of 100 Gbps infrastructure. The decrease in revenue in the CATV market for the year was mainly a result of reduced overall market demand for CATV outside plant products, which we attribute to reduced desire on the part of cable TV MSOs to deploy capex to increase their network capacity.. The decrease in revenue in our telecom market was primarily attributable to decreased demand for certain of our legacy telecom products by our customers

We expect continued sales of our 40 Gbps and 100 Gbps products in 2020, and we expect that sales of 100 Gbps products will likely grow and exceed sales of 40 Gbps products. However, quarter-to-quarter results may show considerable variability as is usual in a period of technology transition. Similar to revenue, our gross margins can fluctuate materially depending on a variety of factors including average selling price changes, product mix, raw material cost reduction or increase, manufacturing utilization rate and changes in manufacturing efficiency. Furthermore, we are continuing to monitor and assess the effects of the coronavirus outbreak on our commercial and manufacturing operations, including any impact on our revenue in 2020.

Our sales model focuses on direct engagement and close coordination with our customers to determine product design, qualifications, performance and price. Our strategy is to use our direct sales force to sell to key accounts and to expand our use of distributors for increased coverage in certain international markets and certain domestic market segments. We have direct sales personnel that cover the U.S., Taiwan and China focusing primarily on major OEM customers and internet data center operators. Throughout our sales cycle, we work closely with our customers to qualify our products into their product lines. As a result, we strive to build strategic and long-lasting customer relationships and deliver products that are customized to our customers' requirements.

Our business depends on winning competitive bid selection processes to develop components, systems and equipment for use in our customers' products. These selection processes are typically lengthy, and as a result our sales cycles will vary based on the level of customization required, market served, whether the design win is with an existing or new customer and whether our solution being designed in our customers' product is our first generation or subsequent generation product. We do not have any long-term purchase commitments (in excess of one year) with any of our customers, most of whom purchase our products on a purchase order basis, however, once one of our solutions is incorporated into a customer's design, we believe that our solution is likely to continue to be purchased for that design throughout that product's life cycle because of the time and expense associated with redesigning the product or substituting an alternative solution.

In 2019, 2018 and 2017, we had 31, 26, and 19 design wins, respectively. We define a design win as the successful completion of the evaluation stage, where our customer has tested our product, verified that our product meets substantially all of their requirements and has informed us that they intend to purchase the product from us. Although we believe that our ability to obtain design wins is a key strength and can provide meaningful and recurring revenue, an increase or decrease in the mere number of design wins does not necessarily correlate to a likely increase or decrease in revenue, particularly in the short term. As such, the number of design wins we achieve on a quarterly or annual basis and any increase or decrease in design wins will not necessarily result in a corresponding increase or decrease in revenue in the same or immediately succeeding quarter or year. For example, if our total number of design wins in an annual or quarterly period increases or decreases compared to the total number of design wins in a prior period, this does not necessarily mean that our revenue in such period will be higher or lower than our revenue in the prior period. In fact, our experience is that some design wins result in significant revenue and some do not, and the timing of such revenue is difficult to predict as it depends on the success of the end customer's product that uses our components. Thus, some design wins result in orders and significant revenue shortly after the design win is awarded and other design wins do not result in significant orders and revenue for several months or longer after the initial design win (if at all). We do believe that over a period of years the collective impact of design wins correlates to our overall revenue growth.

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## Factors Affecting Our Performance

*Increasing Consumer Demand for Bandwidth.* Bandwidth demand in all of our target markets is driving service provider investment in new equipment and in turn generating demand for our products. Increasingly, optical networking technologies are being incorporated into networking equipment, replacing legacy copper-based networking technologies. This shift to optical networking solutions benefits us as a provider of those solutions.

*Pricing, Product Cost and Margins.* Our products are sold in a highly competitive marketplace, and in many cases our products are only minimally differentiated from those of our competitors. In addition, our sales are heavily concentrated with a small number of end customers. As a result, there is strong pricing pressure across many of our product lines. We have addressed this strong pressure in several ways:

- Lowering our material costs. In some cases, we are able to negotiate more favorable pricing from our raw material suppliers. Also, where feasible, we are often able to develop internal production for certain materials that were previously purchased from other companies. This generally has resulted in lower material costs for us.
- Enhancing the efficiency of our production process. We have been able to automate many of our production processes, which often results in lower labor costs and reduced scrap or rework rates, both of which lower our production cost. In some cases, we have been able to redesign our products to make them less complex to manufacture, and when possible during these redesigns we also incorporate lower cost raw materials.
- Introducing new products. In many cases, newly released products have more features and often higher prices compared with older products. By regularly introducing new products, we attempt to minimize the average price reduction we experience. However, we often initially experience lower gross margins on new products, as our pricing is based upon anticipated volume-driven cost reductions over the life of the design win. Thus, if we are unable to realize our expected cost reductions, we may experience declining gross margins on such products.

Our product pricing is established when the product is initially introduced to the market, and thereafter through periodic negotiations with customers. We generally do not agree to periodic automatic price reductions. Furthermore, due to the dynamics in the CATV market and the value of our outsourced design services to our customers, we believe we face less downward price pressure than many of our competitors in this market. We sell a wide variety of products among our four target markets and our gross margin is heavily dependent in any quarter on the product mix achieved during that period as well as any price changes that we have agreed upon with our customers.

*Customer Concentration within End Markets.* Historically, our revenue has been significantly concentrated, first within the CATV market and in 2016-2019 within the internet data center market. Moreover, within these markets, revenue tends to be concentrated among a small number of customers. In the last three years, we have taken several actions to increase the diversity of our customer base. These actions include hiring additional sales staff to improve our ability to serve new customers and introduction of new products that we believe will appeal to new customers. Furthermore, we have developed additional original design manufacturer, or ODM, relationships with customers in each of our target markets which should enable us to diversify our revenue base. We had four and three customers that each accounted for more than 10% of our revenue in 2019 and 2018, respectively.

*Product Development.* We invest heavily to develop new and innovative products. The majority of our research and development expense is allocated to product development, usually with a specific customer and customer platform in mind. We believe our close coordination with our customers regarding their future product requirements enhances the efficiency of our research and development expenditures.

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### **Discussion of Financial Performance**

#### *Revenue*

We generate revenue through the sale of our products to equipment providers for the internet data center, CATV, telecom, FTTH and other markets. We derive a significant portion of our revenue from our top ten customers, and we anticipate that we will continue to do so for the foreseeable future. The following chart provides the revenue contribution from each of the markets we serve for the years 2019, 2018 and 2017, as well as the corresponding percentage of our total revenue for each period (in thousands, except percentages):

Market	Years ended December 31,		
	2019	2018	2017
Data Center	\$ 143,562	\$ 200,236	\$ 306,712
CATV	37,328	51,699	60,756
Telecom	8,429	13,159	12,899
FTTH	190	818	490
Other	1,363	1,553	1,472
Total	<u>\$ 190,872</u>	<u>\$ 267,465</u>	<u>\$ 382,329</u>

	Percentage of Revenue		
Data Center	75.2%	74.9%	80.2%
CATV	19.6%	19.3%	15.9%
Telecom	4.4%	4.9%	3.4%

FTTH	0.1%	0.3%	0.1%
Other	0.7%	0.6%	0.4%
Total Revenue	100%	100%	100%

In 2019, 2018 and 2017, our top ten customers represented 88.1%, 92.9%, and 94.9% of our revenue, respectively.

Revenue is recognized when obligations under the terms of a contract with our customer are satisfied; generally this occurs with the transfer of control of products or services. Revenue is measured as the amount of consideration we expect to receive in exchange for transferring products or providing services. A majority of our annual sales are denominated in U.S. dollars, but some sales from our Taiwan location and China-based subsidiary are denominated in NT dollars and RMB, respectively. For the year ended December 31, 2019, 43.6% of our total revenue was manufactured at our China-based subsidiary, with \$6.05 million denominated in RMB and 51.2% of our total revenue was from products manufactured at our Taiwan-based facility with no revenue denominated in NT dollars. We expect a similar portion of our sales to be denominated in foreign currencies in 2019.

#### *Cost of goods sold and gross margin*

Our cost of goods sold is impacted by variances arising from changes in yields and production volume, as well as increases or decreases in the cost of raw materials used in production. We typically experience lower yields and higher associated costs on new products. For our mature products, we can experience lower yields and higher production costs if customer requirements change or if we experience manufacturing difficulties or quality issues during our production process. Notwithstanding the foregoing, however, in general for our mature products our cost of goods sold for a particular product declines over time as a result of increasing efficiencies in the manufacturing processes, or supply cost declines, as well as yield improvements and testing enhancements.

We manufacture products in three of our four facilities located in the U.S., Taiwan and China. Generally, laser chips and optical components are manufactured in our Sugar Land facility, optical components and subassemblies are manufactured in our Taiwan facility, and optical components, subassemblies and optical equipment are manufactured in our China facility. Because of our vertical integration model, we generally utilize our own optical component products in our semi-finished and finished goods that we sell between and among our respective manufacturing operations. We base those internal sales upon established transfer pricing methodologies. However, we eliminate all of those internal sales, and cost of goods sold transactions, to arrive at total revenue and cost of goods sold on a consolidated basis.

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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 in U.S. or NT dollars or RMB, depending upon the manufacturing location.

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 volumes, the mix of products sold, the geographic region in which products are sold, changes in the cost and volumes of materials purchased from our suppliers, changes in labor costs, changes in overhead costs, reserves for excess and obsolete inventories and changes in the average selling prices of our products. Although our overall gross margins over the past three years have been between 24.2% and 43.5%, our gross margins vary more broadly on a product-by-product basis. Our newer and more advanced products typically have higher average selling prices and higher gross margins; however, until the product volumes scale, the gross margin from newer and advanced products may initially be lower. Within our markets, we may sell similar products to different geographic regions at different prices, and therefore realize different gross margins among those similar products. Our strategy is to improve our gross margins through vertical integration such as utilization of our own laser chips and optical sub-components in our solutions. We expect that our gross margins are likely to continue to fluctuate from quarter to quarter because of the variety of products we sell and the relative product mix within a quarter.

#### *Operating expenses*

Our operating expenses consist of research and development, sales and marketing, and general and administrative expenses. Personnel costs are the most significant component of operating expenses and include salaries, benefits, bonuses and share-based compensation. With regard to sales and marketing expense, personnel costs also include sales commissions.

*Research and development.* Research and development, or R&D, expense consists primarily of personnel costs, including share-based compensation for R&D personnel, and R&D work orders (that include material, direct labor and allocated overhead), as well as allocated development costs, such as engineering services, software and hardware tools, depreciation of capital equipment and facility costs. We record all research and development expense as incurred. Customers rely upon us to assist them with the development of new products and modification of existing products because of our extensive optical design and manufacturing expertise. We work closely with our customers in the critical design phase of product development and are

occasionally reimbursed for some of these development efforts. We expect research and development expense to increase on a dollar basis, but will likely decrease as a percentage of our revenue to the extent that revenue increases over time.

*Sales and marketing.* Sales and marketing expense consists primarily of personnel costs, including share-based compensation for our sales and marketing personnel, as well as travel and trade show expense, sales commissions and the allocation of overall corporate services and facility costs. We sell our products to customers who either incorporate our products into their offering or resell our products to end customers. Because we sell to a limited number of well-established customers, we employ a limited number of sales professionals who are able to cover large markets. We compensate our sales staff through base salary and commissions, with base salary being the largest component of overall compensation. Total sales commissions to employees amounted to less than one percent of our revenue in 2019, 2018 and 2017. Additionally, we pay commissions to third parties on certain product lines and identified customers, which also amounted to less than one percent of our revenue in 2019, 2018 and 2017. As such, our sales and marketing expense does not directly increase with revenue. In the future, we expect sales and marketing expense to increase on a dollar basis as we incrementally increase our overall sales activities, but expect our sales and marketing expense to decline as a percentage of revenue, to the extent our revenue increases over time.

*General and administrative.* General and administrative expense consists primarily of personnel costs, including share-based compensation, primarily for our finance, human resources, legal 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. We expect general and administrative expense to increase as we continue to grow in both size and complexity as a public company. We expect rising costs including increased audit and legal fees, costs to comply with rules and regulations applicable to companies listed on a national stock exchange, as well as investor relations expense and higher insurance premiums. In the future, we expect general and administrative expense to increase on a dollar basis but to decline as a percentage of revenue, to the extent that our revenue increases over time.

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### *Other income (expense)*

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, and convertible senior notes.

Other income (expense), net is primarily made up of foreign currency transaction gains and losses. The functional currency of our China subsidiary is the RMB and the foreign currency transaction gains and losses of our China subsidiary primarily result from their transactions in U.S. dollars. The functional currency of our Taiwan location is the NT dollar and the foreign currency transaction gains and losses of our Taiwan location primarily result from their transactions in U.S. dollars.

### *Income taxes*

We are a U.S. registered company and are subject to income taxes in the U.S. We also operate in a number of countries throughout the world, including Taiwan and China. Consequently, our effective tax rate is impacted by 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. In 2019 our effective tax rate was (28.5%). In 2018 and 2017, our effective tax rate was 78.1% and 12.5%, respectively. Our effective U.S. federal income tax rate was 0% prior to 2016 as we incurred operating losses and had recorded a full valuation allowance against those losses, which was released in July 2016.

Our wholly owned subsidiary, Global Technology, Inc., has received preferential tax concessions in China as a national high-tech enterprise. In March 2007, China's parliament enacted the PRC Enterprise Income Tax Law, or the EIT Law, under which, effective January 1, 2008, China adopted a uniform income tax rate of 25% for all enterprises including foreign invested enterprises. Global was recognized as a national high-tech enterprise in 2008 and was entitled to a 15% tax rate for a three year period from November 2008 to November 2011. In 2011 and 2014 Global renewed its national high-tech enterprise certificate and therefore extended its three year tax preferential status through September 2017. In November 2017, Global again renewed its national high-tech enterprise certificate and therefore extended its three year tax preferential status from November 2017 until November 2020.

For the years ended December 31, 2019 and 2018, we had \$0.2 million and \$0.2 million, respectively, of unrecognized tax benefits related to U.S. tax benefits recognized for which we do not meet the more likely than not threshold.

See additional information regarding income taxes in Note O.

### **Seasonality**

We believe that the demand for our CATV products is seasonal. Historically, revenue derived from our CATV products has usually been highest in the second or third quarter and lowest in the first quarter of each year. The first quarter of the year

has historically been negatively affected by reduced economic activity due to the Lunar New Year holiday and the lower level of deployment of outdoor CATV equipment in cold weather environments.

We are uncertain whether the demand for our internet data center, telecom and FTTH products is seasonal, as our sales data does not indicate a significant trend with respect to these products. In 2017, we began to manufacture a meaningful quantity of internet data center products in our Ningbo, China factory. This factory experiences a lengthy shut-down associated with the Lunar New Year holiday which occurs in Q1 of each year. In addition to the factory shut-down, it is also common for employees in the factory to fail to return to work following resumption of operations. In the years 2019, 2018, and 2017, the percentage of employees in our China factory who resigned or were terminated during Q1, relative to the average number of employees during the quarter was 122%, 90%, and 42%, respectively. As a result of this employee turnover, we must hire and train replacement employees. These replacement employees require a period of training and improvement, and this impacts the quantity of products we can produce in the quarter. The combined effect of the factory shut-down and employee turnover in the quarter may also contribute to negative seasonality in Q1.

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Our gross margin varies quarter to quarter and varies primarily due to the product mix in a particular quarter, as well as from the level of manufacturing efficiencies, production yields (particularly in the laser chip fabrication process) and overall supply costs.

## **Results of Operations**

The following table set forth our results of operations for the periods presented and as a percentage of our revenue for those periods. The period-to-period comparison of our financial results is not necessarily indicative of our financial results to be achieved in future periods.

	<b>Years ended December 31,</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
Revenue, net	100.0%	100.0%	100.0%
Cost of goods sold	75.8%	67.2%	56.5%
Gross profit	24.2%	32.8%	43.5%
Operating expenses			
Research and development	22.7%	18.6%	9.2%
Sales and marketing	5.3%	3.4%	2.3%
General and administrative	21.7%	14.8%	9.2%
Total operating expenses	49.7%	36.8%	20.7%
Income (loss) from operations	(25.5)%	(4.0)%	22.7%
Interest and other income (expense), net	(1.4)%	0.4%	(0.6)%
Income (loss) before income taxes	(26.9)%	(3.6)%	22.1%
Income tax benefit (expense)	(7.7)%	2.8%	(2.8)%
Net income (loss)	(34.6)%	(0.8)%	19.3%

### **Comparison of Years Ended December 31, 2019 and 2018**

#### *Revenue*

We generate revenue through the sale of our products to equipment providers and network operators for the internet data center, CATV, telecom, FTTH and other markets. We derive a significant portion of our revenue from our top ten customers, and we anticipate that we will continue to do so for the foreseeable future. The following charts provide the revenue contribution from each of the markets we served for the years ended December 31, 2019 and 2018 (in thousands, except percentages):

	<b>Years ended December 31,</b>			<b>Change</b>		
	<b>2019</b>	<b>% of Revenue</b>	<b>2018</b>	<b>% of Revenue</b>	<b>Amount</b>	<b>%</b>
Data Center	\$ 143,562	75.2%	\$ 200,236	74.9%	\$ (56,674)	(28.3)%
CATV	37,329	19.6%	51,699	19.3%	(14,370)	(27.8)%
Telecom	8,429	4.4%	13,159	4.9%	(4,730)	(35.9)%
FTTH	190	0.1%	818	0.3%	(628)	(76.8)%
Other	1,362	0.7%	1,553	0.6%	(191)	(12.3)%
Total Revenue	<u>\$ 190,872</u>	<u>100.0%</u>	<u>\$ 267,465</u>	<u>100.0%</u>	<u>\$ (76,593)</u>	<u>(28.6)%</u>

The decrease in revenue for the year was driven primarily by decreased demand for our 40 Gbps and 100 Gbps transceivers. The decrease in 100 Gbps demand was mostly from one major customer, while this decrease was partially offset

by growth in 100 Gbps transceivers from another of our major customers. We believe that the decrease in 40 Gbps transceiver sales is related to a broad industry trend of reducing 40 Gbps infrastructure in favor of 100 Gbps infrastructure. The decrease in revenue in our CATV market for the year was mainly a result of reduced overall market demand for CATV outside plant products, which we attribute to reduced desire on the part of CATV MSOs to deploy capex to increase their network capacity. The decrease in revenue in our telecom market was primarily attributable to decreased demand for certain of our legacy telecom products by our customers, partially offset by sales of newer-generation products such as those designed for 5G mobile networks.

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In the years ended December 31, 2019 and 2018, our top ten customers represented 88.1%, and 92.9% of our revenue, respectively.

### *Cost of goods sold and gross margin*

	Years ended December 31,				Change	
	2019		2018			
	Amount	% of Revenue	Amount	% of Revenue		
(in thousands, except percentages)						
Cost of goods sold	\$ 144,671	75.8%	\$ 179,692	67.20%	\$ (35,021) (19.5)%	
Gross margin	46,201	24.2%	87,773	32.80%		

Cost of goods sold decreased by \$35.0 million, or 19.5%, from 2018 to 2019, primarily due to a 28.6% decrease in sales over the prior year. The decrease in gross margin for the year ended December 31, 2019 compared to the same period ended December 31, 2018 was primarily the result of changes in the mix of products within our datacenter segment. In particular, we saw an increase in sales of certain lower-cost 100 Gbps transceivers, designed for shorter reaches within the datacenter, relative to sales of transceivers designed for longer reaches. This product mix resulted in an overall reduction in gross margin. Also contributing to the reduced gross margin was quality and testing costs that we incurred in the first part of the year.

### *Operating expenses*

	Years ended December 31,				Change	
	2019		2018			
	Amount	% of revenue	Amount	% of revenue		
(in thousands, except percentages)						
Research and development	\$ 43,399	22.7%	\$ 49,903	18.7%	\$ (6,504) (13.0)%	
Sales and marketing	10,060	5.3%	9,141	3.4%	919 10.1%	
General and administrative	41,489	21.7%	39,497	14.8%	1,992 5.0%	
Total operating expenses	<u>\$ 94,948</u>	<u>49.7%</u>	<u>\$ 98,541</u>	<u>36.9%</u>	<u>\$ (3,593) (3.6)%</u>	

### *Research and development expense*

Research and development expense decreased by \$6.5 million, or 13.0%, from 2018 to 2019. Research and development costs consist of R&D work orders, R&D material usage and other project related costs related to 40 Gbps, 100 Gbps, and 200/400 Gbps data center products, DOCSIS 3.1 capable CATV products, including remote-PHY products, and other new product development, and depreciation expense resulting from R&D equipment investments. Research and development costs decreased from 2018 to 2019 due mainly to decreases in costs from R&D work orders, depreciation expense related to R&D equipment, and materials and supplies used in R&D activities. These decreases were offset by increases in personnel related costs.

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### *Sales and marketing expense*

Sales and marketing expense increased by \$0.9 million, or 10.1%, from 2018 to 2019. This increase was due to increases in personnel costs, share-based compensation expenses, duties and freight, and trade show expenses.

### *General and administrative expense*

General and administrative expense increased by \$2.0 million, or 5.0%, from 2018 to 2019. These increases were primarily due to an increase in share-based compensation expenses, depreciation expenses, insurance expenses and professional service fees, including legal expenses. These increases were partially offset by a decrease in personnel related costs.

#### *Other income (expense), net*

	Years ended December 31,					
	2019		2018		Change	
	Amount	% of revenue	Amount	% of revenue	Amount	%
(in thousands, except percentages)						
Interest income	\$ 925	0.5%	\$ 282	0.1%	\$ 643	228.0%
Interest expense	(5,405)	(2.8)%	(1,106)	(0.4)%	(4,299)	388.7%
Other income, net	1,840	1.0%	1,814	0.7%	26	1.4%
Total other income (expense), net	<u>\$ (2,640)</u>	<u>(1.4)%</u>	<u>\$ 990</u>	<u>0.4%</u>	<u>\$ (3,630)</u>	<u>(366.7)%</u>

Interest income increased by \$0.6 million, or 228.0% from 2018 to 2019 due to higher interest rates and larger cash balances during the year.

Interest expense increased by \$4.3 million, or 388.7% from 2018 to 2019 due to higher debt balances, including convertible senior notes and higher interest rates during the year.

Other income increased slightly from 2018 to 2019. This increases was primarily due to the receipt of government subsidies associated with our investments in new product development and for qualifying as a high-tech enterprise in China. These increases were partially offset by the decrease in foreign currency transaction gains.

#### *Benefit (provision) for income taxes*

	Years ended December 31,		
	2019		2018
	(in thousands, except percentages)		
Benefit (provision) for income taxes	\$ (14,662)	\$ 7,632	(22,294) (292.1)%

Our income tax benefit (provision) consists of U.S. income tax, state taxes, and Taiwan and China income tax recorded during the periods. Our effective tax rate is affected by recurring items, such as tax rates in state and foreign jurisdictions and the relative amounts of income we earn in those jurisdictions.

We recorded a tax expense of \$14.7 million for the year ended December 31, 2019 as compared to the tax benefit of \$7.6 million for the year ended December 31, 2018. The income tax expense in the year ended December 31, 2019 was primarily related to the recognition of research and development credits, offset by the recognition a valuation allowance on our US and state deferred tax assets, and due to excess tax benefits attributable to share-based compensation, and as well as the tax rates in foreign jurisdictions. The income tax benefit recorded in the year ended December 31, 2018 was primarily related to the impact of changes to tax law, offset by the recognition of excess tax benefits attributable to share-based compensation as well as the recognition of research and development credits.

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#### **Comparison of Years Ended December 31, 2018 and 2017**

##### *Revenue*

We generate revenue through the sale of our products to equipment providers and network operators for the internet data center, CATV, FTTH, telecom and other markets. We derive a significant portion of our revenue from our top ten customers, and we anticipate that we will continue to do so for the foreseeable future. The following charts provide the revenue contribution from each of the markets we served for the years ended December 31, 2018 and 2017 (in thousands, except percentages):

	Years ended December 31,				Change	
	2018		2017		Amount	%
	2018	% of Revenue	2017	% of Revenue		
Data Center	\$ 200,236	74.9%	\$ 306,712	80.2%	\$ (106,476)	-34.7%
CATV	51,699	19.3%	60,756	15.9%	(9,057)	-14.9%
Telecom	13,159	4.9%	12,899	3.4%	260	2.0%
FTTH	818	0.3%	490	0.1%	328	66.9%

Other	1,553	0.6%	1,472	0.4%	81	5.5%
Total Revenue	\$ 267,465	100.0%	\$ 382,329	100.0%	\$ -114,864	46.6%

The decrease in revenue for the year was driven primarily by decreased demand for our 40 Gbps and 100 Gbps transceivers as one of our customers reduced its demand for optical transceivers due to changes in the way they architect their network. Additionally, in the third and fourth quarters of 2018, we experienced decreased shipments of our 100 Gbps transceiver products to one of our customers due to their concerns about failures of similar products shipped previously. We conducted extensive testing of our products to demonstrate that any potentially affected units could be nearly eliminated in future shipments. During the time that this issue was being investigated, production activity was reduced as resources were redirected to efforts to identify the root cause of any failures observed, and in order to avoid manufacturing product that could not be proven to meet acceptable quality standards. These decreases were partially offset by an increase in demand for 100 Gbps transceivers from other customers. The decrease in revenue in the CATV market for the year was partially a result of decreased available production capacity in our China factory associated with staff turnover related to the Lunar New Year, combined with reduced demand from one of our CATV customers in the second and third quarters associated with excess inventory the customer had previously purchased from us. The increase in revenue in our telecom market was primarily attributable to increased demand for telecom products by our customers as they supply new deployments of telecom infrastructure. The increase in revenue in our FTTH market was due to the fluctuation in demand for certain older legacy products and this demand is expected to continue to fluctuate.

In the years ended December 31, 2018 and 2017, our top ten customers represented 92.9% and 94.9% of our revenue, respectively.

#### *Cost of goods sold and gross margin*

	Years ended December 31,					
	2018		2017		Change	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
(in thousands, except percentages)						
Cost of goods sold	\$ 179,692	67.20%	\$ 216,049	56.5%	\$ (36,357)	(16.8)%
Gross margin	87,773	32.80%	166,280	43.5%		

Cost of goods sold decreased by \$36.4 million, or 16.8%, from 2017 to 2018, primarily due to a 30.0% decrease in sales over the prior year. The decrease in gross margin for the year ended December 31, 2018 compared to the same period ended December 31, 2017 was primarily the result of lower capacity utilization, resulting in higher fixed cost absorption for 100 Gps products produced and shipped in the period. In addition, additional costs were incurred for more extensive quality and reliability testing. As noted in the revenue discussion above, production was reduced while we investigated customer reports of failures of similar products shipped previously. This decreased production quantity resulted in higher fixed-cost absorption, and eliminating potentially defective units from our production process temporarily reduced product yields in the third and fourth quarters of 2018.

#### *Operating expenses*

	Years ended December 31,					
	2018		2017		Change	
	Amount	% of revenue	Amount	% of revenue	Amount	%
(in thousands, except percentages)						
Research and development	\$ 49,903	18.7%	\$ 35,365	9.2%	\$ 14,538	41.1%
Sales and marketing	9,141	3.4%	8,702	2.3%	439	5.0%
General and administrative	39,497	14.8%	35,262	9.2%	4,235	12.0%
Total operating expenses	\$ 98,541	36.9%	\$ 79,329	20.7%	\$ 19,212	24.2%

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#### *Research and development expense*

Research and development expense increased by \$14.5 million, or 41.1%, from 2017 to 2018. Research and development costs consist of R&D work orders, R&D material usage and other project related costs related to 40 Gbps, 100 Gbps, and 200/400 Gbps data center products, DOCSIS 3.1 capable CATV products, including remote-PHY products, and other new product development, and depreciation expense resulting from R&D equipment investments. Research and development costs increased from 2017 to 2018 due mainly to increases in personnel-related costs, depreciation expenses associated with new R&D equipment purchased or transferred during the year, materials and supplies used in R&D activities and an increase in costs from R&D work orders.

### *Sales and marketing expense*

Sales and marketing expense increased by \$0.4 million, or 5.0%, from 2017 to 2018. This increase was due to increases in personnel costs, duties and freight and trade show expenses, offset by decreased commissions, customs taxes and professional fees.

### *General and administrative expense*

General and administrative expense increased by \$4.2 million, or 12.0%, from 2017 to 2018. These increases were primarily due to an increase in personnel-related costs, share-based compensation expenses, depreciation expenses, insurance expenses and professional service fees.

### *Other income (expense), net*

	Years ended December 31,					
	2018		2017		Change	
	Amount	% of revenue	Amount	% of revenue	Amount	%
(in thousands, except percentages)						
Interest income	\$ 282	0.1%	\$ 221	0.1%	\$ 61	27.6%
Interest expense	(1,106)	(0.4)%	(858)	(0.2)%	(248)	28.9%
Other income (expense), net	1,814	0.7%	(1,788)	(0.5)%	3,602	(201.5)%
Total other expense, net	\$ 990	0.4%	\$ (2,425)	(0.6)%	\$ 3,415	(140.8)%

Interest income increased over the same prior year periods due to larger cash balances.

Interest expense increased by 28.9% from 2017 to 2018 due to higher debt balances along with higher interest rates in 2018.

Other income (expense) for 2018 was income of \$1.8 million, a \$3.6 million favorable increase as compared to 2017. These increases were due to the increase of foreign exchange gains resulting from the favorable fluctuation of certain Asian currencies against the U.S. dollar and higher subsidies during the current year from the Chinese government related to our qualification as a high-tech enterprise.

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#### *Benefit (provision) for income taxes*

	Years ended December 31,		
	2018		2017
	(in thousands, except percentages)		
Benefit (provision) for income taxes	\$ 7,632	\$ (10,575)	18,207
			(172.2)%

Our income tax expense (benefit) consisted of U.S. income tax, state taxes, Taiwan and China income tax recorded during the periods. Our effective tax rate was affected by recurring items, such as tax rates in state and foreign jurisdictions and the relative amounts of income we earned in those jurisdictions.

We recorded a tax benefit of \$7.6 million for the year ended December 31, 2018 as compared to the tax expense of \$10.6 million for the year ended December 31, 2017. The income tax benefit in the year ended December 31, 2018 was primarily related to the impact of changes to tax law, offset by the recognition of excess tax benefits attributable to share-based compensation as well as the recognition of research and development credits. The income tax expense recorded in the year ended December 31, 2017 was primarily related to the impact of changes to tax law, offset by the recognition of excess tax benefits attributable to share-based compensation as well as the recognition of research and development credits.

### **Liquidity and Capital Resources**

As of December 31, 2019, we had \$48.8 million of unused borrowing capacity from all of our loan agreements. As of December 31, 2019, our cash, cash equivalents, restricted cash and short-term investments totaled \$67.0 million. Cash and cash equivalents are held for working capital purposes and are invested primarily in money market or time deposit funds. We do not enter into investments for trading or speculative purposes. On October 24, 2019, we filed a Registration Statement on Form S-3 with the Securities and Exchange Commission, which was declared effective on January 9, 2020, providing for the public offer and sale of certain securities of the Company from time to time, at our discretion, up to an aggregate amount of \$250 million. No shares of common stock have been sold pursuant to this Registration Statement on Form S-3.

On March 5, 2019, the Company issued \$80.5 million of 5% convertible senior notes due 2024, bearing interest at a rate of 5% per year maturing on March 15, 2024, unless earlier repurchased, redeemed or converted in accordance with their terms. The sale of the Notes generated net proceeds of \$76.4 million, after expenses. Also refer to Note L “Convertible Senior Notes” to the consolidated financial statements for further discussion of the Notes.

The table below sets forth selected cash flow data for the periods presented (in thousands):

	Years ended December 31,		
	2019	2018	2017
Net cash provided by (used in) operating activities	\$ (1,754)	\$ 14,029	\$ 84,284
Net cash used in investing activities	(32,116)	(76,514)	(70,159)
Net cash provided by financing activities	42,596	34,803	18,244
Effect of exchange rates on cash and cash equivalents	298	1,738	(385)
Net increase (decrease) in cash	<u>\$ 9,024</u>	<u>\$ (25,944)</u>	<u>\$ 31,984</u>

#### *Operating activities*

In 2019, net cash used in operating activities was \$1.8 million. Net cash used in operating activities consisted of our net loss of \$66.0 million, after the exclusion of non-cash items of \$57.8 million, an increase in accounts receivable from our customers of \$4.3 million and a decrease in accrued liabilities of \$0.3 million. These cash decreases were offset by a decrease in inventory of \$1.6 million, an increase in accounts payable to our vendors of \$3.2 million, a decrease in prepaid tax of \$1.0 million and a decrease in other current assets of \$5.5 million.

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In 2018, net cash provided by operating activities was \$14.0 million. Net cash provided by operating activities consisted of our net loss of \$2.1 million, after the exclusion of non-cash items of \$38.5 million, an increase in accounts receivable from our customers of \$29.3 million and an increase in accrued liabilities of \$0.6 million. These cash increases were offset by an increase in inventory of \$28.4 million, a decrease in account payable to our vendors of \$13.7 million, a decrease in accrued income tax of \$7.4 million and an increase in other current assets of \$3.0 million.

In 2017, net cash provided by operating activities was \$84.3 million. Net cash provided by operating activities consisted of our net income of \$74.0 million, after the exclusion of non-cash items of \$30.4 million, increase in accounts payable to our vendors of \$7.2 million, an increase in accrued liabilities of \$4.1 million and an increase in accrued income tax of \$6.2 million. These cash increases were offset by an increase in accounts receivable from our customers of \$10.1 million, an increase in inventory of \$21.9 million and an increase in other current assets of \$5.6 million.

#### *Investing activities*

Our investing activities consisted primarily of capital expenditures and purchases of intangible assets.

In 2019, net cash used in investing activities was \$32.1 million. The net cash used consisted of spending on China factory construction, purchase and prepaid of additional property, plant and equipment of \$31.5 million.

In 2018, net cash used in investing activities was \$76.5 million. The net cash used consisted of spending on property, plant and equipment and land use rights of \$77.4 million offset by sales proceeds from equipment of \$0.7 million.

In 2017, net cash used in investing activities was \$70.2 million. The net cash used consisted of spending on property, plant and equipment of \$67.0 million and an increase of \$2.9 million in deferred charges associated with the purchase of new machinery and equipment.

#### *Financing activities*

Our financing activities have historically consisted primarily of proceeds from the issuance of common stock and arrangements with various commercial lenders.

In 2019, our financing activities provided \$42.6 million in cash. We received \$76.4 million proceeds from the issuance of convertible senior notes offset by net bank loan and bank acceptance notes repayments of \$32.9 million. These activities were offset by \$0.9 million related to tax withholding associated with employee share-based compensation.

In 2018, our financing activities provided \$34.8 million in cash. We received \$38.8 million in net borrowings associated with our bank loans and bank acceptance notes. These activities were offset by \$4.1 million related to tax withholding associated with employee share-based compensation.

In 2017, our financing activities provided \$18.2 million in cash. We received \$21.6 million in net proceeds from the sale of our common stock pursuant to an at-the-market offering and \$6.2 million in net borrowings associated with our bank loans. These activities were offset by \$10.7 million related to tax withholding associated with employee share-based compensation.

#### *Loans and commitments*

We have lending arrangements with several financial institutions. In the US, we have a revolving line of credit with Branch Banking and Trust ("BB&T") Bank in the U.S. This loan contains financial covenants that may limit the amount and types of debt that we may incur. As of December 31, 2019, we were in compliance with these covenants.

In Taiwan, we have a revolving credit facility with Taishin International Bank, a revolving credit facility with Far Eastern International Bank Co., Ltd. and an equipment finance agreement with Chailease Finance Co., Ltd. for Prime World's Taiwan Branch. In China, we have a revolving line of credit with China Merchants Bank Co., Ltd. and Shanghai Pudong Development Bank Co., Ltd and a credit facility with China Zheshang Bank Co., Ltd. for our China subsidiary, Global.

As of December 31, 2019, we had \$48.8 million of unused borrowing capacity.

On March 5, 2019, the Company issued \$80.5 million of 5% convertible senior notes due 2024. The Notes will mature on March 15, 2024, unless earlier repurchased, redeemed or converted in accordance with their terms.

See Note K "Notes Payable and Long-term Debt" and Note L "Convertible Senior Notes" of our Consolidated Financial Statements for a description of our notes payable and long-term debt and convertible senior notes.

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#### *China factory construction*

On February 8, 2018, we entered into a construction contract with Zhejiang Xinyu Construction Group Co., Ltd. for the construction of a new factory and other facilities at our Ningbo, China location. Construction costs for these facilities under this contract are estimated to total approximately \$27.5 million. As of December 31, 2019, approximately \$23.8 million of this total cost has been incurred, with the remaining portion due as the construction progresses. Construction under this contract is expected to be completed in mid 2020.

#### *Future liquidity needs*

We believe that our existing cash and cash equivalents, cash flows from our operating activities, and available credit will be sufficient to meet our anticipated cash needs for 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 our research and development efforts, the expansion of our sales and marketing activities, the introduction of new and enhanced products, changes in our manufacturing capacity and the continuing market acceptance of our products. In the event we need additional liquidity, we will explore additional sources of liquidity. These additional sources of liquidity could include one, or a combination, of the following: (i) issuing equity or debt securities, (ii) incurring indebtedness secured by our assets and (iii) selling product lines, other assets and/or portions of our business. There can be no guarantee that we will be able to raise additional funds on terms acceptable to us, or at all.

#### **Contractual Obligations and Commitments**

The following summarizes our contractual obligations as of December 31, 2019 (in thousands):

	Payments due by period				
	Less than 1		More than		
	Total	Year	1-3 Years	3-5 Years	5 Years
Notes payable and long-term debt(1)	\$ 56,233	\$ 39,681	\$ 16,552	\$ —	\$ —
Convertible senior notes(2)	98,501	4,025	8,050	86,426	—
Operating leases(3)	10,712	1,234	2,257	2,181	5,040
Financing leases(3)	131	22	44	65	—
<b>Total commitments</b>	<b>\$ 165,577</b>	<b>\$ 44,962</b>	<b>\$ 26,903</b>	<b>\$ 88,672</b>	<b>\$ 5,040</b>

- 1) We have several loan and security agreements in China, Taiwan and the U.S. that provide various credit facilities, including lines of credit, bank acceptance payable and term loans. The amount presented in the table represents the principal portion and estimated interest expense for the obligations.

- 2) We issued convertible senior notes due 2024. The amount presented in the table represents the principal portion and estimated interest expense for the obligation.
- 3) We have entered into various non-cancellable lease agreements for our offices in Taiwan and in the U.S.

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**Inflation**

We believe that the relatively low rate of inflation in the U.S. over the past few years has not had a significant impact on our sales or operating results or on the prices of raw materials. To the extent we expand our operations in China and Taiwan, such actions may result in inflation having a more significant impact on our operating results in the future.

**Off-Balance Sheet Arrangements**

During 2019, 2018 and 2017, we did not have any off-balance sheet arrangements that we believe have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that would be material to investors.

**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 flows, and related disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, share-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 B to our consolidated financial statements appearing elsewhere in this Form 10-K, 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 generally employ a direct sales model in North America, and in the rest of the world we use both direct and indirect channels. Our revenue recognition policy is to recognize gross revenue, whether our products are sold on a direct or indirect basis, because our reseller customers (indirect channel) honor the same terms and conditions as do our direct sales customers. Revenue is recognized when obligations under the terms of a contract with our customer are satisfied; generally this occurs with the transfer of control of products or services. Contracts or customer purchase orders are used to determine the existence of an obligation. Shipping documents are used to verify delivery. Revenue is measured as the amount of consideration we expect to receive in exchange for transferring products or providing services. Certain customers may receive cash and/or non-cash incentives, which are accounted for as variable consideration. We assess collectability based primarily on the creditworthiness of the customer as determined by credit checks and the customer's payment history. Customers are generally extended net 30 credit terms from the date of shipment, with some extensions for more creditworthy customers.

Shipping and handling costs are included in operating expenses as fulfillment costs unless we bill our customers for shipping and handling charges, which are included in net sales for the applicable period, and the corresponding shipping and handling expense is reported in cost of sales. We present revenue net of sales returns and allowances, sales taxes and any similar assessments. We provide a limited warranty as part of our standard terms and conditions of sale. This warranty provides for the repair or replacement of our products, at our discretion, that we determine (i) are defective in workmanship, material, or not in compliance with the mutually agreed written applicable specification and (ii) has in fact failed under normal use on or before one year from the date of original shipment of the products. Some of our customers are provided limited warranties between three to five years, on certain limited and identified products. Warranty costs associated with returned goods that are repaired or replaced are charged to cost of goods sold.

During our ordinary course of business, we may enter into new product development agreements to design, customize and develop new products for our customers. Such new product development agreements often involve material cost and engineering hours and therefore non-recurring engineering service (NRE) charges are agreed upon for the customer to reimburse our related costs. We adopt the milestone method in revenue recognition for NRE revenues by using cost-input measurement. We capitalize cost input up to the contractual agreement amount and recognize NRE revenues based upon the agreement schedule. Contracts or customer purchase orders are often used to determine the existence of service agreement.

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[Table of Contents](#)*Share-Based Compensation*

We account for share-based compensation in accordance with the provisions of ASC 718, *Compensation—Stock Compensation*. Share-based compensation expense is recognized based on the estimated grant date fair value in order to recognize compensation cost for those shares expected to vest. Compensation cost is recognized on a straight-line basis over the vesting period of the restricted stock units and adjusted as forfeitures occur.

*Long-lived assets*

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. When we become aware of such changes, we review the anticipated useful life of the affected assets and make any necessary revisions. 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. In December, 2019, our production management undertook a review of the estimated useful life of many of our production-related assets. Based on the results of this review, we believe that it is reasonably likely that estimated asset useful lives may be changed in the near term. If useful lives are revised, we generally expect these revisions to result in longer than current useful lives, and thus lower annual depreciation expense for this equipment.

We evaluate the carrying value of long-lived assets for potential impairment when we determine a triggering event has occurred, or whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. When indicators exist, recoverability of assets is measured by a comparison of the carrying value of the asset group to the estimated undiscounted future net cash flows expected to be generated by the asset. Examples of such triggering events include a significant disposal of a portion of such assets, an adverse change in the market involving the business employing the related asset, a significant decrease in the benefits realized from an acquired business, difficulties or delays in integrating the business, and a significant change in the operations of an acquired business. If such assets are determined not to be recoverable we perform an analysis of the fair value of the asset group and will recognize an impairment loss when the fair value is less than the carrying amount of such assets. The fair value, based on reasonable and supportable assumptions and projections, require subjective judgments. Depending on the assumptions and estimates used, the fair value projected in the evaluation of long-lived assets can vary within a range of outcomes. We consider the likelihood of possible outcomes in determining the best estimate for the fair value of the assets. We did not record any asset impairment charges in 2019 or 2018.

*Valuation of inventories*

Inventories are stated at the lower of cost (average-cost method) or market. Work in process and finished goods includes materials, labor and allocated overhead. We assess the valuation of our inventory on a periodic basis and provide an allowance for the value of estimated excess and obsolete inventory based on estimates of future demand. During the years ended December 31, 2019, 2018 and 2017, we recorded excess and obsolete inventory reserve charges of \$6.8 million, \$7.2 million, and \$1.9 million, respectively. For the years December 2019, 2018 and 2017, the direct inventory write-offs related to scrap, discontinued products and damaged inventories were \$13.4 million, \$12.3 million, and \$6.8 million, respectively.

We have an accounting policy to write down the value of obsolete inventory. We considered the following factors in our determination of the appropriate reserve level: how often we buy material in bulk; the overall market value of raw material, semi-finished goods and finished goods across our varied product lines and within markets; changes in expected demand for our products; the change in valuations historically; the determined safety stock for key customers; and the likelihood of postponement in delivery schedules for materials already placed in finished goods inventory.

[Table of Contents](#)*Accounting for income taxes*

We account for income taxes in accordance with the provisions of ASC 740, *Income Taxes*. The liability method is used to account for deferred income taxes. Under the liability method, deferred tax assets and liabilities are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The ability to realize deferred tax assets is evaluated annually and a valuation allowance is provided if it is unlikely that the deferred tax assets will not give rise to future benefits in our tax returns.

We record uncertain tax positions in accordance with ASC 740 on the basis of a two-step process in which (1) we determine whether it is more likely than not that the tax positions will be sustained on the basis of the technical merits of the

position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, we recognize the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with the related tax authority.

On the basis of this evaluation, as of December 31, 2019, a valuation allowance of \$25.7 million has been recorded related to our US and state deferred tax assets to recognize only the portion of the deferred tax assets that are more likely than not to be realized. The amount of the deferred tax assets considered realizable, however, could be adjusted if estimates of future taxable income during the carryforward period are reduced or increased or if objective negative evidence in the form of cumulative losses is no longer present and additional weight is given to subjective evidence such as our projections for growth.

We recognize interest and penalties related to unrecognized tax benefits on the income tax expense line in the accompanying consolidated statement of operations. Accrued interest and penalties are included on the related tax liability line in the consolidated balance sheet.

See additional information regarding income taxes in Note O of our Consolidated Financial Statements.

## **Recent Accounting Pronouncements**

See Note B of our Consolidated Financial Statements for a description of recent accounting pronouncements.

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### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

#### ***Market Risks***

Market risk represents the risk of loss that may impact our financial statements through adverse changes in financial market prices and rates and inflation. Our market risk exposure results primarily from fluctuations in foreign exchange and interest rates. We manage our exposure to these market risks through our regular operating and financing activities. We have not historically attempted to reduce our market risks through hedging instruments; we may, however, do so in the future.

#### ***Interest Rate Fluctuation Risk***

Our cash equivalents consisted primarily of money market funds, and interest and non-interest bearing bank deposits. Our primary objective is to maintain the security of our principal balances and ensure liquidity. We attempt to maximize the return on these balances without significantly increasing risk, but have little opportunity to do so given the short-term nature of our investments and current interest rate environments. We do not anticipate any material effect on our cash balances or investment portfolio due to fluctuations in interest rates.

We are exposed to market risk due to the possibility of changing interest rates associated with certain debt instruments. As of December 31, 2019, our U.S. debt bears a variable rate of interest that is based on LIBOR. The debt subject to variable rates is subject to fluctuation in the LIBOR. As of December 31, 2019, we had not hedged our interest rate risk.

With respect to our interest expense for the three months ended December 31, 2019, an increase of 1.0% in each of our interest rates would have resulted in an increase of \$1.3 million in our interest expense for such period.

#### ***Foreign Exchange Rates***

We operate on an international basis with a large portion of our business conducted in our Taiwan branch and China subsidiary. We use the U.S. dollar as our reporting currency for our consolidated financial statements. The financial records of our China subsidiary and our Taiwan branch are maintained in their respective local currencies, the RMB and the NT dollar, which are the functional currencies for our China subsidiary and our Taiwan branch, respectively. Assets and liabilities are translated at prevailing exchange rates at the balance sheet date, equity accounts are translated at historical exchange rates and revenues, expenses, gains and losses are translated using the average rate for the then current period using a monthly average. Translation adjustments are reported as cumulative translation adjustments and are shown as a separate component of accumulated other comprehensive income in our statement of stockholders' equity and comprehensive income.

All transactions in currencies other than their functional currencies during the year are subject to foreign exchange risk when the exchange rate fluctuates on the respective relevant dates of such transactions. Transaction gains and losses are recognized in our statements of operations in other income (expense). Monetary assets and liabilities existing at the balance sheet date denominated in currencies other than the functional currencies are re-measured at the exchange rates prevailing on the balance sheet date and unrealized exchange differences are recorded in our consolidated income statement. In October 2015, we determined that certain intercompany loans are long-term investments. Therefore, exchange gain (loss) arising from re-measurement of intercompany loans were recorded in the Cumulative Translation Adjustment accounts.

During the year ended December 31, 2019, we recognized less than \$0.1 million of exchange gains arising from foreign currency transactions and re-measurement of monetary assets and liabilities dominated in non-functional currency on the balance sheet date.

During the year ended December 31, 2019, 3.2% of our revenue was denominated in RMB and none of our revenue was denominated in NT dollars. In the year ended December 31, 2019, 21.9% of our operating expenses were denominated in RMB and 28.2% of our operating expenses were denominated in NT dollars. Accordingly, fluctuations in exchange rates directly affect our cost of goods sold and net income, and have a significant impact on our operating margins. If exchange rates of RMB and NT dollars for U.S. dollars were 1% higher during the year ended December 31, 2019, our operating expenses would have had been higher by \$0.5 million.

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As of December 31, 2019, we held the U.S. dollar denominated assets net of liabilities of approximately \$8.9 million in our China subsidiary and \$6.34 million in our Taiwan branch. With respect to these U.S. dollar denominated net assets as of December 31, 2019, if exchange rates of RMB and NT dollars for U.S. dollars were 1% higher during the year ended December 31, 2019, our other operating expenses would have been increase by \$0.2 million. Any significant revaluation of the RMB and NT dollars may materially and adversely affect the cash flows, revenues, and net income as reported in U.S. dollars.

We currently do not use derivative financial instruments to mitigate this exposure. We continue to review this issue and may consider hedging certain foreign exchange risks through the use of currency forwards or options in future years.

### **Item 8. Financial Statements and Supplementary Data**

The information required by this item is incorporated by reference to the consolidated financial statements and accompanying notes set forth on pages F-1 through F-30 of this Form 10-K.

### **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

### **Item 9A. Controls and Procedures**

#### a. Evaluation of Disclosure Controls and Procedures.

The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their control objectives.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2019. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered in this report, our disclosure controls and procedures were effective.

#### b. Management’s Annual Report on Internal Control over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act). Internal control over financial reporting is a process designed by, or under the supervision of, the issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company’s assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to

future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that our degree of compliance with the policies or procedures may deteriorate.

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Our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of the end of the period covered by this Form 10-K based on the framework in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2019.

Grant Thornton LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this Form 10-K, has issued a report, included below, on the effectiveness of our internal control over financial reporting as of December 31, 2019.

c. Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with management's evaluation required by the Rules 13a-15(d) and 15d-15(d) under the Exchange Act that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Applied Optoelectronics, Inc.

**Opinion on internal control over financial reporting**

We have audited the internal control over financial reporting of Applied Optoelectronics, Inc. (a Delaware corporation) and subsidiaries (the "Company") as of December 31, 2019, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated financial statements of the Company as of and for the year ended December 31, 2019, and our report dated February 28, 2020 expressed an unqualified opinion on those financial statements.

**Basis for opinion**

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

**Definition and limitations of internal control over financial reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the

company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ GRANT THORNTON LLP

Houston, Texas  
February 28, 2020

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**Item 9B. Other Information**

None.

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**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

The information required regarding our directors is incorporated herein by reference from the information contained in our definitive Proxy Statement for the 2020 Annual Meeting of Stockholders (our "Proxy Statement"), a copy of which will be filed with the Securities and Exchange Commission within 120 days after the end of our fiscal year ended December 31, 2019.

The information required regarding our executive officers is incorporated herein by reference from the information contained in our Proxy Statement.

The information required regarding Section 16(a) beneficial ownership reporting compliance is incorporated by reference from the information contained in our Proxy Statement.

The information required with respect to procedures by which security holders may recommend nominees to our board of directors, the composition of our Audit Committee, and whether the Company has an "audit committee financial expert", is incorporated by reference from the information contained in our Proxy Statement.

*Adoption of Code of Ethics*

The Company has adopted a Code of Business Conduct and Ethics (the "Code") applicable to all of our board of director members, employees and executive officers, including our Chief Executive Officer (Principal Executive Officer), and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer). The Company has made the Code available on our website at <http://www.ao-inc.com>.

The Company intends to satisfy the public disclosure requirements regarding (1) any amendments to the Code, or (2) any waivers under the Code given to our Principal Executive Officer, Principal Financial Officer and Principal Accounting Officer by posting such information on our website at [www.ao-inc.com](http://www.ao-inc.com). There were no amendments to the Code or waivers granted thereunder relating to the Principal Executive Officer, Principal Financial Officer or Principal Accounting Officer during 2019.

**Item 11. Executive Compensation**

The information required regarding the compensation of our directors and executive officers is incorporated herein by reference from the information contained in the sections entitled "Summary Compensation Table," "Director Compensation," and "Compensation Committee Report" in our Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required regarding security ownership of our 5% or greater stockholders and of our directors and management is incorporated herein by reference from the information contained in the section entitled "Security Ownership of Certain Beneficial Owners and Management" in our Proxy Statement.

The information required regarding securities authorized for issuance under our equity compensation plans is incorporated herein by reference from the information contained in the section entitled "Equity Compensation Plan Information" in our Proxy Statement.

### **Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required regarding related transactions is incorporated herein by reference from the information contained in our Proxy Statement.

### **Item 14. Principal Accounting Fees and Services**

The information required by Part III, Item 14, regarding principal accounting fees and services is incorporated by reference from the information contained in our Proxy Statement, a copy of which will be filed with the Securities and Exchange Commission within 120 days after the end of our fiscal year ended December 31, 2019.

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## **PART IV**

### **Item 15. Exhibits, Financial Statements Schedules**

(a)(1) The consolidated financial statements are listed on the Index to Consolidated Financial Statements to this report beginning on page F-1.

(a)(2) Financial Statement Schedules. Financial statement schedules have been omitted, as the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto appearing in this Form 10-K.

(a)(3) Exhibits. See the Exhibit immediately following Item 16. Form 10-K Summary of this Form 10-K.

### **Item 16. Form 10-K Summary**

None.

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## **EXHIBIT INDEX**

Number	Exhibit Description	Form	Incorporated By Reference		
			File No.	Exhibit	Filing Date
3.1	<a href="#"><u>Amended and Restated Certificate of Incorporation of the registrant, as currently in effect</u></a>	10-Q	001-36083	3.1	November 14, 2013
3.2	<a href="#"><u>Amended and Restated Bylaws of the registrant, as currently in effect</u></a>	10-Q	001-36083	3.2	November 14, 2013
4.1	<a href="#"><u>Common Stock Specimen</u></a>	8-K	001-36083	4.1	November 14, 2016
4.2	<a href="#"><u>Indenture, dated as of March 5, 2019 between Applied Optoelectronics, Inc. and Wells Fargo Bank, National Association, as trustee, paying agent, and conversion agent</u></a>	8-K	001-36083	4.1	March 5, 2019
4.3	<a href="#"><u>Form of Note representing the Company's 5.00% Convertible Senior Notes due 2024 (included as Exhibit A to the Indenture)</u></a>	8-K	001-36083	4.1	March 5, 2019
4.4*	<a href="#"><u>Description of Company's Common Stock</u></a>				
10.1	<a href="#"><u>Form of Indemnification Agreement between the registrant each of its Directors and certain of its Executive Officers</u></a>	S-1	333-190591	10.1	August 13, 2013

10.2†	<a href="#">2004 Incentive Share Plan</a>	S-1	333-190591	10.4	August 13, 2013
10.2.1†	<a href="#">Form of Stock Option Agreement under 2004 Incentive Share Plan</a>	S-1	333-190591	10.4.1	August 13, 2013
10.3†	<a href="#">2006 Incentive Share Plan</a>	S-1	333-190591	10.5	August 13, 2013
10.3.1†	<a href="#">First Amendment to 2006 Incentive Share Plan</a>	S-1/A	333-190591	10.5.1	August 27, 2013
10.3.2†	<a href="#">Form of Stock Option Agreement under 2006 Incentive Share Plan</a>	S-1	333-190591	10.5.2	August 13, 2013
10.4†	<a href="#">Amended and Restated 2013 Equity Incentive Plan</a>	10-K	001-36083	10.6	March 9, 2017
10.4.1†	<a href="#">Form of Restricted Stock Award Agreement under 2013 Equity Incentive Plan</a>	S-1	333-190591	10.6.1	August 13, 2013
10.4.2†	<a href="#">Form of Restricted Stock Unit Award Agreement under 2013 Equity Incentive Plan</a>	S-1	333-190591	10.6.2	August 13, 2013
10.4.3†	<a href="#">Form of Stock Appreciation Right Award Agreement under 2013 Equity Incentive Plan</a>	S-1	333-190591	10.6.3	August 13, 2013
10.4.4†	<a href="#">Form of Notice of Stock Option Award and Stock Option Award Agreement under 2013 Equity Incentive Plan</a>	S-1	333-190591	10.6.4	August 13, 2013
10.5†	<a href="#">Employment Agreement regarding Change of Control or Separation of Service between the registrant and Chih-Hsiang (Thompson) Lin, dated January 28, 2007</a>	S-1	333-190591	10.12	August 13, 2013
10.5.1†	<a href="#">Amended and Restated Employment Agreement regarding Change of Control or Separation of Service between the registrant and Chih-Hsiang (Thompson) Lin, dated April 16, 2013</a>	S-1	333-190591	10.12.1	August 13, 2013
10.6†	<a href="#">Employment Agreement, dated August 5, 2016, between Applied Optoelectronics, Inc. and Stefan J. Murry</a>	10-Q/A	001-36083	10.20	August 9, 2016
10.7†	<a href="#">Employment Agreement, dated August 5, 2016, between Applied Optoelectronics, Inc. and Mr. Joshua Yeh</a>	10-Q/A	001-36083	10.21	August 9, 2016
10.8†	<a href="#">Employment Agreement, dated August 5, 2016, between Applied Optoelectronics, Inc. and Dr. Fred Chang</a>	10-Q/A	001-36083	10.22	August 9, 2016
10.9†	<a href="#">Employment Agreement, dated August 5, 2016, between Applied Optoelectronics, Inc. and David C. Kuo</a>	10-K	001-36083	10.9	February 28, 2018

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Number	Exhibit Description	Form	Incorporated By Reference		
			File No.	Exhibit	Filing Date
10.10	<a href="#">Loan Agreement, dated September 28, 2017, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</a>	8-K	001-36083	10.1	October 4, 2017
10.10.1	<a href="#">Promissory Note, dated September 28, 2017, between Applied Optoelectronics, Inc. and</a>	8-K	001-36-83	10.2	October 4, 2017

Branch Banking and Trust Company

10.10.2	<a href="#"><u>Addendum to the Promissory Note, dated September 28, 2017, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.3	October 4, 2017
10.10.3	<a href="#"><u>BB&amp;T Security Agreement, dated September 28, 2017, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.4	October 4, 2017
10.10.4	<a href="#"><u>Trademark Security Agreement, dated September 28, 2017, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.5	October 4, 2017
10.10.5	<a href="#"><u>Patent Security Agreement, dated September 28, 2017, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.6	October 4, 2017
10.11	<a href="#"><u>Supply Agreement, effective November 8, 2017, between Applied Optoelectronics, Inc. and Facebook, Inc.</u></a>	8-K	001-36083	10.1	February 24, 2018
10.12	<a href="#"><u>Master Purchase Agreement, effective January 2, 2018, between Applied Optoelectronics, Inc. and Facebook, Inc.</u></a>	8-K	001-36083	10.2	February 21, 2018
10.13	<a href="#"><u>Translation of Lease Agreement between Global Technology, Inc. and the People's Republic of China in Zhejiang Province, Ningbo City, Land Resources Bureau</u></a>	10-K	001-36083	10.30	February 28, 2018
10.13.1	<a href="#"><u>Translation of Investment and Construction Agreement between Global Technology, Inc. and the People's Republic of China in Zhejiang Province, Ningbo City, Land Resources Bureau</u></a>	10-K	001-36083	10.30.1	February 28, 2018
10.14	<a href="#"><u>Translation of Construction Agreement between Global Technology, Inc. and Zhejiang Xinyu Construction Group Co., Ltd. dated February 8, 2018</u></a>	10-Q	001-36083	10.5	May 8, 2018
10.15	<a href="#"><u>First Amendment to Loan Agreement, dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.1	April 5, 2018
10.15.1	<a href="#"><u>Addendum to the Promissory Note (\$60 million), dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.2	April 5, 2018
10.15.2	<a href="#"><u>Promissory Note (\$26 million), dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.3	April 5, 2018
10.15.3	<a href="#"><u>Addendum to the Promissory Note (\$26 million), dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.4	April 5, 2018
10.15.4	<a href="#"><u>Promissory Note (\$21.5 million), dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.5	April 5, 2018

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<b>Number</b>	<b>Exhibit Description</b>	<b>Form</b>	<b>Incorporated By Reference</b>		
			<b>File No.</b>	<b>Exhibit</b>	<b>Filing Date</b>
10.15.5	<a href="#"><u>Addendum to the Promissory Note (\$21.5 million), dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.6	April 5, 2018
10.15.6	<a href="#"><u>Note Modification Agreement, dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.7	April 5, 2018
10.15.7	<a href="#"><u>Assignment of Lease and Rent, dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.8	April 5, 2018
10.15.8	<a href="#"><u>Texas Deed of Trust and Security Agreement, dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.9	April 5, 2018
10.15.9	<a href="#"><u>Environmental Certification and Indemnity Agreement, dated March 30, 2018, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.10	April 5, 2018
10.16	<a href="#"><u>Translation of the Approval Notice of Credit Line, dated June 12, 2018, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	8-K	001-36083	10.1	June 25, 2018
10.16.1	<a href="#"><u>Translation of the Credit Facility Agreement, dated June 19, 2018, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	8-K	001-36083	10.2	June 25, 2018
10.16.2	<a href="#"><u>Translation of the Agreement on Providing Collateral, dated June 19, 2018, between Prime World International Holdings Ltd., and Taishin International Bank</u></a>	8-K	001-36083	10.3	June 25, 2018
10.16.3	<a href="#"><u>Translation of the NT\$300 Million Promissory Note, dated June 19, 2018, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	8-K	001-36083	10.4	June 25, 2018
10.16.4	<a href="#"><u>Translation of the Maximum Loan (Credit Line) Agreement, dated September 21, 2018, between Global Technology, Inc. and China Construction Bank Co., Ltd.</u></a>	8-K	001-36083	10.1	September 27, 2018
10.16.5	<a href="#"><u>Translation of the Security Agreement, dated September 21, 2018, between Global Technology, Inc. and China Construction Bank Co., Ltd.</u></a>	8-K	001-36083	10.2	September 27, 2018
10.17	<a href="#"><u>Letter of Offer, dated July 26, 2018, between Prime World International Holdings, Ltd. and the Development Bank of Singapore (Taiwan) Ltd.</u></a>	8-K	001-36083	10.1	October 9, 2018

<b>Number</b>	<b>Exhibit Description</b>	<b>Form</b>	<b>File No.</b>	<b>Exhibit</b>	<b>Filing Date</b>
10.17.1	<a href="#"><u>Conditions Governing Facilities Granted by and Transactions Entered into with DBS Bank (Taiwan) Ltd., dated October 3, 2018, between Prime World International Holdings Ltd. and the Development Bank of Singapore (Taiwan) Ltd.</u></a>	8-K	001-36083	10.2	October 9, 2018
10.18	<a href="#"><u>First Amendment to Lease, dated October 8, 2018, between Applied Optoelectronics, Inc. and GIG VAOI Breckinridge, LLC.</u></a>	8-K	001-36083	10.1	October 12, 2018
10.19	<a href="#"><u>Translation of Purchase and Sale Contract, Finance Lease Agreement and Promissory Note, dated November 29, 2019, between Prime World International Holdings, Ltd., and Chailease Finance Co., Ltd.</u></a>	8-K	001-36083	10.1	December 6, 2018
10.20	<a href="#"><u>Translation of Agreement for Individually Negotiated Terms and Conditions, dated December 11, 2018, between Prime World International Holdings, Ltd., and CTBC Bank, Ltd.</u></a>	8-K	001-36083	10.1	December 17, 2018
10.20.1	<a href="#"><u>Translation of Approval Notice, dated October 31, 2018, between Prime World International Holdings, Ltd., and CTBC Bank, Ltd.</u></a>	8-K	001-36083	10.2	December 17, 2018
10.20.2	<a href="#"><u>Translation of General Agreement for Omnibus Credit Lines, dated December 11, 2018, between Prime World International Holdings, Ltd., and CTBC Bank, Ltd.</u></a>	8-K	001-36083	10.3	December 17, 2018
10.20.3	<a href="#"><u>Translation of Promissory Note, dated December 11, 2018, between Prime World International Holdings, Ltd., and CTBC Bank, Ltd.</u></a>	8-K	001-36083	10.4	December 17, 2018
10.21	<a href="#"><u>Translation of Purchase and Sale Contract, Finance Lease Agreement and Promissory Note, dated January 21, 2019, between Prime World International Holdings, Ltd. and Chailease Finance Co., Ltd.</u></a>	8-K	001-36083	10.1	January 25, 2019
10.22	<a href="#"><u>Second Amendment to Loan Agreement, dated February 1, 2019, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.1	February 7, 2019
10.23	<a href="#"><u>Purchase Agreement, dated as of February 28, 2019 by and among Applied Optoelectronics, Inc., Raymond James &amp; Associates, Inc. and Cowen and Company, LLC</u></a>	8-K	001-36083	10.1	March 5, 2019
10.23.1	<a href="#"><u>Third Amendment to Loan Agreement, dated March 5, 2019, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.2	March 5, 2019
10.24	<a href="#"><u>Translation of Approval Notice between, Prime World International Holdings, Ltd., and Far Eastern International Bank Co., Ltd., dated April 11, 2019</u></a>	8-K	001-36083	10.1	April 17, 2019
10.24.1	<a href="#"><u>Translation of Comprehensive Credit Facilities Master Agreement between, Prime World International Holdings, Ltd., and Far Eastern</u></a>	8-K	001-36083	10.2	April 17, 2019

International Bank Co., Ltd., dated April 11, 2019

10.24.2	<a href="#"><u>Translation of Credit Terms / Financial Transaction Terms Agreement between, Prime World International Holdings, Ltd., and Far Eastern International Bank Co., Ltd., dated April 11, 2019</u></a>	8-K	001-36083	10.3	April 17, 2019
10.24.3	<a href="#"><u>Translation of Promissory Note between, Prime World International Holdings, Ltd., and Far Eastern International Bank Co., Ltd., dated April 11, 2019</u></a>	8-K	001-36083	10.4	April 17, 2019
10.25	<a href="#"><u>Translation of the Credit Granting Agreement, between Global Technology, Inc. and China Merchants Bank Co., Ltd., dated April 19, 2019</u></a>	8-K	001-36083	10.1	April 25, 2019
10.26	<a href="#"><u>Translation of the Working Capital Loan Contract, between Global Technology, Inc. and Shanghai Pudong Development Bank Co., Ltd., dated April 30, 2019</u></a>	8-K	001-36083	10.1	May 6, 2019
10.27	<a href="#"><u>Translation of the Working Capital Loan Contract (RMB 30,000,000), between Global Technology, Inc. and Shanghai Pudong Development Bank Co., Ltd., dated May 7, 2019</u></a>	8-K	001-36083	10.1	May 13, 2019

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10.27.1	<a href="#"><u>Translation of the Working Capital Loan Contract (USD 2,000,000), between Global Technology, Inc. and Shanghai Pudong Development Bank Co., Ltd., dated May 8, 2019</u></a>	8-K	001-36083	10.2	May 13, 2019
10.28	<a href="#"><u>Translation of the Financing Credit Line Agreement, dated May 24, 2019, between Global Technology, Inc. and Shanghai Pudong Development Bank Co., Ltd.</u></a>	8-K	001-36083	10.1	May 31, 2019
10.28.1	<a href="#"><u>Translation of the Maximum Mortgage Contract (Security Agreement), dated May 24, 2019, between Global Technology, Inc. and Shanghai Pudong Development Bank Co., Ltd.</u></a>	8-K	001-36083	10.2	May 31, 2019
10.29	<a href="#"><u>Translation of the Maximum Loan Contract (¥100M), dated June 21, 2019, between Global Technology, Inc. and China Zheshang Bank Co., Ltd</u></a>	8-K	001-36083	10.1	June 27, 2019
10.29.1	<a href="#"><u>Translation of the Maximum Mortgage Contract (the “Real Estate Security Agreement”), dated June 21, 2019, between Global Technology, Inc. and China Zheshang Bank Co., Ltd</u></a>	8-K	001-36083	10.2	June 27, 2019
10.29.2	<a href="#"><u>Translation of the Maximum Loan Contract (¥50M), dated June 21, 2019, between Global Technology, Inc. and China Zheshang Bank Co., Ltd</u></a>	8-K	001-36083	10.3	June 27, 2019
10.29.3	<a href="#"><u>Translation of the Maximum Mortgage Contract (the “Machinery and Equipment Security Agreement”), dated June 21, 2019, between</u></a>	8-K	001-36083	10.4	June 27, 2019

Global Technology, Inc. and China Zheshang  
Bank Co., Ltd

10.30	<a href="#"><u>Translation of the Approval Notice of Credit Line, dated July 8, 2019, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	10-Q	001-36083	10.11	August 8, 2019
10.30.1	<a href="#"><u>Translation of the General Agreement for Financial Transaction, dated July 23, 2019, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	10-Q	001-36083	10.12	August 8, 2019
10.30.2	<a href="#"><u>Translation of the Credit Facility Agreement, dated July 23, 2019, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	10-Q	001-36083	10.13	August 8, 2019
10.30.3	<a href="#"><u>Translation of the Promissory Note, dated July 23, 2019, between Prime World International Holdings Ltd. and Taishin International Bank</u></a>	10-Q	001-36083	10.14	August 8, 2019
10.31	<a href="#"><u>Fourth Amendment to Loan Agreement, dated September 30, 2019, between Applied Optoelectronics, Inc. and Branch Banking and Trust Company</u></a>	8-K	001-36083	10.1	October 4, 2019
10.31.1	<a href="#"><u>Note Modification Agreement, dated September 30, 2019, executed by Applied Optoelectronics, Inc.</u></a>	8-K	001-36083	10.2	October 4, 2019
10.31.2	<a href="#"><u>Addendum To Promissory Note, dated September 30, 2019, executed by Applied Optoelectronics, Inc.</u></a>	8-K	001-36083	10.3	October 4, 2019
10.32	<a href="#"><u>Second Amendment to Lease, dated November 11, 2019, between Applied Optoelectronics, Inc. and ROIB2 Breckinridge, LLC.</u></a>	8-K	001-36083	10.1	November 18, 2019
23.1*	<a href="#"><u>Consent of Grant Thornton LLP</u></a>				
24.1	<a href="#"><u>Power of Attorney (see the signature page in this Annual Report on Form 10-K).</u></a>				
31.1*	<a href="#"><u>Certification of Principal Executive Officer Required Under Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of The Sarbanes-Oxley Act of 2002.</u></a>				
31.2*	<a href="#"><u>Certification of Principal Financial Officer Required Under Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of The Sarbanes-Oxley Act of 2002.</u></a>				

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Number	Exhibit Description	Form	Incorporated By Reference		
			File No.	Exhibit	Filing Date
32.1*	<a href="#"><u>Certification of Principal Executive Officer and Principal Financial Officer Required Under Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended, and 18</u></a>				

101.INS	Inline XBRL Instance Document
101.SCH	Inline XBRL Taxonomy Extension Schema Document
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document
104	Cover Page Interactive Data File (formatted as Inline XBRL and contained in Exhibit 101)

\* Filed herewith.

† Management contract, compensatory plan or arrangement.

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**SIGNATURES**

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, on February 28, 2020.

**APPLIED OPTOELECTRONICS, INC.**

By: /s/ CHIH-HSIANG (THOMPSON) LIN  
*CHIH-HSIANG (THOMPSON) LIN,*  
*President and Chief Executive Officer and*  
*Chairman of the Board of Directors*

February 28, 2020

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Chih-Hsiang (Thompson) Lin and Stefan J. Murry, and each of them, jointly and severally, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Form 10-K has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

**Signature**

**Date**

/s/ CHIH-HSIANG (THOMPSON) LIN

*CHIH-HSIANG (THOMPSON) LIN,*  
*President, Chief Executive Officer and*  
*Chairman of the Board of Directors*  
*(principal executive officer)*

February 28, 2020

/s/ STEFAN J. MURRY

*STEFAN J. MURRY,*  
*Chief Financial Officer*  
*(principal financial officer and*

February 28, 2020

*principal accounting officer)*

<b>Signature</b>	<b>Date</b>
/s/ WILLIAM H. YEH WILLIAM H. YEH, <i>Director</i>	February 28, 2020
/s/ RICHARD B. BLACK RICHARD B. BLACK, <i>Director</i>	February 28, 2020
/s/ CHE-WEI LIN CHE-WEI LIN, <i>Director</i>	February 28, 2020
/s/ ALEX IGNATIEV ALEX IGNATIEV, <i>Director</i>	February 28, 2020
/s/ ALAN MOORE ALAN MOORE, <i>Director</i>	February 28, 2020
/s/ MIN-CHU (MIKE) CHEN MIN-CHU (MIKE) CHEN, <i>Director</i>	February 28, 2020

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders  
Applied Optoelectronics, Inc.

**Opinion on the Financial Statements**

We have audited the accompanying consolidated balance sheets of Applied Optoelectronics, Inc. (a Delaware corporation) and subsidiaries (the "Company") as of December 31, 2019 and 2018, the related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2019, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and

the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of December 31, 2019, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”), and our report February 28, 2020 expressed an unqualified opinion.

#### **Change in accounting principle**

As discussed in Note B to the consolidated financial statements, the Company has changed its method of accounting for leases on January 1, 2019 due to the adoption of Accounting Standards Update No. 2016-02: Leases (Topic 842).

#### **Basis for Opinion**

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ GRANT THORNTON LLP

We have served as the Company’s auditor since 2008.

Houston, Texas  
February 28, 2020

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#### **Applied Optoelectronics, Inc. and Subsidiaries CONSOLIDATED BALANCE SHEETS (in thousands)**

	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 59,977	\$ 55,646
Restricted cash	7,051	2,358
Accounts receivable - trade, net of allowance of \$30 and \$32, respectively	34,655	30,534
Inventories	85,028	93,256
Prepaid income tax	224	1,188
Prepaid expenses and other current assets	5,869	11,293
Total current assets	192,804	194,275
Property, plant and equipment, net	248,444	234,211
Land use rights, net	5,598	5,814
Operating right of use asset	7,768	—
Financing right of use asset	119	—
Intangible assets, net	4,081	3,977
Deferred income tax assets	7,287	21,714
Other assets, net	724	6,849
<b>TOTAL ASSETS</b>	<b>\$ 466,825</b>	<b>\$ 466,840</b>

**LIABILITIES AND STOCKHOLDERS' EQUITY**
**Current liabilities**

Current portion of notes payable and long-term debt	\$ 33,371	\$ 23,589
Accounts payable	32,828	29,910
Bank acceptance payable	6,310	4,628
Current lease liability - operating	965	—
Current lease liability - financing	17	—
Accrued liabilities	17,864	19,291
Total current liabilities	91,355	77,418
Notes payable and long-term debt, less current portion	16,552	60,328
Convertible senior notes	77,041	—
Non-current lease liability - operating	7,983	—
Non-current lease liability - financing	100	—
<b>TOTAL LIABILITIES</b>	<b>193,031</b>	<b>137,746</b>
<b>Stockholders' equity:</b>		
Preferred Stock; 5,000 shares authorized at \$0.001 par value; no shares issued and outstanding at December 31, 2019 and December 31, 2018, respectively	—	—
Common Stock; 45,000 shares authorized at \$0.001 par value; 20,140 and 19,810 shares issued and outstanding at December 31, 2019 and December 31, 2018, respectively	20	20
Additional paid-in capital	303,401	292,480
Accumulated other comprehensive income	430	602
Retained earnings (Accumulated deficit)	(30,057)	35,992
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>273,794</b>	<b>329,094</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 466,825</b>	<b>\$ 466,840</b>

The accompanying notes are an integral part of these consolidated financial statements.

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**Applied Optoelectronics, Inc. and Subsidiaries**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except share and per share data)

	<b>Year ended December 31,</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
Revenue, net	\$ 190,872	\$ 267,465	\$ 382,329
Cost of goods sold	144,671	179,692	216,049
Gross profit	46,201	87,773	166,280
Operating expenses			
Research and development	43,399	49,903	35,365
Sales and marketing	10,060	9,141	8,702
General and administrative	41,489	39,497	35,262
Total operating expenses	94,948	98,541	79,329
Income (loss) from operations	(48,747)	(10,768)	86,951
Other income (expense)			
Interest income	925	282	221
Interest expense	(5,405)	(1,106)	(858)
Other income, net	1,840	1,814	(1,788)
Total other income (expense), net	(2,640)	990	(2,425)
Income (loss) before income taxes	(51,387)	(9,778)	84,526
Income tax benefit (expense)	(14,662)	7,632	(10,575)
Net income (loss)	<u>\$ (66,049)</u>	<u>\$ (2,146)</u>	<u>\$ 73,951</u>
Net income (loss) per share			
Basic	\$ (3.31)	\$ (0.11)	\$ 3.87
Diluted	\$ (3.31)	\$ (0.11)	\$ 3.67
Weighted average shares used to compute net income (loss) per share:			
Basic	19,982,363	19,646,646	19,097,355
Diluted	19,982,363	19,646,646	20,139,105

The accompanying notes are an integral part of these consolidated financial statements.

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**Applied Optoelectronics, Inc. and Subsidiaries**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(in thousands)

	Year ended December 31,		
	2019	2018	2017
Net income (loss)	\$ (66,049)	\$ (2,146)	\$ 73,951
Loss on foreign currency translation adjustment	(172)	(9,141)	10,628
Comprehensive loss	<u>\$ (66,221)</u>	<u>\$ (11,287)</u>	<u>\$ 84,579</u>

The accompanying notes are an integral part of these consolidated financial statements.

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**Applied Optoelectronics, Inc. and Subsidiaries**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
Years ended December 2017, 2018 and 2019  
(in thousands)

	Preferred Stock		Common Stock		Additional paid-in capital	Accumulated other comprehensive gain (loss)	Retained earnings/ (Accumulated deficit)	Stockholders' equity
	Number of shares	Amount	Number of shares	Amount				
January 1, 2017	—	\$ —	18,400	\$ 18	\$ 265,264	\$ (885)	\$ (37,013)	\$ 227,384
Public offering of common stock, net	—	—	459	1	21,571	—	—	21,572
Stock options exercised, net of shares withheld for employee tax	—	—	418	—	(6,623)	—	—	(6,623)
Issuance of restricted stock, net of shares withheld for employee tax	—	—	174	—	(2,631)	—	—	(2,631)
Share-based compensation	—	—	—	—	7,795	—	—	7,795
Cumulative effect of previously unrecognized tax benefits	—	—	—	—	—	—	1,200	1,200
Net income	—	—	—	—	—	—	73,951	73,951
Foreign currency translation adjustment	—	—	—	—	—	10,628	—	10,628
December 31, 2017	—	\$ —	19,451	\$ 19	\$ 285,376	\$ 9,743	\$ 38,138	\$ 333,276
Stock options exercised, net of shares withheld for employee tax	—	—	121	—	(2,073)	—	—	(2,073)
Issuance of restricted stock, net of shares	—	—	238	1	(1,943)	—	—	(1,942)

withheld for employee tax									
Share-based compensation	—	—	—	—	11,120	—	—	—	11,120
Cumulative effect of previously unrecognized tax benefits	—	—	—	—	—	(9,141)	—	—	(9,141)
Net loss	—	—	—	—	—	—	(2,146)	(2,146)	(2,146)
December 31, 2018	—	\$ 19,810	\$ 20	\$ 292,480	\$ 602	\$ 35,992	\$ 329,094		
Stock options exercised, net of shares withheld for employee tax	—	—	3	—	14	—	—	—	14
Issuance of restricted stock, net of shares withheld for employee tax	—	—	327	0	(897)	—	—	—	(897)
Share-based compensation	—	—	—	—	11,804	—	—	—	11,804
Foreign currency translation adjustment	—	—	—	—	—	(172)	—	—	(172)
Net loss	—	—	—	—	—	—	(66,049)	(66,049)	(66,049)
December 31, 2019	—	\$ 20,140	\$ 20	\$ 303,401	\$ 430	\$ (30,057)	\$ 273,794		

The accompanying notes are an integral part of these consolidated financial statements.

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### Applied Optoelectronics, Inc. and Subsidiaries CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands)

	<b>Year ended December 31,</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
<b>Operating activities:</b>			
Net income (loss)	\$ (66,049)	\$ (2,146)	\$ 73,951
Adjustments to reconcile net income to net cash provided by operating activities:			
Lower of cost or market reserve adjustment to inventory	6,774	7,166	1,866
Depreciation and amortization	24,014	29,698	20,381
Amortization of debt issuance costs	892	42	81
Deferred income taxes, net	14,570	(8,964)	(114)
Loss on disposal of assets	13	7	97
Share-based compensation	11,804	11,120	7,795
Unrealized foreign exchange gain (loss)	(245)	(548)	330
<b>Changes in operating assets and liabilities:</b>			
Accounts receivable, trade	(4,355)	29,316	(10,080)
Prepaid income tax	961	230	(1,386)
Inventories	1,560	(28,403)	(21,876)
Other current assets	5,514	(2,939)	(4,266)
Operating right of use asset	847	—	—
Accounts payable	3,150	(13,714)	7,249
Accrued income taxes	—	(7,390)	6,204
Accrued liabilities	(308)	554	4,052
Lease liability	(896)	—	—
Net cash provided (used in) by operating activities	<u>(1,754)</u>	<u>14,029</u>	<u>84,284</u>
<b>Investing activities:</b>			
Maturities of short-term investments	—	36	8

Purchase of property, plant and equipment	(28,789)	(71,854)	(66,968)
Purchase of land use rights	—	(5,591)	—
Proceeds from disposal of equipment	1	697	171
Deposits and prepaid for equipment	(2,688)	674	(2,871)
Purchase of intangible assets	(640)	(476)	(499)
Net cash used in investing activities	<u>(32,116)</u>	<u>(76,514)</u>	<u>(70,159)</u>
Financing activities:			
Proceeds from issuance of notes payable and long-term debt, net of debt issuance costs	13,661	47,849	—
Principal payments of long-term debt and notes payable	(43,363)	(3,133)	(42,758)
Proceeds from line of credit borrowings	83,434	155,078	88,003
Repayments of line of credit borrowings	(88,299)	(165,569)	(39,003)
Proceeds from bank acceptance payable	13,638	4,595	—
Repayments of bank acceptance payable	(11,952)	—	(309)
Proceeds from issuance of convertible senior notes, net of debt issuance costs	76,362	—	—
Principal payments of financing lease	(2)		
Exercise of stock options	14	120	1,460
Payments of tax withholding on behalf of employees related to share-based compensation	(897)	(4,137)	(10,721)
Proceeds from common stock offering, net	—	—	21,572
Net cash provided by financing activities	42,596	34,803	18,244
Effect of exchange rate changes on cash	298	1,738	(385)
Net increase (decrease) in cash, cash equivalents and restricted cash	9,024	(25,944)	31,984
Cash, cash equivalents and restricted cash at beginning of period	58,004	83,948	51,964
Cash, cash equivalents and restricted cash at end of period	<u>\$ 67,028</u>	<u>\$ 58,004</u>	<u>\$ 83,948</u>
Supplemental disclosure of cash flow information:			
Cash paid (received) for:			
Interest	\$ 3,172	\$ 848	\$ 872
Income taxes	(890)	8,470	5,835
Non-cash investing and financing activities:			
Net change in accounts payable related to property and equipment additions	\$ (3,869)	\$ (1,151)	\$ 4,582
Net change in deposits and prepaid for equipment related to property and equipment additions	8,801	—	—

The accompanying notes are an integral part of these consolidated financial statements.

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### **Applied Optoelectronics, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE A—ORGANIZATION AND OPERATIONS**

Applied Optoelectronics, Inc. (“AOI” or the “Company”) was incorporated in the State of Texas on February 28, 1997. In March 2013, the Company converted into a Delaware corporation. The Company is a leading, vertically integrated provider of fiber-optic networking products, primarily for four networking end-markets: internet data center, CATV, telecom and FTTH. The Company designs and manufactures a wide range of optical communications products at varying levels of integration, from components, subassemblies and modules to complete turn-key equipment.

The Company has manufacturing and research and development facilities located in the U.S., Taiwan and China. At its corporate headquarters and manufacturing facilities in Sugar Land, Texas, the Company primarily manufactures lasers and laser components and performs research and development activities for laser component and optical module products. The Company operates in Taipei, Taiwan and Ningbo, China through its wholly-owned subsidiary Prime World International Holdings, Ltd. (“Prime World”, incorporated in the British Virgin Islands). Prime World is the parent of Global Technology, Inc. (“Global”, incorporated in the People’s Republic of China). Through Global, the Company primarily manufactures certain of its data center transceiver products, including subassemblies and transceivers, as well as Cable TV Broadband (“CATV”) systems and equipment, and performs research and development activities for the CATV products. Prime World also operates a branch in Taiwan, which primarily manufactures transceivers. The Company also has a research and development center in Duluth, Georgia.

## **NOTE B—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **1. Basis of Presentation**

The consolidated financial statements include the accounts of the Company and all of its wholly-owned subsidiaries and are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All intercompany balances and transactions have been eliminated in consolidation.

### **2. Use of Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported. Actual results could differ from those estimates in the consolidated financial statements and accompanying notes. Significant estimates and assumptions that impact these financial statements relate to, among other things, allowance for doubtful accounts, inventory reserve, product warranty costs, share-based compensation expense, estimated useful lives of property and equipment, and taxes.

### **3. Foreign Currency Translation**

The functional currency for the Company's foreign operations is the local currency. The assets and liabilities of these operations are translated at the rate of exchange in effect on the balance sheet date and sales and expenses are translated at monthly average rates. The resulting gains or losses from translation are included in a separate component of other comprehensive income. There is no tax effect on the foreign currency translation because it is management's intent to reinvest the undistributed earnings of its foreign subsidiaries indefinitely. Transaction gains and losses resulting from re-measuring monetary asset and liability accounts that are denominated in a currency other than a subsidiary's functional currency are included in net foreign exchange gain and loss and are included in net income except for those intercompany balances that are long-term investments in nature. The translation gain or losses from the long-term investment nature of intercompany balances are treated as translation adjustments and included in comprehensive income.

### **4. Fair Value**

The carrying value of cash, cash equivalents and short-term investments, accounts receivable, accounts payable, and note receivable approximate their historical fair values due to their short-term maturities. The carrying value of the debt approximates its fair value due to the short-term nature of the debt since it renews frequently at current interest rates. Management believes that the interest rates in effect at each year end represent the current market rates for similar borrowings.

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The fair value measurement standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard characterizes inputs used in determining fair value according to a hierarchy that prioritized inputs based on the degree to which they are observable. The three levels of the fair value hierarchy are as follows:

Level 1—Inputs represent quoted prices in active markets for identical assets or liabilities.

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

Level 3—Inputs that are not observable from objective sources, such as management's internally developed assumptions used in pricing an asset or liability.

Assets and liabilities that are required to be fair valued on a recurring basis include money market funds, marketable securities, equity instruments and contingent consideration.

Money market funds are valued with Level 1 inputs, using quoted market prices, and are included in cash and cash equivalents on the Company's consolidated balance sheets.

### 5. *Cash and Cash Equivalents*

The Company considers all highly liquid securities with an original maturity of ninety days or less from the date of purchase to be cash equivalents. Cash in foreign accounts was approximately \$15.1 million and \$8.0 million at December 31, 2019 and 2018, respectively.

The Company maintains cash and cash equivalents at U.S. financial institutions for which the combined account balances in individual institutions may exceed Federal Deposit Insurance Corporation ("FDIC") insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage. As of December 31, 2019, approximately \$51.3 million of U.S. deposits were not covered by FDIC insurance. The Company has not experienced any losses and believes it is not exposed to any significant risk with such accounts.

### 6. *Restricted Cash/Compensating Balances*

Restricted cash includes guarantee deposits for customs duties and compensating balances associated with credit facilities.

### 7. *Accounts Receivable/Allowance for Doubtful Accounts*

The Company carries its accounts receivable at the net amount that it estimates to be collectible. An allowance for uncollectable accounts is maintained through a charge against operations. The allowance is determined by management review of outstanding amounts per customer, historical payments and the aging of accounts.

### 8. *Concentration of Credit Risk and Significant Customers*

Financial instruments which potentially subject the Company to concentrations of credit risk include cash, cash equivalents and accounts receivable. The Company places all cash and cash equivalents with high-credit quality financial institutions.

The Company performs ongoing credit valuations of its customers' financial condition whenever deemed necessary and generally does not require deposits or collateral to support customer receivables. The historical amount of losses on uncollectible accounts has been within the Company's estimates. The Company generates much of its revenue from a limited number of customers. In 2019, 2018 and 2017, its top five customers represented 80.7%, 85.7%, and 86.1% of its revenue, respectively. In 2019, Microsoft, Amazon, Facebook and Cisco represented 32.2%, 24.0%, 10.9% and 10.0% of its revenue, respectively. In 2018, Facebook, Microsoft, Amazon and Cisco represented 38.3%, 22.1%, 12.1% and 9.9% of its revenue, respectively. In 2017, Amazon, Facebook, Microsoft and Cisco represented 35.4%, 28.6%, 13.8% and 4.8% of its revenue, respectively. The five largest receivable balances for customers represented an aggregate of 82.0% and 70.2% of total accounts receivable at December 31, 2019 and 2018, respectively. As of December 31, 2019, Microsoft and Amazon represented 32.0% and 33.0% of total accounts receivable, respectively. As of December 31, 2018, Microsoft, Amazon and Facebook represented 23.2%, 18.7%, and 12.6% of total accounts receivable, respectively. No other customer represented greater than ten percent of revenue in 2019, 2018 or 2017 had greater than ten percent of total accounts receivable at December 31, 2019 or 2018.

[Table of Contents](#)9. *Inventories*

Inventories are stated at the lower of cost (average-cost method) or market. Work in process and finished goods includes materials, labor and allocated overhead. The Company assesses the valuation of its inventory on a periodic basis and provides write-offs for the value of estimated excess and obsolete inventory based on estimates of future demand.

10. *Property, Plant and Equipment*

Property, plant and equipment are stated at cost, net of accumulated depreciation and amortization. The Company calculates depreciation using the straight-line method over the following estimated useful lives:

<b>Useful lives</b>	
Buildings	20 - 42 years
Land improvements	10 years
Machinery and equipment	2 - 20 years
Furniture and fixtures	3 - 7 years
Computer equipment and software	3 - 10 years
Leasehold improvements	The shorter of the life of the applicable lease or the useful life of the improvement
Transportation equipment	5 years

Major improvements are capitalized and expenditures for maintenance and repairs are expensed as incurred. Construction in progress represents property, plant and equipment under construction or being installed. Costs include original cost, installation, construction and other direct costs which include interest on borrowings used to finance the asset. Construction in progress is transferred to the appropriate fixed asset account and depreciation commences when the asset has been substantially completed and placed in service.

Land use rights allow the Company rights for 50 years to certain land in Ningbo, China on which the Company built a facility that included office space, manufacturing operations and employee dormitories. The land use rights are recorded at cost and are amortized on the straight-line basis over the useful life of the related contract. The land use rights expire on October 7, 2054 and December 28, 2067.

11. *Intangible Assets*

Intangible assets consist of intellectual property that is stated at cost less accumulated amortization. As of December 31, 2019, the Company had 291 total patents issued. The costs incurred to obtain such patents have been capitalized and are being amortized over an estimated life between 10 and 20 years. The Company periodically evaluates its intangible assets to determine whether events or changes in circumstances indicate that a patent or trademark may not be applicable to the Company's current products or is no longer in use. If such a determination is made, the intangible asset is impaired and the remaining value of the patent or trademark will be expensed at that time.

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### 12. *Impairment of Long-Lived Assets*

The Company accounts for impairment of long-lived assets in accordance with Accounting Standards Codification (“ASC”) 360, *Property, Plant and Equipment*, (“ASC 360”). Long-lived assets consist primarily of property, plant and equipment, right-of-use assets and intangible assets. In accordance with ASC 360, the Company evaluates the carrying value of long-lived assets when it determines a triggering event has occurred, or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When indicators exist, recoverability of assets is measured by a comparison of the carrying value of the asset group to the estimated undiscounted future net cash flows expected to be generated by the asset. Examples of such triggering events include a significant disposal of a portion of such assets, an adverse change in the market involving the business employing the related asset, a significant decrease in the benefits realized from an acquired business, difficulties or delays in integrating the business, and a significant change in the operations of an acquired business. If such assets are determined not to be recoverable, the Company performs an analysis of the fair value of the asset group and will recognize an impairment loss when the fair value is less than the carrying amounts of such assets. The fair value, based on reasonable and supportable assumptions and projections, require subjective judgments. Depending on the assumptions and estimates used, the appraised fair value projected in the evaluation of long-lived assets can vary within a range of outcomes. The Company considers the likelihood of possible outcomes in determining the best estimate for the fair value of the assets. The Company did not record any asset impairment charges in 2019 or 2018.

### 13. *Comprehensive Income (Loss)*

ASC 220, *Comprehensive Income*, (“ASC 220”) establishes rules for reporting and display of comprehensive income and its components. ASC 220 requires that unrealized gains and losses on the Company’s foreign currency translation adjustments be included in comprehensive income (loss).

### 14. *Share-based Compensation*

The Company accounts for share-based compensation in accordance with the provisions of ASC 718, *Compensation—Stock Compensation*. Share-based compensation expense is recognized based on the estimated grant date fair value in order to recognize compensation cost for those shares expected to vest. Compensation cost is recognized on a straight-line basis over the vesting period of the restricted stock units and adjusted as forfeitures occur.

### 15. *Revenue Recognition*

The Company derives revenue from the manufacture and sale of fiber optic networking products. Revenue recognition follows the criteria of ASC 606, *Revenue from Contracts with Customers*. Specifically, the Company recognizes revenue when obligations under the terms of a contract with its customer are satisfied; generally this occurs with the transfer of control of products or services.

### 16. *Product Warranty*

The Company generally offers a one-year limited warranty for its products but it can extend for longer periods of three to five years for certain products sold to certain customers. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability for the amount of such costs at the time when product defects occur. Factors that affect the Company’s warranty liability include the historical and anticipated rates of warranty claims and cost to repair. While the Company believes that its warranty accrual is adequate, the actual warranty costs may exceed the accrual, in which case the cost of sales will increase in the future. As of December 31, 2019 and 2018, the amount of accrued warranty was \$0.8 million and \$1.0 million, respectively.

### 17. *Advertising Costs*

Advertising costs are charged to operations as incurred and amounted to approximately \$0.5 million, \$0.5 million, and \$0.3 million for the years ended December 31, 2019, 2018 and 2017, respectively.

[Table of Contents](#)18. *Research and Development*

Research and development costs are charged to operations as incurred. The Company receives reimbursement for certain development costs, which are capitalized when incurred, up to the reimbursable amount.

19. *Income Taxes*

The Company accounts for income taxes in accordance with the provisions of ASC 740, *Income Taxes*. The liability method is used to account for deferred income taxes. Under the liability method, deferred tax assets and liabilities are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The ability to realize deferred tax assets is evaluated annually and a valuation allowance is provided if it is unlikely that the deferred tax assets will not give rise to future benefits in the Company's tax returns.

The Company records uncertain tax positions in accordance with ASC 740 on the basis of a two-step process in which (1) it determines whether it is more likely than not that the tax positions will be sustained on the basis of the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, it recognizes the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with the related tax authority.

The Company recognizes interest and penalties related to unrecognized tax benefits on the income tax expense line in the accompanying consolidated statement of operations. Accrued interest and penalties are included on the related tax liability line in the consolidated balance sheet.

20. *Recent Accounting Pronouncements***Recent Accounting Pronouncements Adopted in 2019**

On February 25, 2016, the FASB released Accounting Standards Update ("ASU") No. 2016-02, Leases, to complete its project to overhaul lease accounting. The ASU codifies ASC 842, Leases, which will replace the guidance in ASC 840. The new standard establishes a right-of-use model ("ROU") that requires a lessee to recognize a ROU asset and lease liability on the balance sheet for all leases with a term longer than 12 months. The Company adopted this ASU on January 1, 2019 without any impact to beginning retained earnings. Upon adoption of the new lease standard, the Company elected the package of practical expedients which allowed it to carry forward the historical lease classification on existing leases at adoption. In addition, the Company elected the short-term lease recognition exemption for all leases that qualify. The Company also elected the practical expedient to not separate lease and non-lease components for all of its leases. The Company has implemented internal controls to enable the presentation of financial information on adoption. The standard has a material impact on the Company's consolidated balance sheet, but did not have an impact in its consolidated income statements. The most significant effects of adopting the new standard relate to the recognition of new ROU assets and lease liabilities on its balance sheet for its Taiwan branch. See Note D, "Operating Leases" for additional information on the required disclosures related to the impact of adopting this standard.

In June 2018, the FASB issued ASU 2018-07, Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting, which simplifies the accounting for nonemployee share-based payment transactions. The amendments specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor's own operations by issuing share-based payment awards. The Company adopted this ASU on January 1, 2019 with no impact on its consolidated financial statements.

## **Recent Accounting Pronouncements Yet to be Adopted**

In June 2016, the FASB issued ASU 2016-13 Financial Instruments - Credit Losses, Measurement of Credit Losses on Financial Instruments, which changes the way entities measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net earnings. The new standard is effective for annual periods beginning after December 15, 2019, including interim periods within those annual periods. Based on the composition of the Company's investment portfolio, current market conditions, and historical credit loss activity, the adoption of ASU 2016-13 is not expected to have a material impact on its consolidated financial statements.

## **NOTE C—REVENUE RECOGNITION**

### *Revenue from Contracts with Customers*

On January 1, 2018, the Company adopted Topic 606 using the modified retrospective method. Under the modified retrospective method, the Company did not record a cumulative effect adjustment to retained earnings for initially applying the new guidance as no revenue recognition differences were identified in the timing or amount of revenue. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with its historic accounting under Revenue Recognition ("Topic 605").

The adoption of Topic 606 represents a change in accounting principle that will provide financial statement readers with enhanced revenue recognition disclosures. In accordance with Topic 606, revenue is recognized when obligations under the terms of a contract with its customer are satisfied; generally this occurs with the transfer of control of products or services. Revenue is measured as the amount of consideration the Company expects to receive in exchange for transferring products or providing services. Certain customers may receive cash and/or non-cash incentives, which are accounted for as variable consideration. To achieve this core principle, the Company applies the following five steps:

#### 1. Identify the contract with a customer

A contract with a customer exists when (i) the Company enters into an agreement with a customer that defines each party's rights regarding the products or services to be transferred and identifies the payment terms related to these products or services, (ii) both parties to the contract are committed to perform their respective obligations, (iii) the contract has commercial substance, and (iv) the Company determines that collection of substantially all consideration for products or services that are transferred is probable based on the customer's intent and ability to pay the promised consideration. The Company applies judgment in determining the customer's ability and intention to pay, which is based on a variety of factors including the customer's payment history or, in the case of a new customer, published credit and financial information pertaining to the customer.

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### 2. Identify the performance obligations in the contract

Performance obligations promised in a contract are identified based on the products or services that will be transferred to the customer that are both capable of being distinct, whereby the customer can benefit from the product or service either on its own or together with other resources that are readily available from third parties or from the Company, and are distinct in the context of the contract, whereby the transfer of the products or services is separately identifiable from other promises in the contract. To the extent a contract includes multiple promised products or services, the Company must apply judgment to determine whether promised products or services are capable of being distinct and distinct in the context of the contract. If these criteria are not met, the promised products or services are accounted for as a combined performance obligation. The Company has elected to account for shipping and handling activities as a fulfillment cost as permitted by the standard.

### 3. Determine the transaction price

The transaction price is determined based on the consideration to which the Company will be entitled in exchange for transferring products or services to the customer. To the extent the transaction price is variable, revenue is recognized at an amount equal to the consideration to which the Company expects to be entitled. This estimate includes customer sales incentives which are accounted for as a reduction to revenue and estimated using either the expected value method or the most likely amount method, depending on the nature of the program. The Company will adjust its consideration for any rebates if it is more likely than not that the rebate conditions will be met.

### 4. Allocate the transaction price to performance obligations in the contract

If the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price basis unless a portion of the variable consideration related to the contract is allocated entirely to a performance obligation. The Company determines standalone selling price based on the price at which the performance obligation is sold separately.

### 5. Recognize revenue when or as the Company satisfies a performance obligation

The Company generally satisfies performance obligations at a point in time. Revenue is recognized based on the transaction price at the time the related performance obligation is satisfied by transferring a promised product or service to a customer.

#### *Disaggregation of Revenue*

Revenue is classified based on the location of where the product is manufactured. For additional information on the disaggregated revenues by geographical region, see Note R, "Segments and Geographic Information."

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Revenue is also classified by major product category and is presented below (in thousands):

	Years ended December 31,					
	% of Revenue		% of Revenue		% of Revenue	
	2019	2018	2019	2018	2017	2016
Data Center	\$ 143,563	75.2%	\$ 200,236	74.9%	\$ 306,712	80.2%
CATV	37,328	19.6%	51,699	19.3%	60,756	15.9%
Telecom	8,429	4.4%	13,159	4.9%	12,899	3.4%
FTTH	190	0.1%	818	0.3%	490	0.1%
Other	1,362	0.7%	1,553	0.6%	1,472	0.4%
Total Revenue	<u>\$ 190,872</u>	<u>100.0%</u>	<u>\$ 267,465</u>	<u>100.0%</u>	<u>\$ 382,329</u>	<u>100.0%</u>

## NOTE D—OPERATING LEASES

The Company leases space under non-cancelable operating leases for manufacturing facilities, research and development offices and certain storage facilities and apartments. These leases do not contain contingent rent provisions. The Company also leases certain machinery, office equipment and a vehicle under operating leases. Many of its leases include both lease (e.g. fixed payments including rent, taxes, and insurance costs) and non-lease components (e.g. common-area or other maintenance costs) which are accounted for as a single lease component as the Company has elected the practical expedient to group lease and non-lease components for all leases. Several of the leases include one or more options to renew which have been assessed and either includes or excludes from the calculation of the lease liability of the ROU asset based on management's intentions and individual fact patterns. Several warehouses and apartments have non-cancelable lease terms of less than one-year and therefore, the Company has elected the practical expedient to exclude these short-term leases from its ROU asset and lease liabilities.

As most of the Company's leases do not provide an implicit rate, the Company uses its incremental borrowing rate, which is the rate incurred to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. Based on the applicable lease terms and current economic environment, the Company applies a location approach for determining the incremental borrowing rate.

The Components of lease expense were as follows for the periods indicated (in thousands):

	Year ended December 31, 2019
Operating lease expense	\$ 1,229
Financing lease expense	5
Short Term lease expense	111
Total lease expense	<u><u>\$ 1,345</u></u>

Maturities of lease liabilities are as follows for the future one-year periods ending December 31, (in thousands):

	Operating	Financing
2020	\$ 1,234	\$ 22
2021	1,159	22
2022	1,098	22
2023	1,091	65
2024	1,090	—
2025 and thereafter	5,040	—
Total lease payments	<u><u>\$ 10,712</u></u>	<u><u>\$ 131</u></u>
Less imputed interest	(1,764)	(14)
Present value	<u><u>\$ 8,948</u></u>	<u><u>\$ 117</u></u>

The weighted average remaining lease term and discount rate for operating leases were as follows for the periods indicated:

	December 31, 2019
Weighted Average Remaining Lease Term (Years) - operating leases	9.23
Weighted Average Remaining Lease Term (Years) - financing leases	3.83
Weighted Average Discount Rate - operating leases	3.13%
Weighted Average Discount Rate - financing leases	5.00%

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Supplemental cash flow information related to operating leases was as follows for the periods indicated (in thousands):

	<b>Year ended December 31, 2019</b>
Cash paid for amounts included in the measurement of lease liabilities	
Operating cash flows from operating leases	1,325
Operating cash flows from financing lease	8
Financing cash flows from financing lease	2
Right-of-use assets obtained in exchange for new operating lease liabilities	64
Right-of-use assets obtained in exchange for new finance lease liabilities	124

## **NOTE E—CASH, CASH EQUIVALENTS AND RESTRICTED CASH**

The following table provides a reconciliation of cash, cash equivalents and restricted cash reported within the statement of financial position that sum to the total of the same such amounts in the statement of cash flows (in thousands):

	<b>December 31, 2019</b>	<b>December 31, 2018</b>
Cash and cash equivalents	\$ 59,977	\$ 55,646
Restricted cash	7,051	2,358
Total cash, cash equivalents and restricted cash shown in the statement of cash flows	<u>\$ 67,028</u>	<u>\$ 58,004</u>

Restricted cash includes guarantee deposits for customs duties and compensating balances associated with certain credit facilities. As of December 31, 2019 and 2018, there was \$1.9 million and \$2.4 million of restricted cash required for bank acceptance notes issued to vendors, respectively. There was \$4.2 million and \$0.0 million certificate of deposit associated with credit facilities with a bank in China as of December 31, 2019 and 2018 respectively.

## **NOTE F—EARNINGS PER SHARE**

Basic net income (loss) per share has been computed using the weighted-average number of shares of common stock outstanding during the period. Diluted net income (loss) per share has been computed using the weighted-average number of shares of common stock and dilutive potential common shares from options and restricted stock units outstanding during the period. In periods with net losses, normally dilutive shares become anti-dilutive. Therefore, basic and dilutive earnings per share are the same.

The following table presents the computation of the basic and diluted net income (loss) per share for the periods indicated (in thousands):

	<b>Year ended December 31,</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
<b>Numerator:</b>			
Net income (loss)	\$ (66,049)	\$ (2,146)	\$ 73,951
<b>Denominator:</b>			
Weighted average shares used to compute net income (loss) per share			
Basic	19,982	19,647	19,097
Effect of dilutive options and restricted stock units	<u>—</u>	<u>—</u>	1,042
Diluted	19,982	19,647	20,139
Net income (loss) per share			
Basic	\$ (3.31)	\$ (0.11)	\$ 3.87
Diluted	\$ (3.31)	\$ (0.11)	\$ 3.67

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The following potentially dilutive securities were excluded from diluted net income (loss) per share as their effect would have been antidilutive (in thousands):

	As of 2019	As of December 31, 2018
Employee stock options	44	263
Restricted stock units	1	117
Shares for convertible senior notes	<u>4,587</u>	<u>—</u>
Total antidilutive shares	<u>4,632</u>	<u>380</u>

## **NOTE G—INVENTORIES**

At December 31, 2019 and 2018, inventories consisted of the following (in thousands):

	As of December 31,	
	2019	2018
Raw materials	\$ 15,570	\$ 30,214
Work in process and sub-assemblies	50,787	49,192
Finished goods	18,671	13,850
Total inventory	<u>\$ 85,028</u>	<u>\$ 93,256</u>

For the years ended December 31, 2019, 2018 and 2017, the lower of cost or market reserve adjustment expensed for inventory was \$6.8 million, \$7.2 million, and \$1.9 million , respectively. For the years December 31, 2019, 2018 and 2017, the direct inventory write-offs related to scrap, discontinued products, and damaged inventories were \$13.4 million, \$12.3 million, and \$6.8 million, respectively.

## **NOTE H—PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment consisted of the following for the periods indicated (in thousands):

	December 31, 2019	December 31, 2018
Land improvements	\$ 806	\$ 806
Building and improvements	83,846	80,960
Machinery and equipment	237,464	214,718
Furniture and fixtures	5,105	5,043
Computer equipment and software	10,506	9,709
Transportation equipment	658	658
	338,385	311,894
Less accumulated depreciation and amortization	<u>(116,979)</u>	<u>(95,233)</u>
	221,406	216,661
Construction in progress	25,937	16,449
Land	1,101	1,101
Total property, plant and equipment, net	<u>\$ 248,444</u>	<u>\$ 234,211</u>

For the years ended December 31, 2019, 2018 and 2017, depreciation expense of property, plant and equipment was \$23.5 million, \$29.2 million and \$19.9 million , respectively.

As of December 31, 2019, the Company concluded that its continued loss history constitutes a triggering event as described in ASC 360-10-35-21, *Property, Plant, and Equipment*. The Company performed a recoverability test and concluded that future undiscounted cash flows exceed the carrying amount of the Company's long-lived assets and therefore no impairment charge was recorded.

## NOTE I—INTANGIBLE ASSETS

Intangible assets consisted of the following for the periods indicated (in thousands):

	December 31, 2019		
	Gross Amount	Accumulated amortization	Intangible assets, net
Patents	\$ 7,638	\$ (3,560)	\$ 4,078
Trademarks	17	(14)	3
Total intangible assets	<u>\$ 7,655</u>	<u>\$ (3,574)</u>	<u>\$ 4,081</u>

	December 31, 2018		
	Gross Amount	Accumulated amortization	Intangible assets, net
Patents	\$ 6,983	\$ (3,008)	\$ 3,975
Trademarks	15	(13)	2
Total intangible assets	<u>\$ 6,998</u>	<u>\$ (3,021)</u>	<u>\$ 3,977</u>

For the years ended December 31, 2019, 2018 and 2017, amortization expense for intangible assets, included in general and administrative expenses on the income statement, was \$0.5 million each year. The remaining weighted average amortization period for intangible assets is approximately 7 years.

At December 31, 2019, future amortization expense for intangible assets is estimated to be (in thousands):

2020	\$ 537
2021	537
2022	537
2023	537
2024	537
thereafter	1,396
	<u>\$ 4,081</u>

## NOTE J—FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents a summary of the Company's financial instruments measured at fair value on a recurring basis as of December 31, 2019 (in thousands):

	Quoted prices in active markets for identical assets (Level 1)	Significant other observable remaining inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
<b>Assets:</b>				
Cash and cash equivalents	\$ 59,977	\$ —	\$ —	\$ 59,977
Restricted cash	7,051	—	—	7,051
<b>Total assets</b>	<u>\$ 67,028</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 67,028</u>
<b>Liabilities:</b>				
Bank acceptance payable	—	\$ 6,310	—	\$ 6,310
Convertible senior notes	—	77,191	—	77,191
<b>Total liabilities</b>	<u>\$ —</u>	<u>\$ 83,501</u>	<u>\$ —</u>	<u>\$ 83,501</u>

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The following table presents a summary of the Company's financial instruments measured at fair value on a recurring basis as of December 31, 2018 (in thousands):

	Quoted prices in active markets for identical assets (Level 1)	Significant other observable remaining inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
<b>Assets:</b>				
Cash and cash equivalents	\$ 55,646	\$ —	\$ —	\$ 55,646
Restricted cash	2,358	—	—	2,358
Total assets	<u><u>\$ 58,004</u></u>	<u><u>\$ —</u></u>	<u><u>\$ —</u></u>	<u><u>\$ 58,004</u></u>
<b>Liabilities:</b>				
Bank acceptance payable	—	\$ 4,628	—	\$ 4,628
Total liabilities	<u><u>\$ —</u></u>	<u><u>\$ 4,628</u></u>	<u><u>\$ —</u></u>	<u><u>\$ 4,628</u></u>

#### **NOTE K—NOTES PAYABLE AND LONG-TERM DEBT**

Notes payable and long-term debt consisted of the following for the periods indicated (in thousands):

	December 31, 2019	December 31, 2018
Revolving line of credit with a U.S. bank up to \$20,000 (2019) and \$60,000 (2018) with interest at LIBOR plus 1.5% (2019) and 1.4% (2018), maturing April 2, 2021	\$ 20,000	\$ 23,104
Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 1.15%, maturing April 1, 2024	—	20,067
Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 1.3%, maturing between April 1, 2023 and December 18, 2023	—	19,164
Revolving line of credit with a Taiwan bank up to \$9,767 with 2% interest, maturing May 31, 2019	3,256	
Revolving line of credit with a Taiwan bank up to \$7,000 with interest ranging from 1.5% to 3.5%, matured July 26, 2019	—	3,550
Revolving line of credit with a Taiwan bank up to \$3,336 with 2.2% interest, maturing July 31, 2020	3,336	—
Notes payable to a finance company due in monthly installments with 3.4% interest, maturing November 30, 2021	4,262	6,331
Notes payable to a finance company due in monthly installments with 3.1% interest, maturing January 21, 2022	4,633	—
Revolving line of credit with a Taiwan bank up to \$2,668 with interest of 1.7%, maturing April 11, 2020	2,668	—
Revolving line of credit with a China bank up to \$18,599 with interest ranging from 4.1% to 4.6%, maturing September 21, 2023	—	8,652
Revolving line of credit with a China bank up to \$25,449 with interest of 4.57%, maturing May 24, 2024	7,919	—
Credit facility with a China bank up to \$7,167 with interest of 5.7%, maturing June 20, 2022	7,167	—
<b>Sub-total</b>	<b>49,985</b>	<b>84,124</b>
Less debt issuance costs, net	(62)	(207)
<b>Grand total</b>	<b>49,923</b>	<b>83,917</b>
Less current portion	(33,371)	(23,589)
<b>Non-current portion</b>	<b>\$ 16,552</b>	<b>\$ 60,328</b>
<b>Bank Acceptance Notes Payable</b>		
Bank acceptance notes issued to vendors with a zero percent interest rate	\$ 6,310	\$ 4,628

The current portion of long-term debt is the amount payable within one year of the balance sheet date of December 31, 2019.

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Maturities of notes payable and long-term debt are as follows for the future years ending December 31 (in thousands):

2020	\$ 33,371
2021	10,838
2022	5,714
Total outstanding	<u>\$ 49,923</u>

On September 28, 2017, the Company entered into a Loan Agreement, a Promissory Note, an Addendum to the Promissory Note, a BB&T Security Agreement, a Trademark Security Agreement, and a Patent Security Agreement (together the “Credit Facility”) with Branch Banking and Trust Company (“BB&T”). The Credit Facility provides the Company with a three year, \$50 million, revolving line of credit. Borrowings under the Credit Facility will be used for general corporate purposes. The Company makes monthly payments of accrued interest with the final monthly payment being for all principal and all accrued interest not yet paid. The Company’s obligations under the Credit Facility are secured by the Company’s accounts receivable, inventory, intellectual property, and all business assets with the exception of real estate and equipment. Borrowings under the Credit Facility bear interest at a rate equal to the one-month LIBOR plus 1.50%. The Credit Facility requires the Company to maintain certain financial covenants and also contains representations and warranties, and events of default applicable to the Company that are customary for agreements of this type.

On March 30, 2018, the Company executed a First Amendment to Loan Agreement, a Note Modification Agreement and Addendum to Promissory Note for \$60 million, a Promissory Note and Addendum to Promissory Note for \$26 million, a Promissory Note and Addendum to Promissory Note for \$21.5 million, a Texas Deed of Trust and Security Agreement, an Assignment of Lease and Rent, and an Environmental Certification and Indemnity Agreement, (collectively, the “Amended Credit Facility”), with BB&T. The Amended Credit Facility amends the Company’s three-year \$50 million line of credit with BB&T, originally executed on September 28, 2017 (the “Existing Loan”). The Amended Credit Facility (1) increases the principal amount of the three-year line of credit from \$50 million to \$60 million (the “Line of Credit”); (2) allows the Company to borrow an additional \$26 million from BB&T in the form of a five-year capital expenditure loan (the “CapEx Loan”) and (3) allows the Company to borrow an additional \$21.5 million in the form of a seventy-month real estate term loan (the “Term Loan”) to refinance the Company’s plant and facilities in Sugar Land, Texas. Borrowings under the Line of Credit bear interest at a rate equal to the one-month LIBOR plus a Line of Credit margin ranging between 1.40% and 2.0%. Borrowings under the CapEx Loan bear interest at a rate equal to the one-month LIBOR plus a CapEx Loan margin ranging between 1.30% and 2.0%. Borrowings under the Term Loan bear interest at a rate equal to the one-month LIBOR plus a Term Loan margin ranging between 1.15% and 2.0%. The Company is required to make monthly payments of principal and accrued interest with the final monthly payments being for all principal and accrued interest not yet paid. The Company’s obligations under the Amended Credit Facility are secured by the Company’s accounts receivable, inventory, equipment, intellectual property, real property, and virtually all business assets.

On February 1, 2019, the Company executed a Second Amendment to Loan Agreement (the "Second Amendment") with BB&T. The original loan agreement with BB&T, executed on September 28, 2017, and a first amendment to the original loan agreement, executed on March 30, 2018, provided the Company with a three-year \$60 million line of credit; a \$26 million five-year CapEx Loan and a \$21.5 million seventy-month real estate term loan for the Company’s plant and facilities in Sugar Land, Texas. The Second Amendment extends the CapEx Loan draw-down date from March 30, 2019 to September 30, 2019, requires the Company to provide BB&T monthly financial statements and allows additional unfinanced capital expenditures.

On March 5, 2019, the Company executed a Third Amendment to Loan Agreement (the “Third Amendment”) with BB&T pursuant to which the Company has established a revolving credit line used for working capital purposes. The Third Amendment, among other things: (i) contemplates the issuance of the Notes (as defined in Note L below) and the subsequent conversion of the Notes into common stock in accordance with the terms of the Indenture, including the payment of cash for any fractional shares; (ii) adjusts pricing of the unused line fee to 0.20% per annum; (iii) reduces the maximum commitment under the line of credit from \$60,000,000 to \$25,000,000; and (iv) provides that, so long as the Company’s utilization of the revolving credit line is not greater than 60% of the available commitment, the Company will not be required to comply with its financial covenants, including its fixed charge coverage ratio or funded debt to EBITDA covenant, and provided that, such restriction on utilization will not apply during the period of time commencing seven business days prior to the end of any fiscal quarter through seven business days after the subsequent fiscal quarter.

On March 5, 2019, the Company used approximately \$37.8 million of the net proceeds from the offering of the Notes to fully repay the CapEx Loan and Term Loan with BB&T.

On September 30, 2019, the Company executed a Fourth Amendment to Loan Agreement (the “Fourth Amendment”) with BB&T. Under the terms of the Fourth Amendment (i) the maximum commitment under the line of credit was reduced from \$25,000,000 to \$20,000,000; (ii) the maturity date of the line of credit was extended from September 28, 2020 to April 2, 2021; (iii) pricing of the unused line fee was adjusted to 0.30% per annum; and (iv) the Covenant Threshold Amount test created in the Third Amendment was removed and replaced with the requirement that if, at any time during any reporting period and pursuant to the most recent loan base report received by BB&T, the principal balance outstanding under the line of credit exceeds the lesser of the approved maximum amount of the line of credit commitment amount or the collateral loan value

reduced by the reserves, the Company shall immediately prepay the line of credit to the extent necessary to eliminate such excess. Such reserves shall, at any time that the fixed charge coverage ratio for the loan is less than 1.5 to 1.0, tested for the period of twelve months ended on the applicable covenant measurement date, equal to an amount equal to seventy-five percent (75%) of the lesser of the line of credit commitment amount or collateral loan value reduced by the sum of (i) the principal balance outstanding under the line of credit, (ii) the letter of credit exposure reserve, and (iii) the availability reserve as determined by BB&T from the most recent loan base report and otherwise in the sole discretion of BB&T after consideration of collections.

As of December 31, 2019, the Company was in compliance with all covenants under the Loan Agreement. As of December 31, 2019, \$20.0 million was outstanding under the Line of Credit.

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On June 19, 2018, Prime World entered into a one year revolving credit facility totaling 300 million NT dollars, or approximately \$9.7 million, (the “Taiwan Credit Facility”) with Taishin International Bank in Taiwan (“Taishin”). Borrowing under the Taiwan Credit Facility would have been used for short-term working capital. Prime World could have drawn upon the Taiwan Credit Facility from June 19, 2018 until July 31, 2019. The term of each draw would have been either 90 or 120 days. Borrowings under the Taiwan Credit Facility bore interest at a rate of 2.00% for 90 day draws and 1.95% for 120 day draws. At the end of the draw term, Prime World would have been required to make payments for all principal and accrued interest. The agreements for the Taiwan Credit Facility contained representations and warranties and events of default applicable to Prime World that are customary for agreements of this type. As of December 31, 2019, the Taiwan Credit Facility has been fully repaid and the agreement has terminated.

On July 23, 2019, Prime World entered into a one-year revolving credit facility totaling 100 million NT dollars, or approximately \$3.3 million, (the “NT\$100M Credit Line”) and 1 million USD (the “US\$1M Credit Line”) with Taishin. Borrowing under the NT\$100M Credit Line will be used for short-term working capital; the borrowing under the US\$1M Credit Line will be strictly used for spot transactions in the foreign exchange market. The NT\$100M Credit Line and US\$1M Credit Line are collectively referred to as the “Credit Facility”. Prime World may draw upon the Credit Facility from July 23, 2019 through July 31, 2020. The term of each draw shall be either 90 or 120 days. Borrowings under the NT\$100M Credit Line will bear interest at a rate of 2.25% for 90 day draws and 2.2% for 120 day draws; borrowings under the US\$1M Credit Line will bear interest equal to the Taishin’s foreign exchange rate effective on the day of the applicable draw. At the end of the draw term Prime World will make payment for all principal and accrued interest. Prime World’s obligations under the Credit Facility will be secured by a promissory note executed between Prime World and Taishin. The agreements for the Credit Facility contain representations and warranties, and events of default applicable to Prime World that are customary for agreements of this type. As of December 31, 2019, \$3.3 million was outstanding under the Credit Facility.

On October 3, 2018, Prime World entered into a revolving credit facility for up to \$7 million, (the “Revolving Credit Facility”) with the Development Bank of Singapore (Taiwan) Ltd. (“DBS”). Borrowing under the Revolving Credit Facility will be used for short-term working capital. Prime World may draw upon the Revolving Credit Facility from October 3, 2018 until July 26, 2019. The term of each draw shall be either 60 or 90 days depending on the purpose of the draw. Borrowings under the Revolving Credit Facility bear interest at a rate equal to DBS’s cost of funds rate plus 1.25% for draws in U.S. dollars and 1.35% plus the Bank’s cost of funds rate for draws in NT dollars. As of the execution of the Revolving Credit Facility, DBS’s cost of fund’s rate is 0.77% for loans made in NT dollars and 2.54% for loans made in U.S. Dollars. DBS’s cost of fund’s rate is adjusted daily. Prime World is required to make monthly payments of accrued interest with the final monthly payment being for all principal and all accrued interest not yet paid. Prime World’s obligations under the Revolving Credit Facility is secured by promissory notes executed between Prime World and DBS at the time of each draw. The agreements for the Revolving Credit Facility contain representations and warranties and events of default applicable to the Prime World that are customary for agreements of this type. As of December 31, 2019, the Revolving Credit Facility has been fully repaid and the agreement has terminated.

On November 29, 2018, Prime World entered into a Purchase and Sale Contract (the “Sale Contract”) and an Equipment Finance Agreement with Chailease Finance Co., Ltd. (“Chailease”) in connection with certain equipment. Pursuant to the Sale Contract, Prime World sold certain equipment to Chailease for a purchase price of NT\$267,340,468, or approximately \$8.7 million. Simultaneously, Prime World financed the equipment back from Chailease for a term of three-years, pursuant to the Equipment Finance Agreement. Prime World is obligated to pay an initial payment of NT\$67,340,468, or approximately \$2.2 million, thereafter the monthly payments range from NT\$5,571,229, or \$0.2 million, to NT\$6,139,188, or approximately \$0.2 million. Based on the monthly payments made under the Equipment Finance Agreement, the annual interest rate is calculated to be 3.5%. Upon an event of default under the Equipment Finance Agreement, Prime World’s payment obligation will be secured by a promissory note to Chailease in the amount of NT\$210,601,605, or approximately \$6.8 million, subject to certain terms and conditions. The title of the equipment will be transferred to Prime World upon expiration of the Equipment Finance Agreement. As of December 31, 2019, \$4.3 million was outstanding under the Equipment Finance Agreement.

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On January 21, 2019, Prime World entered into a Second Purchase and Sale Contract (the “Second Sales Contract”), Promissory Note, and a second Equipment Finance Agreement with Chailease in connection with certain equipment. Pursuant to the Second Sales Contract, Prime World sold certain equipment to Chailease for a purchase price of NT\$267,333,186, or approximately \$8.7 million. Simultaneously, Prime World financed the equipment back from Chailease for a term of three-years, pursuant to the Second Equipment Finance Agreement. Prime World is obligated to pay an initial monthly payment of NT\$67,333,186, or approximately \$2.2 million, thereafter the monthly payments range from NT\$5,570,167, or approximately \$0.2 million to NT\$6,082,131, or approximately \$0.2 million. Based on the monthly payments made under the Second Equipment Finance Agreement, the annual interest rate is calculated to be 3.1%. Upon an event of default under the Second Equipment Finance Agreement, Prime World’s payment obligation will be secured by a promissory note to Chailease at the amount of NT\$209,555,736 or approximately \$6.8 million, subject to certain terms and conditions. The title of the equipment will be transferred to Prime World upon expiration of the Second Equipment Finance Agreement. As of December 31, 2019, \$4.6 million was outstanding under the Second Equipment Finance Agreement.

On December 11, 2018, Prime World entered into a one-year credit facility totaling NT\$150 million, or approximately \$4.9 million, (the “Credit Facility”) with CTBC Bank Co., Ltd. (“CTBC”). Borrowing under the Credit Facility will be used for short-term working capital. Prime World may draw upon the Credit Facility from December 11, 2018 until October 31, 2019. The term of each draw shall be up to 120 days. Under the Credit Facility borrowing in NT dollars will bear interest at a rate equal to CTBC’s Enterprise Swap Index Rate plus 1.2%; for all foreign currency borrowing interest bear at a rate equal to CTBC’s Cost of Fund lending rate plus 1.2%. As of the execution of the Credit Facility, CTBC’s Enterprise Swap Index Rate and Cost of Funds lending rate is 0.69% and 3.40% respectively. At the end of the draw term, Prime World is required to make payments for all principal and accrued interest. The Credit Facility contains representations and warranties, and events of default applicable to Prime World that are customary for agreements of this type. As of December 31, 2019, the Credit Facility has been fully repaid and the agreement has terminated.

On April 11, 2019, Prime World entered into a one-year credit facility totaling NT\$80 million, or approximately \$2.6 million, (the “Far Eastern Credit Facility”) with Far Eastern International Bank Co., Ltd. (“Far Eastern”). Prime World may draw upon the Far Eastern Credit Facility from April 11, 2019 until April 11, 2020. The term of each draw shall be up to 180 days. Under the Far Eastern Credit Facility borrowing in NT dollars will bear interest at a rate equal to Far Eastern’s published one-year fixed term time deposits rate, plus 0.655%; for all foreign currency borrowing, interest shall be the TAIFX3 rate for the length of time equal to the term of the loan or the next longer tenor for which rates are quoted, plus 0.7%. As of the execution of the Far Eastern Credit Facility, Far Eastern’s published one-year fixed term time deposits rate and TAIFX3 rate are 1.045 % and 2.75%, respectively. Prime World’s obligations under the Far Eastern Credit Facility will be secured by a promissory note executed between Prime World and Far Eastern. As of December 31, 2019, \$2.7 million was outstanding under the Far Eastern Credit Facility.

On September 21, 2018, the Company’s China subsidiary, Global Technology, Inc., entered into a five-year revolving credit line agreement, totaling 129,000,000 Chinese Renminbi, or RMB, or approximately \$18.6 million, (the “Credit Line”) and a Security Agreement with China Construction Bank Co., Ltd., in Ningbo, China (“CCB”). Borrowing under the Credit Line will be used for general corporate and capital investment purposes, including the issuance of bank acceptance notes to Global’s vendors. Global may draw upon the Credit Line between September 21, 2018 and September 17, 2023; however, the amount of available credit under the Credit Line may be reduced by CCB without notice to Global and may be decreased subject to changes of Chinese government regulations. Each draw bears interest equal to CCB’s commercial banking interest rate effective on the day of the applicable draw. Global’s obligations under the Credit Line is secured by real property owned by Global in China and mortgaged to CCB under the terms of the Security Agreement. On May 10, 2019, Global repaid the Credit Line without penalty and terminated the agreement.

On April 19, 2019, the Company’s China subsidiary, Global, entered into a twelve (12) month revolving line of credit agreement, totaling 60,000,000 RMB, or approximately \$8.9 million, (the “China Merchants Credit Line”), with China Merchants Bank Co., Ltd., in Ningbo, China (“China Merchants”). The China Merchants Credit Line will be used by Global for general corporate purposes, including the issuance of bank acceptance notes to Global’s vendors. Global may draw upon the China Merchants Credit Line from April 19, 2019 until April 18, 2020 (the “Credit Period”). During the Credit Period, Global may request to draw upon the China Merchants Credit Line on an as-needed basis; however, the amount of available credit under the China Merchants Credit Line and the approval of each draw may be reduced or declined by China Merchants due to changes in Chinese government regulations and/or changes in Global’s financial and operational condition at the time of each requested draw. Each draw will bear interest equal to China Merchants’ commercial banking interest rate effective on the day of the applicable draw. Global’s obligations under the China Merchants Credit Line are unsecured. As of December 31, 2019, there was no outstanding balance under the China Merchants Credit Line and the outstanding balance of bank acceptance notes issued to vendors was \$0.1 million.

On April 30, 2019, the Company’s China subsidiary, Global, entered into a one-year credit facility totaling 9,900,000 RMB, or approximately \$1.5 million, (the “SPD ¥9.9M Credit Facility”), with Shanghai Pudong Development Bank Co. (“SPD”). Borrowing under the SPD ¥9.9M Credit Facility will be used for short-term working capital. Global may draw upon the SPD ¥9.9M Credit Facility from April 30, 2019 until May 9, 2019. Borrowing under the SPD ¥9.9M Credit Facility will mature on April 30, 2020 and will bear interest equal to SPD’s published twelve (12) month prime loan rate in effect on the date of the draw, plus 0.2475%. Under the SPD ¥9.9M Credit Facility, Global will make monthly payments of accrued interest and

the principal shall be repaid upon maturity. Global's obligations under the SPD ¥9.9M Credit Facility are unsecured. The SPD ¥9.9M Credit Facility has been replaced by the SPD Credit Line on May 24, 2019.

On May 7, 2019, the Company's China subsidiary, Global, entered into a one-year credit facility totaling 30,000,000 RMB, or approximately \$4.5 million, (the "SPD ¥30M Credit Facility"), with SPD. Borrowing under the SPD ¥30M Credit Facility will be used to repay Global's outstanding loans with China Construction Bank. Borrowing under the SPD ¥30M Credit Facility will mature on May 7, 2020 and will bear interest equal to the Bank's published twelve (12) month prime loan rate in effect on the date of the draw, plus 0.2475%. As of the execution of the Credit Facility agreement, the Bank's published 12 months prime loan rate is 4.32%. Under the SPD ¥30M Credit Facility, Global will make monthly payments of accrued interest; principal shall be repaid upon maturity. Global's obligations under the SPD ¥30M Credit Facility are unsecured. The SPD ¥30M Credit Facility has been replaced by the SPD Credit Line on May 24, 2019.

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On May 8, 2019, the Company's China subsidiary, Global, entered into a six-month credit facility totaling 2,000,000 USD (the “\$2M Credit Facility”) with SPD. Borrowing under the \$2M Credit Facility will be used to repay Global’s outstanding loans with CCB and for general corporate purposes. Borrowing under the \$2M Credit Facility will mature on November 7, 2019 and will bear interest equal to SPD’s published six (6) month LIBOR in effect on the date of the draw, plus 1.48%. As of the execution of the \$2M Credit Facility agreement, the SPD published 6 months LIBOR rate was 2.59438%. Under the \$2M Credit Facility, Global will make quarterly payments of accrued interest; principal shall be repaid upon maturity. Global’s obligations under the \$2M Credit Facility are unsecured. The \$2M Credit Facility has been replaced by the SPD Credit Line on May 24, 2019.

On May 24, 2019, the Company’s China subsidiary, Global, entered into a five-year revolving credit line agreement, totaling 180,000,000 RMB (the “SPD Credit Line”), or approximately \$25.4 million, and a mortgage security agreement (the “Security Agreement”), with SPD. Borrowing under the SPD Credit Line will be used for general corporate and capital investment purposes, including the issuance of bank acceptance notes to Global’s vendors. The total SPD Credit Line of 180 million RMB is inclusive of all credit facilities previously entered into with SPD including: a 30 million RMB credit facility entered into on May 7, 2019; and a 9.9 million RMB credit facility entered into on April 30, 2019. Global may draw upon the SPD Credit Line on an as-needed basis at any time during the 5-year term; however, draws under the SPD Credit Line may become due and repayable to SPD at SPD’s discretion due to changes in Chinese government regulations and/or changes in Global’s financial and operational condition. Each draw will bear interest equal to SPD’s commercial banking interest rate effective on the day of the applicable draw. Global’s obligations under the SPD Credit Line will be secured by real property owned by Global and mortgaged to the Bank under the terms of the Security Agreement. As of December 31, 2019, \$7.9 million was outstanding under the SPD Credit Line and the outstanding balance of bank acceptance notes issued to vendors was \$5.5 million.

On June 21, 2019, the Company’s China subsidiary, Global, entered into an 18 month credit facility totaling 100,000,000 RMB (the “¥100M Credit Facility”), or approximately \$14.1 million, with China Zheshang Bank Co., Ltd., in Ningbo City, China (“CZB”). Borrowing under the ¥100M Credit Facility will be used by Global for general corporate purposes. Global may draw upon the ¥100M Credit Facility from June 21, 2019 until January 4, 2021 (the “¥100M Credit Period”). During the ¥100M Credit Period, Global may request to draw upon the ¥100M Credit Facility on an as-needed basis; however, draws under the ¥100M Credit Facility may become due and repayable to CZB at CZB’s discretion due to changes in Chinese government regulations and/or changes in Global’s financial and operational condition. Each draw will bear interest equal to CZB’s commercial banking interest rate effective on the day of the applicable draw. Global’s obligations under the ¥100M Credit Facility will be secured by real property owned by Global and mortgaged to CZB under the terms of the Real Estate Security Agreement. As of December 31, 2019, there was no outstanding balance under the ¥100M Credit Facility.

On June 21, 2019, the Company’s China subsidiary, Global, entered into a three-year credit facility totaling 50,000,000 RMB (the “¥50M Credit Facility”), or approximately \$7.1 million, with China Zheshang Bank Co., Ltd., in Ningbo City, China (“CZB”). Borrowing under the ¥50M Credit Facility will be used by Global for general corporate purposes. Global may draw upon the ¥50M Credit Facility from June 21, 2019 until June 20, 2022 (the “¥50M Credit Period”). During the ¥50M Credit Period, Global may request to draw upon the Credit Facility on an as-needed basis; however, draws under the ¥50M Credit Facility may become due and repayable to CZB at CZB’s discretion due to changes in Chinese government regulations and/or changes in Global’s financial and operational condition. Each draw will bear interest equal to CZB’s commercial banking interest rate effective on the day of the applicable draw. Global’s obligations under the ¥50M Credit Facility will be secured by machinery and equipment owned by Global and mortgaged to CZB under the terms of the Machinery and Equipment Security Agreement. As of December 31, 2019, \$7.2 million was outstanding under the ¥50M Credit Facility and the outstanding balance of bank acceptance notes issued to vendors was \$0.8 million.

As of December 31, 2019 and 2018, the Company had \$48.8 million and \$69.4 million of unused borrowing capacity, respectively.

One-month LIBOR rates were 1.76% and 2.50% at December 31, 2019 and 2018, respectively.

As of December 31, 2019 and 2018, there was \$6.1 million and \$2.4 million of restricted cash, investments or security deposit associated mainly with the loan facilities, respectively.

**NOTE L—CONVERTIBLE SENIOR NOTES**

On March 5, 2019, the Company issued \$80.5 million of 5% convertible senior notes due 2024 (the “Notes”). The Notes were issued pursuant to an indenture, dated as of March 5, 2019 (the “Indenture”), between the Company and Wells Fargo Bank, National Association, as trustee, paying agent, and conversion agent (the “Trustee”). The Notes bear interest at a rate of 5.00% per year, payable in cash semi-annually in arrears on March 15 and September 15 of each year, beginning on September 15, 2019. The Notes will mature on March 15, 2024, unless earlier repurchased, redeemed or converted in accordance with their terms.

The sale of the Notes generated net proceeds of \$76.4 million, after deducting the Initial Purchasers’ discounts and offering expenses payable by the Company. The Company used approximately \$37.8 million of the net proceeds from the offering to fully repay the CapEx Loan and Term Loan with BB&T and the remainder will be used for general corporate purposes.

The following table presents the carrying value of the Notes for the periods indicated (in thousands):

	<b>December 31, 2019</b>
Principal	\$ 80,500
Unamortized debt issuance costs	(3,459)
<b>Net carrying amount</b>	<b>\$ 77,041</b>

The Notes are convertible at the option of holders of the Notes at any time until the close of business on the scheduled trading day immediately preceding the maturity date. Upon conversion, holders of the Notes will receive shares of the Company’s common stock, together, if applicable, with cash in lieu of any fractional share, at the then-applicable conversion rate. The initial conversion rate is 56.9801 shares of the Company’s common stock per \$1,000 principal amount of Notes (representing an initial conversion price of approximately \$17.55 per share of common stock, which represents an initial conversion premium of approximately 30% above the closing price of \$13.50 per share of the Company’s common stock on February 28, 2019), subject to customary adjustments. If a make-whole fundamental change (as defined in the Indenture) occurs, and in connection with certain other conversions before March 15, 2022, the Company will in certain circumstances increase the conversion rate for a specified period of time.

Initially there are no guarantors of the Notes, but the Notes will be fully and unconditionally guaranteed, on a senior, unsecured basis by certain of the Company’s future domestic subsidiaries. The Notes are the Company’s senior, unsecured obligations and are equal in right of payment with existing and future senior, unsecured indebtedness, senior in right of payment to the Company’s existing and future indebtedness that is expressly subordinated to the Notes and effectively subordinated to the Company’s existing and future secured indebtedness, to the extent of the value of the collateral securing that indebtedness. The Note Guarantee (as defined in the Indenture) of each future guarantor, if any, will be such guarantor’s senior, unsecured obligations and are equal in right of payment with existing and future senior, unsecured indebtedness, senior in right of payment to such future guarantor’s existing and future indebtedness that is expressly subordinated to the Notes and effectively subordinated to such future guarantor’s existing and future secured indebtedness, to the extent of the value of the collateral securing that indebtedness.

Holders may require the Company to repurchase their Notes upon the occurrence of a fundamental change (as defined in the Indenture) at a cash purchase price equal to the principal amount thereof plus accrued and unpaid interest, if any.

The Company may not redeem the Notes prior to March 15, 2022. On or after March 15, 2022, the Company may redeem for cash all or part of the Notes if the last reported sale price per share of the Company’s common stock exceeds 130% of the conversion price on (i) each of at least 20 trading days, whether or not consecutive, during the 30 consecutive trading days ending on, and including, the trading day immediately before the date the Company sends the related redemption notice; and (ii) the trading day immediately before the date the Company sends such redemption notice. The redemption price is equal to 100% of the principal amount of the notes to be redeemed, plus accrued and unpaid interest to, but excluding, the redemption date. In addition, calling any Note for redemption will constitute a “make-whole fundamental change” with respect to that Note, in which case the conversion rate applicable to the conversion of that Note will be increased in certain circumstances if it is converted after it is called for redemption.

The Indenture contains covenants that limit the Company’s ability and the ability of our subsidiaries to, among other things: (i) incur or guarantee additional indebtedness or issue disqualified stock; and (ii) create or incur liens.

Pursuant to the guidance in ASC 815-40, *Contracts in Entity’s Own Equity*, the Company evaluated whether the conversion feature of the note needed to be bifurcated from the host instrument as a freestanding financial instrument. Under ASC 815-40, to qualify for equity classification (or non-bifurcation, if embedded) the instrument (or embedded feature) must be both (1) indexed to the issuer’s own stock and (2) meet the requirements of the equity classification guidance. Based upon the

Company's analysis, it was determined the conversion option is indexed to its own stock and also met all the criteria for equity classification contained in ASC 815-40-25-7 and 815-40-25-10. Accordingly, the conversion option is not required to be bifurcated from the host instrument as a freestanding financial instrument. Since the conversion feature meets the equity scope exception from derivative accounting, the Company then evaluated whether the conversion feature needed to be separately accounted for as an equity component under ASC 470-20, *Debt with Conversion and Other Options*. The Company determined that notes should be accounted for in their entirety as a liability.

The Company incurred approximately \$4.1 million in transaction costs in connection with the issuance of the Notes. These costs were recognized as a reduction of the carrying amount of the Notes utilizing the effective interest method and are being amortized over the term of the notes.

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The following table sets forth interest expense information related to the Notes (in thousands):

	Three months ended December 31,		Year ended December 31,	
	2019	2018	2019	2018
Contractual interest expense	984	—	3,276	—
Amortization of debt issuance costs	207	—	681	—
Total interest cost	\$ 1,191	\$ —	\$ 3,957	\$ —
Effective interest rate	5.1%	0%	5.1%	0%

## NOTE M—ACCRUED LIABILITIES

Accrued liabilities consisted of the following for the periods indicated (in thousands):

	December 31, 2019	December 31, 2018
Accrued payroll	\$ 11,009	\$ 10,772
Accrued rent	—	1,200
Accrued employee benefits	2,288	2,862
Accrued state and local taxes	1,215	1,088
Accrued interest	1,208	163
Advance payments	312	426
Accrued product warranty	821	995
Accrued commission expenses	420	398
Accrued professional fees	222	315
Accrued capital expenditures	—	371
Accrued other	369	701
Total accrued liabilities	\$ 17,864	\$ 19,291

## NOTE N—OTHER INCOME AND EXPENSE

Other income and expense consisted of the following for the periods indicated (in thousands):

	Year ended December 31,		
	2019	2018	2017
Foreign exchange transaction gain (loss)	\$ 20	\$ 663	\$ (2,012)
Government subsidy income	1,614	934	211
Other non-operating gain	219	224	110
Loss on disposal of assets	(13)	(7)	(97)
Total other income (expense), net	\$ 1,840	\$ 1,814	\$ (1,788)

## NOTE O—INCOME TAXES

The sources of the Company's income (loss) from operations before income taxes were as follows (in thousands):

	Year ended December 31,		
	2019	2018	2017
Domestic	\$ (35,279)	\$ (11,444)	17,497
Foreign	(16,108)	1,666	67,029
Total income (loss) before income taxes	\$ (51,387)	\$ (9,778)	84,526

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The provision for income tax expense (benefit) for the years ended December 31, was as follows (in thousands):

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Current:			
Federal	\$ —	\$ —	\$ —
State	16	80	(292)
Foreign	97	1,349	10,965
Total	\$ 113	\$ 1,429	\$ 10,673
Deferred:			
Federal	\$ 16,375	\$ (6,391)	\$ 2,015
State	1,716	61	(1,669)
Foreign	(3,542)	(2,731)	(444)
Total	\$ 14,549	\$ (9,061)	\$ (98)
Income tax (benefit) expense	<b>\$ 14,662</b>	<b>\$ (7,632)</b>	<b>\$ 10,575</b>

Deferred income tax assets and liabilities result principally from net operating losses, different methods of recognizing depreciation, reserves for doubtful accounts and inventory, research and development credits and foreign tax credits. At December 31, the net deferred tax assets and liabilities are comprised of the following approximate amounts (in thousands):

	<b>2019</b>	<b>2018</b>
NOL carryforward	\$ 21,516	\$ 12,049
Inventory reserves	2,385	1,490
AMT credit	172	172
Unrealized gains and losses	96	69
Share-based compensation	528	510
Foreign tax credit	4,599	4,599
Research and development credits	8,264	6,648
Interest	888	208
ASC 842 Assets	1,641	—
Other	520	718
Deferred tax assets	40,609	26,463
Less valuation allowance	(25,736)	—
Deferred tax assets, net	14,873	26,463
Depreciation and amortization	(6,180)	(4,749)
ASC 842 Liabilities	(1,406)	—
Deferred tax liabilities	(7,586)	(4,749)
Deferred tax assets, net	<b>\$ 7,287</b>	<b>\$ 21,714</b>

The Company has a U.S. net operating loss carry forward of approximately \$75.9 million, \$32.7 million of which, if unused, expires between 2026 and 2032 and \$43.2 million of which, can be carried forward indefinitely. The Company has U.S. and state research and development tax credits of \$8.3 million, which, if unused, expire between 2028 and 2038. In addition, the Company has foreign tax credits of \$4.6 million, which, if unused, will expire in 2028. Utilization of U.S. net operating losses and tax credit carry forwards are subject to an annual limitation due to the ownership change limitations set forth in Internal Revenue Code Section 382.

Management assesses the available positive and negative evidence to estimate whether sufficient future taxable income will be generated to permit use of the existing deferred tax assets. A significant piece of objective negative evidence evaluated was the cumulative loss incurred over the three-year period ended December 31, 2019. Such objective evidence limits the ability to consider other subjective evidence, such as our projections for future growth.

On the basis of this evaluation, as of December 31, 2019, a valuation allowance of \$25.7 million has been recorded to recognize only the portion of the deferred tax asset that is more likely than not to be realized. Substantially all of the the deferred taxes in the US has been reserved with the remaining deferred taxes in Taiwan and China considered more likely than not to be realizable as of December 31, 2019. The amount of the deferred tax asset considered realizable, however, could be adjusted if estimates of future taxable income during the carryforward period are reduced or increased or if objective negative evidence in the form of cumulative losses is no longer present and additional weight is given to subjective evidence such as our projections for growth.

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A reconciliation of the U.S. federal income tax rate of 21%, 21% and 35% for the years ended December 31, 2019, 2018 and 2017, respectively, to the Company's effective income tax rate follows (in thousands):

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Expected taxes at statutory rate	\$ (10,791)	\$ (2,053)	\$ 29,584
Non-deductible/non-taxable items	962	1,020	1,212
Foreign rate differences	590	(1,043)	(11,656)
Foreign permanent differences	(671)	(1,067)	416
Increase (decrease) in valuation allowance	25,736	—	(1,700)
Share-based compensation	607	(1,325)	(10,348)
Changes in tax rates	—	(103)	2,768
Transition tax adjustment, net of foreign tax credits		(1,777)	5,067
Research and development credits	(1,616)	(2,022)	(2,821)
Uncertain tax positions	—	—	(1,616)
Foreign other	27	514	—
Other, net	(182)	224	(331)
Tax (benefit) expense	\$ 14,662	\$ (7,632)	\$ 10,575

The Company's provision for income taxes in 2019 was higher than 2018 primarily due to the recognition of a valuation allowance on our US and state deferred tax assets, along with excess tax expense from stock-based compensation, partially offset by differences in pre-tax income and recording research and development credits.

The Company's provision for income taxes in 2018 was lower than in 2017 primarily due to a decrease in pre-tax income and the impact of the 2017 Tax Act, partially offset by excess tax benefits from stock-based compensation, recording research and development credits, and the U.S. return-to-accrual adjustment as a result of the 2017 Tax Act as discussed below.

The Company's wholly owned subsidiary, Prime World is a tax-exempt entity under the Income Tax Code of the British Virgin Islands.

The Company's wholly owned subsidiary, Global Technology, Inc., has enjoyed preferential tax concessions in China as a national high-tech enterprise. In March 2007, China's parliament enacted the PRC Enterprise Income Tax Law, or the EIT Law, under which, effective January 1, 2008, China adopted a uniform income tax rate of 25% for all enterprises including foreign invested enterprises. Global Technology, Inc. was recognized as a National high-tech enterprise in 2008 and was entitled to a 15% tax rate for a three year period from November 2008 to November 2011. In 2011 and 2014, Global Technology, Inc. renewed its National high-tech enterprise certificate and was therefore extended its three-year tax preferential status through September 2017. In November 2017, Global Technology, Inc. again renewed its National high-tech enterprise certificate and was therefore extended its three-year tax preferential status from November 2017 until November 2020. This tax holiday reduced its 2019, 2018 and 2017 income tax provision by approximately \$1.0, \$0.5 and \$1.4 million respectively. This tax holiday reduced its fiscal 2019, 2018 and 2017 diluted earnings per share by approximately \$0.05, \$0.03 and \$0.07 respectively. Effective January 1, 2016, China expanded the scope of the National high-tech enterprise to include additional deductions for qualifying research and development.

As of December 31, 2019, 2018 and 2017, the total amount of unrecognized tax benefit was \$0.2 million, \$0.2 million, and \$0.2 million, respectively. The following is a tabular reconciliation of the total amounts of unrecognized tax benefits (in thousands):

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Unrecognized tax benefits — January 1	\$ 181	\$ 181	\$ 181
Gross increases — tax positions in prior period	—	—	—
Gross decreases — tax positions in prior period	—	—	—
Unrecognized tax benefits — December 31	\$ 181	\$ 181	\$ 181

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The Company recognizes interest accrued related to unrecognized tax benefits and penalties as income tax expense. Related to the unrecognized tax benefits noted above, it has not accrued penalties or interest during 2019 as a result of net operating losses. During 2018 or 2017, the Company also accrued no penalties or interest.

The Company is subject to taxation in the United States and various states and foreign jurisdictions. The Company's open tax years subject to examination in the U.S. federal and state jurisdictions are 2016 through 2018. To the extent allowed by law, the taxing authorities may have the right to examine prior periods where net operating losses or tax credits were generated and carried forward, and make adjustments up to the amount of the net operating loss or tax credit carryforward. The Company is subject to examination for tax years 2010 forward for various foreign jurisdictions.

The U.S. Tax Act significantly changed how the U.S. taxes corporations. The U.S. Tax Act requires complex computations to be performed that were not previously required by U.S. tax law, significant judgments to be made in interpretation of the provisions of the U.S. Tax Act, significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury Department, the IRS, and other standard-setting bodies will continue to interpret or issue guidance on how provisions of the U.S. Tax Act will be applied or otherwise administered. As future guidance is issued, the Company may make adjustments to amounts that we have previously recorded that may materially impact our provision for income taxes in the period in which the adjustments are made.

As of December 31, 2019, the Company has accumulated undistributed earnings generated by its foreign subsidiaries of approximately \$27.9 million. Because \$27.9 million of such earnings have previously been subject to the one-time transition tax on foreign earnings required by the U.S. Tax Act, any additional taxes due with respect to such earnings or the excess of the amount for financial reporting over the tax basis of our foreign investments would generally be limited to foreign and state taxes. The Company intends, however, to indefinitely reinvest these earnings and expects future U.S. cash generation to be sufficient to meet future U.S. cash needs.

## **NOTE P—SHARE-BASED COMPENSATION**

### *Equity Plans*

The Company's board of directors and stockholders approved the following equity plans:

- the 1998 Share Incentive Plan

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- the 2000 Share Incentive Plan
- the 2004 Share Incentive Plan
- the 2006 Share Incentive Plan
- the Amended and Restated 2013 Equity Incentive Plan (“2013 Plan”)

The Company issued stock options, restricted stock awards (“RSAs”) and restricted stock units (“RSUs”) to employees, consultants and non-employee directors. Stock option awards generally vest over a four year period and have a maximum term of ten years. Stock options under these plans have been granted with an exercise price equal to the fair market value on the date of the grant. Nonqualified and Incentive Stock Options, RSAs and RSUs may be granted from these plans. Prior to the Company’s initial public offering in September 2013, the fair market value of the Company’s stock had been historically determined by the board of directors and from time to time with the assistance of third party valuation specialists.

### *Stock Options*

Options have been granted to the Company’s employees under the five incentive plans and generally become exercisable as to 25% of the shares on the first anniversary date following the date of grant and semi-annually thereafter. All options expire ten years after the date of grant.

The following is a summary of option activity (in thousands, except per share data):

	<b>Number of shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Share Price on Date of Exercise</b>	<b>Weighted Average Fair Value</b>	<b>Weighted Average Remaining Contractual Life</b>	<b>Aggregate Intrinsic Value</b>
(in thousands, except price data)						
Outstanding, January 1, 2019	287	\$ 10.19		\$ 5.31		\$ 1,503
Exercised	(4)	7.79	\$ 12.91	3.95		15
Forfeited	(2)	12.20		6.08		2
Outstanding, December 31, 2019	281	\$ 10.21		\$ 5.32	3.87	573
Exercisable, December 31, 2019	281	\$ 10.21			3.87	573
Vested and expected to vest	281	\$ 10.21			3.87	\$ 573

As of December 31, 2019, there was no unrecognized stock option expense.

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*Restricted Stock Unit/Awards*

The following is a summary of RSU/RSA activity (in thousands, except per share data):

	Number of shares	Date of Release	Weighted Average Share Price on Date of Release	Weighted Average Fair Value	Aggregate Intrinsic Value
(in thousands, except price data)					
Outstanding at January 1, 2019	826		\$ 32.07	\$ 12,744	
Granted	445		13.30	6	
Released	(452)	\$ 25.95	25.95	6	
Cancelled/Forfeited	(49)		26.17	584	
<b>Outstanding, December 31, 2019</b>	<b>770</b>		<b>25.18</b>	<b>9,143</b>	
Vested and expected to vest	<u>770</u>		<u>\$ 25.18</u>	<u>\$ 9,143</u>	

The aggregate intrinsic value of RSUs and RSAs outstanding at December 31, 2019 was \$9.8 million. Unrecognized compensation expense related to these RSUs and RSAs at December 31, 2019 was \$16.8 million. This expense is expected to be recognized over 1.99 years.

*Share-Based Compensation*

The Company recognizes compensation expense on a straight-line basis over the applicable vesting term of the award and expense is adjusted as forfeitures occur.

In 2014, the Company ceased issuing stock options and began issuing RSUs and RSAs as share-based compensation to employees. The Company estimates the fair value of RSUs and RSAs at the fair market value on the grant date.

Employee share-based compensation expenses recognized for the years ended December 31, were as follows (in thousands):

Share-Based compensation - by expense type:

	2019	2018	2017
Cost of goods sold	\$ 772	\$ 795	\$ 461
Research and development	2,557	2,419	1,496
Sales and marketing	1,070	925	481
General and administrative	7,405	6,981	5,357
<b>Total share-based compensation expense</b>	<b>\$ 11,804</b>	<b>\$ 11,120</b>	<b>\$ 7,795</b>

Share-Based compensation - by award type:

	2019	2018	2017
Employee stock options	\$ —	\$ 12	\$ 853
Restricted stock units	11,804	11,108	6,942
<b>Total share-based compensation expense</b>	<b>\$ 11,804</b>	<b>\$ 11,120</b>	<b>\$ 7,795</b>

## **NOTE Q—STOCKHOLDERS’ EQUITY**

### *Common Stock*

The Company’s Amended and Restated Certificate of Incorporation authorizes the issuance of up to 45,000,000 shares of common stock, all of which have been designated voting common stock.

### *Preferred Stock*

The Company’s Amended and Restated Certificate of Incorporation authorizes the issuance of up to 5,000,000 shares of preferred stock.

### *Public Offerings of Common Stock*

On October 17, 2016, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission effective November 1, 2016, providing for the public offer and sale of certain securities of the Company from time to time, at its discretion, up to an aggregate amount of \$250 million. In connection with such Form S-3, the Company entered into an Equity Distribution Agreement with Raymond James & Associates, Inc. pursuant to which the Company may issue and sell shares of the Company’s stock having an aggregate offering price of up to \$50.0 million (the “Second ATM Offering”) from time to time through Raymond James & Associates, Inc. On November 22, 2016, the Company commenced sales of common stock through the Second ATM Offering. The Company completed its Second ATM Offering in March 2017 and sold 1.6 million shares of common stock at a weighted average price of \$31.55 per share, providing proceeds of \$48.8 million, net of expenses and underwriting discounts and commissions. On October 24, 2019, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission effective January 9, 2020, providing for the public offer and sale of certain securities of the Company from time to time, at its discretion, up to an aggregate amount of \$250 million. No shares of common stock have been sold pursuant to this Registration Statement on Form S-3.

## NOTE R—SEGMENT AND GEOGRAPHIC INFORMATION

The Company operates in one reportable segment. The Company's Chief Executive Officer, who is considered to be the chief operating decision maker, manages the Company's operations as a whole and reviews financial information presented on a consolidated basis, accompanied by information about product revenue, for purposes of evaluating financial performance and allocating resources.

The following tables set forth the Company's revenue and asset information by geographic region. Revenue is classified based on the location of where the product is manufactured. Long-lived assets in the tables below comprise only property, plant, equipment and intangible assets (in thousands):

	For the Years ended December 31,		
	2019	2018	2017
<b>Revenues:</b>			
United States	\$ 9,795	\$ 10,795	\$ 18,209
Taiwan	97,776	113,547	241,820
China	83,301	143,123	122,300
	<b>\$ 190,872</b>	<b>\$ 267,465</b>	<b>\$ 382,329</b>

	As of December 31,		
	2019	2018	2017
<b>Long-lived assets:</b>			
United States	\$ 94,507	\$ 88,815	\$ 75,446
Taiwan	73,816	65,451	67,379
China	97,687	89,736	59,929
	<b>\$ 266,010</b>	<b>\$ 244,002</b>	<b>\$ 202,754</b>

The Company serves four primary markets, the internet data center, CATV, telecom and FTTH markets. Of the Company's total revenues in 2019, the Company earned \$143.6 million, or 75.2%, from the internet data center market, \$37.3 million, or 19.6%, from the CATV market, \$8.4 million, or 4.4%, from the telecom market and \$0.2 million, or 0.1%, from the FTTH market. Of the Company's total revenues in 2018, the Company earned \$200.2 million, or 74.9%, from the internet data center market, \$51.7 million, or 19.3%, from the CATV market, \$13.2 million, or 4.9%, from the telecom market and \$0.8 million, or 0.3%, from the FTTH market. Of the Company's total revenues in 2017, the Company earned \$306.7 million, or 80.2%, from the internet data center market, \$60.8 million, or 15.9%, from the CATV market, \$12.9 million, or 3.4%, from the telecom market and \$0.5 million, or 0.1%, from the FTTH market.

## NOTE S—EMPLOYEE BENEFIT PLANS

On August 1, 2000, the Company established a 401(k) profit sharing plan covering employees meeting certain age and service requirements. The plan provides for discretionary Company contributions to be allocated based on the employee's eligible contributions. The Company made contributions of \$0.8 million \$0.8 million, and \$0.6 million to the 401(k) plan for the years ended December 31, 2019, 2018 and 2017, respectively.

Employees of Global participate in a state-mandated social security program in China. Under this program, pension costs are recorded on the basis of required monthly contributions to employees' individual accounts during their service periods. Under the regulations of the People's Republic of China, Global is required to make fixed contributions to a fund, which is under the administration of the local labor departments. Pension expense for Global was \$0.7 million, \$0.9 million, and \$0.8 million in the years ended for the year ended December 31, 2019, 2018 and 2017, respectively.

Employees Prime World's Taiwan branch participate in a pension program under the Taiwan Labor Pension Act. Pension expense for the Prime World's Taiwan branch was \$0.8 million, \$0.9 million, and \$0.9 million for the years ended December 31, 2019, 2018 and 2017, respectively.

## NOTE T—COMMITMENTS AND CONTINGENCIES

### *Commitments*

The Company conducts part of its operations from leased facilities and also leases equipment. Rent expense was \$1.3 million, \$1.1 million and \$1.1 million, respectively, for the years ended December 31, 2019, 2018 and 2017, respectively.

At December 31, 2019, the approximate minimum rental commitments under noncancelable leases in excess of one year that expire at varying dates through 2029 were as follows (in thousands):

<b>Year ended December 31,</b>	<b>Amount</b>
2020	\$ 1,256
2021	1,181
2022	1,120
2023	1,156
2024	1,090
thereafter	5,040
	<b>\$ 10,843</b>

### *Employment Agreements and Consultancy Agreements*

The Company has entered into employment and indemnification agreements with three executive officers. These agreements provide that if their employment is terminated as a result of a change of control of the Company, or if their employment is terminated for certain other reasons set forth in the agreements, the Company will be required to pay a severance payment in an amount equal to their annual base salary, and other additional compensation due under the terms of the agreements.

The Company has also entered into employment and indemnification agreements with one other executive officer. These agreements provide that if their employment is terminated as a result of a change of control of the Company, the Company will be required to pay a severance payment in an amount equal to six months of their annual base salary and other additional compensation due under the terms of the agreements.

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### *Contingencies*

From time to time, the Company may be subject to legal proceedings and litigation arising in the ordinary course of business, including, but not limited to, inquiries, investigations, audits and other regulatory proceedings, such as described below. The Company records a loss provision when it believes it is both probable that a liability has been incurred and the amount can be reasonably estimated. Unless otherwise disclosed, the Company is unable to estimate the possible loss or range of loss for the legal proceeding described below.

Except for the lawsuits described below, the Company believes that there are no claims or actions pending or threatened against it, the ultimate disposition of which would have a material adverse effect on it.

#### *Class Action and Shareholder Derivative Litigation*

On August 5, 2017, a lawsuit was filed in the U.S. District Court for the Southern District of Texas against the Company and two of its officers in *Mona Abouzied v. Applied Optoelectronics, Inc., Chih-Hsiang (Thompson) Lin, and Stefan J. Murry, et al.*, Case No. 4:17-cv-02399. The complaint in this matter seeks class action status on behalf of the Company's shareholders, alleging violations of Sections 10(b) and 20(a) of the Exchange Act against the Company, its chief executive officer, and its chief financial officer, arising out of its announcement on August 3, 2017 that "we see softer than expected demand for our 40G solutions with one of our large customers that will offset the sequential growth and increased demand we expect in 100G." A second, related action was filed by Plaintiff Chad Ludwig on August 16, 2017 (Case No. 4:17-cv-02512) in the Southern District of Texas. The two cases were consolidated before Judge Vanessa D. Gilmore. On January 22, 2018, the court appointed Lawrence Rougier as Lead Plaintiff and Levi & Korinsky LLP as Lead Counsel. Lead Plaintiff filed an amended consolidated class action complaint on March 6, 2018. The amended complaint requests unspecified damages and other relief. The Company filed a motion to dismiss on April 4, 2018, which was denied on March 28, 2019. The Company disputes the allegations, and intends to continue to vigorously defend against these claims. On May 15, 2019, Lead Plaintiff filed a motion for leave to amend the consolidated class action complaint for the purpose of adding named Plaintiffs Richard Hamilton, Kenneth X. Luthy, Roy H. Cetlin, and John Kugel (together with Lead Plaintiff Lawrence Rougier, "Plaintiffs") to the case. The court granted the motion on May 16, 2019. The substantive allegations in the Plaintiffs' operative second amended consolidated class action complaint remain unchanged. On May 28, 2019, Plaintiffs filed a motion seeking to certify the case as a class action pursuant to Federal Rule of Civil Procedure 23 and seeking appointment of Plaintiffs as class representatives and Levi & Korsinsky as class counsel. On July 12, 2019, the Company filed a response in opposition to the motion for class certification, and on August 26, 2019, Plaintiffs filed their Reply Brief. On November 13, 2019, the Magistrate Judge issued a Memorandum and Recommendation recommending that the Plaintiffs' motion for class certification be granted, to which Defendants filed written objections on November 27, 2019. On December 11, 2019, Plaintiffs filed a response in opposition to Defendants' objections, and on December 16, 2019, Defendants filed their reply brief. The court entered an order adopting the Magistrate Judge's Memorandum and Recommendation over Defendants' objections on December 20, 2019. Thereafter, on January 3, 2020, Defendants filed a petition for permission to appeal the class certification order to the Fifth Circuit Court of Appeals. Plaintiffs filed an answer in opposition to Defendants' petition on January 13, 2020, and Defendants filed a reply brief in further support of the petition for permission to appeal on January 21, 2020. On January 23, 2020, Defendants filed an unopposed motion in the Fifth Circuit requesting that the court stay further proceedings for 90 days to allow the parties to conduct settlement negotiations. The Fifth Circuit entered an order granting the motion on January 24, 2020. The case is currently in the discovery phase, and fact discovery is scheduled to be completed by June 1, 2020. At this stage, The Company is not yet able to determine the likelihood of loss, if any, arising from this matter.

On August 7, 2018, Plaintiff Lei Jin filed a purported derivative action on behalf of nominal defendant Applied Optoelectronics, Inc. in the U.S. District Court for the Southern District of Texas against the Company's chief executive officer, chief financial officer and board of directors (Case No. 4:18-cv-02713). This case was consolidated with a later filed derivative lawsuit filed by Plaintiff Yiu Kwong Ng in the U.S. District Court for the Southern District of Texas (Case No. 4:18-cv-4751). The allegations in the consolidated derivative complaints are substantially similar to those underlying the *Abouzied* securities class action and the *Taneja* securities class action discussed below. The consolidated derivative action is stayed pending a ruling on defendants' forthcoming motion to dismiss in the *Taneja* securities class action. The Company disputes the allegations and intends to vigorously contest the matter.

On October 1, 2018, a lawsuit was filed in the U.S. District Court for the Southern District of Texas against the Company and two of its officers in *Gaurav Taneja v. Applied Optoelectronics, Inc., Thompson Lin, and Stefan Murry*, Case No. 4:18-cv-03544. The complaint in this matter seeks class action status on behalf of the Company's shareholders, alleging violations of Sections 10(b) and 20(a) of the Exchange Act against the Company, its chief executive officer, and its chief financial officer, arising out of its announcement on September 28, 2018 that it was revising its third quarter revenue guidance due to "an issue with a small percentage of 25G lasers within a specific customer environment." This case was consolidated with two identical cases styled *Davin Pokoik v. Applied Optoelectronics, Inc., Chih-Hsiang Lin, and Stefan J. Murry*, Case No. 4:18-cv-3722 and *Stephen McGrath v. Applied Optoelectronics, Inc., Chih-Hsiang Lin, and Stefan J. Murry*. Mark Naglich was appointed as Lead Plaintiff on the consolidated matter on January 4, 2019. Lead Plaintiff filed an amended consolidated complaint on March 5, 2019, and the Company filed a motion to dismiss the amended consolidated complaint on May 6, 2019. On July 5, 2019, Plaintiff filed a response in opposition to the motion to dismiss, and the Company filed its reply brief in further support of the motion on August 5, 2019. On January 29, 2020, the district court entered an order granting Defendants' motion

to dismiss and dismissing the amended consolidated complaint with prejudice. The court also entered an order denying Lead Plaintiff's request for leave to further amend the complaint, and entered a final judgment terminating the case. An appeal by Lead Plaintiff, if any, must be filed with the Fifth Circuit by February 28, 2020. The Company continues to dispute the allegations and intends to vigorously contest the matter should an appeal be filed.

**NOTE U—SUBSEQUENT EVENTS**

The Company has evaluated subsequent events through the date the financial statements were issued.

In January 2020, the Company repaid its revolving bank link of credit of \$20 million.

**NOTE V—SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

The following tables set forth a summary of the Company's quarterly financial information for each of the four quarters for the years ended December 31, 2019 and 2018 (in thousands, except per share data):

<b>Year ended December 31, 2019</b>	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth Quarter</b>
Revenue	\$ 52,719	\$ 43,411	\$ 46,084	\$ 48,658
Cost of goods sold	40,368	32,873	34,108	37,322
Gross profit	12,351	10,538	11,976	11,336
Gross margin	23.4%	24.3%	26.0%	23.3%
Operating expenses:				
Research and development	11,185	11,151	10,466	10,597
Sales and marketing	2,595	2,331	2,518	2,615
General and administrative	10,440	10,884	9,988	10,178
Total operating expenses	24,220	24,366	22,972	23,390
Income (loss) from operations	(11,869)	(13,828)	(10,996)	(12,054)
Interest and other income (expense), net	(1,079)	(729)	276	(1,109)
Net income (loss) before taxes	(12,948)	(14,557)	(10,720)	(13,163)
Income tax (expense) benefit	2,474	3,191	1,940	(22,267)
Net income (loss)	\$ (10,474)	\$ (11,366)	\$ (8,780)	\$ (35,430)
Net income (loss) per share—basic	\$ (0.53)	\$ (0.57)	\$ (0.44)	\$ (1.76)
Net income (loss) per share—diluted	\$ (0.53)	\$ (0.57)	\$ (0.44)	\$ (1.76)

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Year ended December 31, 2018	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenue	\$ 65,239	\$ 87,822	\$ 56,386	\$ 58,018
Cost of goods sold	39,403	53,959	38,849	47,481
Gross profit	25,836	33,863	17,537	10,537
Gross margin	39.6%	38.6%	31.1%	18.2%
Operating expenses:				
Research and development	11,736	12,645	14,180	11,342
Sales and marketing	2,474	2,377	2,370	1,920
General and administrative	9,456	9,898	10,591	9,552
Total operating expenses	23,666	24,920	27,141	22,814
Income from operations	2,170	8,943	(9,604)	(12,277)
Interest and other expense, net	(1,046)	1,387	578	71
Net income before taxes	1,124	10,330	(9,026)	(12,206)
Income tax (expense) benefit	996	(2,296)	5,294	3,638
Net income	\$ 2,120	\$ 8,034	\$ (3,732)	\$ (8,568)
Net income per share—basic	\$ 0.11	\$ 0.41	\$ (0.19)	\$ (0.43)
Net income per share—diluted	\$ 0.11	\$ 0.40	\$ (0.19)	\$ (0.43)