Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

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 Annual Report on Form 10-K. This discussion and other parts of this Annual Report on 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 three networking end-markets: internet data centers, CATV 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, 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 three 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 gigabits per second 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 global build-out of CATV infrastructure, 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 telecommunication service providers.

We sell our products to leading original equipment manufacturers, or OEMs, in the CATV and FTTH markets as well as internet data center operators. In 2014, we earned 36.3% of our total revenue from the CATV market, and 49.4% of our total revenue from the data center market. In 2014, our key customers in the CATV market included Cisco Systems and Arris Group, Inc. In 2014, 2013 and 2012, Cisco Systems accounted for 8.9%, 21.8%, and 33.2%, respectively, of our revenue and Arris Group, Inc. accounted for 4.5%, 3.3% and 0.8%, respectively, of our revenue. In 2014, our key customers that contributed most to our FTTH revenue were a leading internet service provider and Genexis B.V., which accounted for 5.8% and 0.8% of our total revenue, respectively. In 2014, our key customers in the internet data center market included Amazon and Microsoft. In 2014 and 2013, Amazon accounted for 45.8% and 18.2% of our revenue, respectively, and Microsoft accounted for 3.6% and 6.1% of our revenue, respectively. In 2014, revenue from the CATV market, data center market, FTTH market and other markets provided 36.3%, 49.4%, 10.4%, and 3.9% of our revenue, respectively, compared to 60.4%, 24.7%, 5.6% and 9.3% of our 2013 revenue, respectively.

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, all of whom purchase our products on a purchase order basis. Once one of our solutions is incorporated into a customer's design, however, 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 2014, 2013 and 2012, we had 15, 17 and 15 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.

We believe we have an attractive financial profile, with strong revenue performance and control over our manufacturing costs through our vertically integrated manufacturing model. While we have incurred substantial losses since our inception, and as of December 31, 2014 had an accumulated deficit of $79.0 million, we achieved profitability in 2014. We have grown our revenue at a 31.7% CAGR between 2009 and 2014, including 66.3% growth year-over-year from 2013 to 2014.

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 solution pricing varies depending upon the end market, the complexity of the product and the level of competition. Our product costs also vary with complexity as well as the degree to which we can utilize components designed and manufactured ourselves. We tend to realize higher gross margins on products that incorporate a higher percentage of our own components. 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. We sell a wide variety of products among our three target markets and our gross margin is heavily dependent in any quarter on the product mix achieved during that period.

Customer Concentration within End Markets. Historically, our revenue has been significantly concentrated, first within the CATV market and in 2014 within the internet data center market. Moreover, within these markets revenue tends to be concentrated among a small number of customers. In 2014, we have taken several actions to increase the diversity of our customer base. These actions include the creation of a new sales incentive program, hiring additional sales staff to improve our ability to serve new customers, and additional customized design of 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.

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.

Discussion of Financial Performance

Revenue

We generate revenue through the sale of our products to equipment providers for the CATV, FTTH and internet data center 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 2014, 2013 and 2012, as well as the corresponding percentage of our total revenue for each period:

Market	**Dec. 31, 2014**	**Sep. 30, 2014**	**Jun. 30, 2014**	**Mar. 31, 2014**	**Dec. 31, 2013**	**Sep. 30, 2013**	**Jun. 30, 2013**	**Mar. 31, 2013**	**Dec. 31, 2012**	**Sep. 30, 2012**	**Jun. 30, 2012**	**Mar. 31, 2012**
	(in thousands, except percentages)											
CATV	14,749	12,245	10,646	9,748	14,041	14,559	10,514	8,259	13,277	13,530	13,274	9,761
Datacenter	14,923	20,056	17,899	11,575	5,910	3,216	6,640	3,620	2,998	977	647	670
FTTH	5,663	2,616	3,096	2,216	1,603	982	705	1,087	1,512	698	418	1,063
Other	1,056	1,632	1,009	1,320	2,190	2,009	1,738	1,351	1,074	1,211	1,299	1,012
Total	36,391	36,549	32,650	24,859	23,744	20,766	19,597	14,317	18,861	16,416	15,638	12,506
	Percentage of Revenue											
CATV	40.5%	33.5%	32.6%	39.2%	59.1%	70.1%	53.7%	57.7%	70.4%	82.4%	84.9%	78.1%
Datacenter	41.0%	54.9%	54.8%	46.6%	24.9%	15.5%	33.9%	25.3%	15.9%	6.0%	4.1%	5.4%
FTTH	15.6%	7.2%	9.5%	8.9%	6.7%	4.7%	3.6%	7.6%	8.0%	4.2%	2.7%	8.5%
Other	2.9%	4.4%	3.1%	5.3%	9.3%	9.7%	8.8%	9.4%	5.7%	7.4%	8.3%	8.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

In 2014, 2013 and 2012, our top ten customers represented 87.2%, 76.9% and 77.6% of our revenue, respectively. In 2014, our key customers in the CATV market included Cisco Systems, Arris Group, Inc. and Pace plc. In 2014, 2013 and 2012, Cisco Systems accounted for 8.9%, 21.8%, and 33.2%, respectively, of our revenue and Arris Group, Inc. accounted for 4.5%, 3.3% and 0.8%, respectively, of our revenue. In 2014, our key customers in the internet data center market included Amazon and Microsoft. In 2014 and 2013, Amazon accounted for 45.8% and 18.2% of our revenue, respectively, and Microsoft accounted for 3.6% and 6.1% of our revenue, respectively.

In 2014, our key customers that contributed most to our FTTH revenue were a leading internet service provider and Genexis B.V. , which accounted for 5.8% and 0.8% of our total revenue, respectively.

Revenue is recognized when the product is shipped and title has transferred to the customer. We bear all costs and risks of loss or damage to the goods up to that point. On most orders, our terms of sale provide that title passes to the customer upon placement by us with a common carrier (upon shipment). 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, 2014, 7.9% of our total revenue was derived from our China-based subsidiary, with $5.4 million denominated in RMB and an immaterial amount denominated in NT dollars. We expect a similar portion of our sales to be denominated in foreign currencies in 2015.

Cost of goods sold and gross margin

Our cost of goods sold is impacted by variances arising from changes in yields and production volume. We typically experience lower yields and higher associated costs on new products. In general, 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 our products in all three of our facilities in the U.S., Taiwan and China. Generally, laser chips and optical components are manufactured in our U.S. facility, optical components and subassemblies are manufactured in our Taiwan facility, and optical equipment is manufactured in our China facility. Because of our vertical integration model, we utilize our own 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.

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 27.8% and 34.8%, 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 sell similar products to different geographic regions at different prices, and therefore realize different gross margins among those similar products. We generally realize a lower gross margin in sales to Asian markets. 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 often reimbursed for those development efforts. By virtue of our overseas R&D operations and by focusing on customer-specific projects, our research and development expenses have tended to represent a lower percentage of revenue compared to some of our competitors. In the future, we expect research and development expense to increase on a dollar basis, but continue to decline as a percentage of revenue, to the extent our 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 2014. 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 2014. 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 in the short term, as we develop the infrastructure necessary to operate as a public company, including increased audit and legal fees, costs to comply with the Sarbanes-Oxley Act and the rules and regulations applicable to companies listed on a national stock exchange, as well as investor relations expense and higher insurance premiums. In the future, we expect general and administrative expense to increase on a dollar basis but continue to decline as a percentage of revenue, to the extent our revenue increases over time.

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.

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. Our effective U.S. federal income tax rate was 0% prior to 2014 as we incurred operating losses and have recorded a valuation allowance against those losses. At December 31, 2014, our U.S. accumulated net operating loss, or NOL, was $56.5 million. If we earn profits in the U.S., we expect to reduce our cash tax obligations by the utilization of NOL carry forwards. Our NOL benefits expire over the twelve-year period from 2020 to 2032. Under Section 382 of the Internal Revenue Code of 1986, as amended, if a corporation undergoes an “ownership change,” the corporation’s ability to use its pre-change NOLs, capital loss carry forwards and other pre-change tax attributes to offset its post-change income may be limited going forward. Based upon an analysis of our equity ownership, we have experienced an ownership change and our NOL carry forwards are limited in dollar amount. As of December 31, 2014, of the total accumulated NOL only $31.5 million is available for utilization in future periods to offset federal taxable income. Each year after 2014, an additional $0.3 million is added to the total available NOL, until a maximum of $34.9 million is reached. The amount of NOL available each year may decrease by the amount of NOL utilized and may increase by the amount of any operating losses incurred. Should we experience additional ownership changes our NOL carry forwards may be further limited.

Our 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, Global Technology, Inc. renewed its National high-tech enterprise certificate and therefore extended its three year tax preferential status from November 2011 to November 2014. An application to extend the tax preferential status to September 2017 has been approved by the Chinese government.

For 2012, there were no identified uncertain tax positions. For the years ended December 31, 2014, and December 31, 2013, we had $1.6 million and $2.2 million, respectively, of unrecognized tax benefits related to U.S. tax benefits recognized for which do not meet the more likely than not threshold. We believe that it is reasonably possible that $0.3 million of our remaining unrecognized tax positions may be recognized by the end of 2015. If recognized, there would be no impact to our effective tax rate as a result of the full valuation allowance previously recognized.

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.

	Years ended December 31,		
	2014	2013	2012
Revenue, net	100.0%	100.0%	100.0%
Cost of goods sold	66.1%	70.6%	70.2%
Gross profit	33.9%	29.4%	29.8%
Operating expenses			
Research and development	12.2%	10.9%	12.0%
Sales and marketing	4.6%	5.3%	4.9%
General and administrative	13.1%	13.6%	12.6%
Total operating expenses	29.9%	29.8%	29.5%
Income (loss) from operations	4.0%	-0.4%	0.4%
Interest and other income (expense), net	-0.5%	-1.4%	-1.8%
Income (loss) before income taxes	3.5%	-1.8%	-1.4%
Income taxes	-0.2%	0.0%	0.0%
Net income (loss)	3.3%	-1.8%	-1.4%

Comparison of Years Ended December 31, 2014 and 2013

Revenue

The following charts provide the revenue contribution from each of the markets we served for the years ended December 31, 2014 and 2013:

	Years ended December 31,	
	2014	2013
CATV	36.3%	60.4%
Data Center	49.4%	24.7%
FTTH	10.4%	5.6%
Other	3.9%	9.3%
Total Revenue	100.0%	100.0%

	Years ended December 31,		Change	
	2014	2013	Amount	%
	(in thousands, except percentages)			
CATV	$ 47,389	$ 47,373	$ 16	0.0%
Data Center	64,453	19,386	45,067	232.5%
FTTH	13,591	4,377	9,214	210.5%
Other	5,016	7,288	(2,272)	(31.2%)
Total Revenue	$ 130,449	$ 78,424	$ 52,025	66.3%

Of our total revenue in 2014, we generated $47.4 million, or 36.3%, from the CATV market, $64.5 million, or 49.4%, from the internet data center market, $13.6 million, or 10.4%, from the FTTH market, and $5.0 million, or 3.9%, from other markets. Total revenue increased by $52.0 million, or 66.3%, from 2013 to 2014.

The increase in revenue was attributable to a $45.1 million increase from the internet data center market, primarily driven by increasing demand for our 10 gigabits per second and 40 gigabits per second transceivers as our customers continued to upgrade their technology infrastructure. Revenues in the FTTH market increased by $9.2 million, primarily driven by increasing demand for our WMD-PON products to existing customers. CATV revenues were flat year over year due to a decline in sales in certain emerging markets, offset by increased sales for newly-designed products.

Cost of goods sold and gross margin

	Years ended December 31,								
	2014			2013			Change		
	Amount		% of Revenue	Amount		% of Revenue	Amount		%
				(in thousands, except percentages)					
Cost of goods sold	$	86,203	66.1%	$	55,396	70.6%	$	30,807	55.6%
Gross margin			33.9%			29.4%			

Cost of goods sold increased by $30.8 million, or 55.6%, from 2013 to 2014, primarily due to the combination of a $21.8 million increase in direct material costs and a $9.0 million increase in labor and overhead costs, both of which were associated with our increase in revenues. Different products within our portfolio may have gross margins that vary from other products. Moreover, among the markets that we serve, average gross margins vary. In general, products that incorporate newer technology or are more differentiated from our competitors generate higher gross margins, whereas products that are older or incorporate less differentiated technology generate lower gross margins. The increase in gross margin is primarily due to a larger percentage of sales of newer, more technologically differentiated products in 2014 compared with 2013 and an overall increase in revenue.

Operating expenses

	Years ended December 31,								
	2014			2013			Change		
	Amount		% of revenue	Amount		% of revenue	Amount		%
				(in thousands, except percentages)					
Research and development	$	15,970	12.2%	$	8,512	10.9%	$	7,458	87.6%
Sales and marketing		6,043	4.6%		4,191	5.3%		1,852	44.2%
General and administrative		17,095	13.1%		10,632	13.6%		6,463	60.8%
Total operating expenses	$	39,108	30.0%	$	23,335	29.8%	$	15,773	67.6%

Research and development expense

Research and development expense increased by $7.5 million, or 87.6%, from 2013 to 2014. This was primarily due to increases in personnel costs, rent and utilities, R&D work orders and project costs related to FTTH WDM-PON products, 40G and 100G data center products and other new product development. Depreciation expense also increased due to additional R&D equipment investments.

Sales and marketing expense

Sales and marketing expense increased by $1.9 million, or 44.2%, from 2013 to 2014. This was due to an increase in personnel costs due to additional sales and marketing staff to better serve our customers, expenses for a new sales incentive program and an increase in sales commissions directly related to our revenue growth.

General and administrative expense

General and administrative expense increased by $6.5 million, or 60.8%, from 2013 to 2014. This was primarily due to an increase in share-based compensation expense, personnel costs, various expenses incurred due to becoming a public company as well as non-recurring expenses related to relocation of our Taiwan plant and CFO separation costs.

Other income (expense), net

	Years ended December 31,					
	2014		2013		Change	
	Amount	% of revenue	Amount	% of revenue	Amount	%
	(in thousands, except percentages)					
Interest income	$ 369	0.3%	$ 104	0.1%	$ 265	254.8%
Interest expense	(326)	(0.2%)	(1,125)	(1.4%)	799	(71.0%)
Other income (expense), net	(699)	(0.5%)	(78)	(0.1%)	(621)	796.2%
Total Other income (expense), net	$ (656)	(0.4%)	$ (1,099)	(1.4%)	$ 443	(40.3%)

Interest income increased over the same prior year periods due to higher cash and investment balances.

Interest expense decreased overall for the periods due to the benefit of lower interest rates as well as lower loan balances.

Other income (expense), net increased by $0.4 million from 2013 to 2014. Other net expense increased due to unrealized foreign exchange losses recognized resulting from the depreciation of the Asia currencies against the U.S. dollar compared to unrealized foreign exchange losses in the same prior year period. We have historically qualified as a high-tech enterprise in China, as determined by the Chinese government, and are paid subsidies from time to time by the Chinese government to foster local high-tech manufacturing. We received less subsidy in 2014 compared to 2013.

Provision for income taxes

	Years ended December 31,			
	2014	2013	Change	
	(in thousands, except percentages)			
Provision for income taxes	$ (199)	$ –	(199)	100.0%

Our income tax expense for 2014 consists of U.S. alternative minimum tax recorded during the period. Due to historic losses in the U.S., our net deferred tax assets are fully offset by a deferred tax valuation allowance.

Comparison of Years Ended December 31, 2013 and 2012

Revenue

The following charts provide the revenue contribution from each of the markets we served for the years ended December 31, 2013 and 2012:

	Years ended December 31,	
	2013	**2012**
CATV	60.4%	78.6%
Data Center	24.7%	8.3%
FTTH	5.6%	5.8%
Other	9.3%	7.3%
Total Revenue	100.0%	100.0%

	Years ended December 31,		Change	
	2013	**2012**	**Amount**	**%**
	(in thousands, except percentages)			
CATV	$ 47,373	$ 49,842	$ (2,469)	(5.0%)
Data Center	19,386	5,293	14,093	266.3%
FTTH	4,377	3,690	687	18.6%
Other	7,288	4,596	2,692	58.6%
Total Revenue	$ 78,424	$ 63,421	$ 15,003	23.7%

Of our total revenue in 2013, we generated $47.4 million, or 60.4%, from the CATV market, $19.4 million, or 24.7%, from the internet data center market, $4.4 million, or 5.6%, from the FTTH market, and $7.3 million, or 9.3%, from other markets. Total revenue increased by $15.0 million, or 23.7%, from 2012 to 2013.

The increase in revenue was attributable to a $14.1 million increase from the internet data center market, and a $3.4 million increase from other markets, partially offset by a $2.5 million decrease from our CATV market. The increase in revenues in the internet data center market were driven by increasing sales to customers we added late in 2012. The decline in revenues in the CATV market in 2013 was a result of market-wide weakness, particularly in China, as well as delays in orders as a consequence of mergers among several of our CATV customers.

Cost of goods sold and gross margin

	Years ended December 31,				Change	
	2013		**2012**			
	Amount	**% of revenue**	**Amount**	**% of revenue**	**Amount**	**%**
	(in thousands, except percentages)					
Cost of goods sold	$ 55,396	70.6%	$ 44,492	70.2%	$ 10,904	24.5%
Gross margin		29.4%		29.8%		

Cost of goods sold increased by $10.9 million, or 24.5%, from 2012 to 2013, primarily due to the combination of a $7.2 million increase in direct material costs and a $3.7 million increase in labor and overhead costs, both of which were associated with our increase in revenues. Within our markets, we sell similar products in different geographic regions at different prices, resulting in different gross margins among our products. The decrease in gross margin was primarily the result of a higher percentage of sales of lower margin CATV equipment in Asia and a lower percentage of higher margin component sales in the US.

Operating expenses

	Years ended December 31,				Change	
	2013		2012			
	Amount	% of revenue	Amount	% of revenue	Amount	%
	(in thousands, except percentages)					
Research and development	$ 8,512	10.9%	$ 7,603	12.0%	$ 909	12.0%
Sales and marketing	4,191	5.3%	3,135	4.9%	1,056	33.7%
General and administrative	10,632	13.6%	8,012	12.6%	2,620	32.7%
Total operating expenses	$ 23,335	29.8%	$ 18,750	29.5%	$ 4,585	24.5%

Research and development expense

Research and development expense increased by $0.9 million, or 11.9%, from 2012 to 2013. This was primarily due to increases in personnel costs and R&D work order and project costs related to new product development.

Sales and marketing expense

Sales and marketing expense increased by $1.1 million, or 33.7%, from 2012 to 2013. This was due to an increase in personnel costs due to additional sales and marketing staff to better serve our customers, and an increase in sales commissions directly related to our revenue growth.

General and administrative expense

General and administrative expense increased by $2.6 million, or 32.7%, from 2012 to 2013. This was primarily due to an increase in share- based compensation expense as well as an increase in personnel costs, expenses related to being a public company, professional fees and travel expenses.

Other income (expense), net

	Years ended December 31,				Change	
	2013		2012			
	Amount	% of revenue	Amount	% of revenue	Amount	%
	(in thousands, except percentages)					
Interest income	$ 104	0.1%	$ 26	0.0%	$ 78	300.0%
Interest expense	(1,125)	(1.4%)	(1,381)	(2.2%)	256	(18.5%)
Other income (expense), net	(78)	(0.1%)	231	0.4%	(309)	(133.8%)
Total Other income (expense), net	$ (1,099)	(1.4%)	$ (1,124)	(1.8%)	$ 25	(2.2%)

Total net other expense decreased slightly from 2012 to 2013. Interest expense decreased while average loan balances increased from 2012 to 2013 due to a further reduction in interest rates in 2013. Our net other expense decreased by $0.3 million from 2012 to 2013 primarily due to a $0.6 million unrealized foreign currency revaluation loss from U.S. denominated accounts in 2013 when the NT dollar depreciated against the U.S. dollar which was offset by an additional $0.2 million of government subsidies received by our China subsidiary.

Provision for income taxes	Years ended December 31, 2013	2012	Change
	(in thousands, except percentages)		
Provision for income taxes	$ –	$ –	$ –
Effective tax rate	0.0%	0.0%	0.0%

Our effective tax rate was 0.0% for 2012 and 2013, as we did not generate positive taxable income.

Liquidity and Capital Resources

From inception until our initial public offering, we financed our operations through private sales of equity securities, cash generated from operations and from various lending arrangements. On October 1, 2013, we completed our initial public offering, in which we issued and sold 3.6 million shares of our common stock at a public offering price of $10.00 per share, providing proceeds of $31.4 million, net of underwriting discounts and commissions and offering expenses. On March 25, 2014, we completed a secondary offering, in which we issued and sold 1.6 million shares of our common stock at an offering price of $24.25 per share, and on March 28, 2014, we sold an additional 0.4 million shares as a result of the underwriters' exercise of their option to purchase additional shares, providing proceeds of $45.6 million, net of underwriting discounts and commissions and offering expenses. As of September 30, 2014, our cash, cash equivalents, restricted cash and short-term investments totaled $45.8 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.

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

	Years Ended December 31, 2014	2013	2012
		(in thousands)	
Net cash provided by (used in) operating activities	$ 7,242	$ (6,552)	$ (358)
Net cash used in investing activities	(45,388)	(17,736)	(3,290)
Net cash provided by financing activities	47,250	35,368	12,754
Effect of exchange rates on cash and cash equivalents	1,065	203	(150)
Net increase in cash and cash equivalents	$ 10,169	$ 11,283	$ 8,956

Operating activities

In 2014, net cash provided by operating activities was $7.2 million. During 2014, we recognized net income of $4.3 million. Our net income included non-cash charges, including depreciation and amortization of $6.2 million, share-based compensation expense of $2.1 million and non-cash increases to our inventory reserve accounts of $0.9 million. Accounts payable increases of $18.8 million were offset by an increase in accounts receivable from our customers of $9.7 million and an increase in inventories of $16.1 million to support revenue growth.

In 2013, net cash used in operating activities was $6.6 million. Cash used in operating activities primarily related to an increase in receivables from customers from the sale of our products in excess of cash paid to our suppliers. During the year ended December 31, 2013, we recognized a net loss of $1.4 million. The net loss incorporated non-cash charges, including depreciation and amortization of $3.4 million, share-based compensation expenses of $1.1 million and non-cash increases to our inventory reserve accounts of $0.5 million. We also spent $7.5 million to increases our inventories to support increases in sales volumes, but this was offset by an increase in accounts payable.

In 2012, net cash used in operating activities was $0.4 million. Cash used in operating activities primarily related to payments to suppliers in excess of cash received from our customers from the sale of our products. During 2012, we recognized a net loss of $0.9 million. However, that net loss incorporated non-cash charges, including depreciation and amortization of $2.9 million, share-based compensation expense of $0.1 million and non-cash increases to our inventory reserve accounts of $0.9 million. In addition, we spent $0.5 million in 2012 to increase our inventories in anticipation of expected increases in sales volumes.

Investing activities

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

In 2014, net cash used in investing activities was $45.4 million for the purchase of additional machinery and equipment, for investment in leasehold improvements for our Taiwan plant expansion and the payment for intellectual property licenses to support new product development efforts and manufacturing activities as well as an increase in deferred charges.

In 2013, we used $17.7 million of cash for investing activities, of which $9.3 million of cash was used for the purchase of additional machinery and equipment to support our research and development efforts and manufacturing activities and $8.0 million of cash was used for the purchase of short-term investments.

In 2012, we used $3.3 million of cash for investing activities. We used $3.2 million of cash for the purchase of additional machinery and equipment to support our research and development efforts and manufacturing activities, partially offset by $0.1 million of cash provided by the sale of obsolete equipment.

Financing activities

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

In 2014, our financing activities provided $47.3 million in cash. We received $45.7 million in net proceeds from a secondary offering of common stock. Net borrowings associated with our bank loans and bank acceptance payable provided $1.9 million in cash.

In 2013, our financing activities provided $35.4 million in cash. We received $31.5 million in net proceeds from our initial public offering. We received $3.5 million in net borrowings associated with our bank loans and $0.7 million from the exercise of stock options and warrants. These increases were offset by an increase in our restricted cash by $0.2 million, related to the compensating balances required by our loans in China.

In 2012, our financing activities provided $12.8 million in cash. We received $10.2 million in cash from the issuance of preferred stock, $2.7 million in net borrowings associated with our bank loans and $0.8 million from the issuance of notes payable, offset in part by $0.7 million of payments of principal on our term loans and notes payable and $0.2 million to repay loans from stockholders.

Loans and commitments

We have lending arrangements with several financial institutions, including a revolving line of credit and a term loan with East West Bank in the U.S., several lines of credit arrangements for our China subsidiary and lines of credit and financing agreements for our Taiwan location.

As of December 31, 2014, our loan and security agreement in the U.S. included a $15.0 million revolving line of credit which matures on July 15, 2017. Also included with the same bank is a term loan of up to $5.0 million with monthly payments of principal and interest that matures on July 31, 2019. The interest rate on these loans is the LIBOR Borrowing Rate plus 2.75%. As of December 31, 2014, we had $15.0 million outstanding under the revolving line of credit and $5.0 million outstanding under the term loan.

On January 6, 2015, we entered into a Credit Facility Agreement (the “Credit Facility”) with CTBC Bank Co. Ltd. in Taipei, Taiwan (the “Bank”) for 90,000,000.00 NTD (New Taiwan Dollars), one year revolving credit facility. Borrowings under the Credit Facility will be used for general corporate purposes. Our obligations under the Credit Facility are unsecured. Borrowings under the Credit Facility will bear interest at a rate based on the Bank’s corporate interest rate swap index plus 1.5%, adjusted monthly. As of the execution of the Credit Facility the Bank’s corporate interest rate swap index is 0.91%. The Credit Facility contains representations and warranties, affirmative, restrictive and financial covenants, and events of default (applicable to the Company) which are customary for credit facilities of this type.

On January 26, 2015, we entered into a construction loan agreement with East West Bank for up to $22.0 million dollars to finance the construction of our campus expansion plan in Sugar Land, Texas. The loan will have a fifteen month draw down period with monthly interest payments commencing on February 26, 2015 and ending April 26, 2016. Thereafter, the entire outstanding principal balance shall be converted to a sixty-nine month term loan with principal and interest payments due monthly amortized over three hundred months. The first principal and interest payment is due on May 26, 2016 and will continue the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. We may pay without penalty all or a portion of the amount owed earlier than due. Under the loan agreement, the loan bears interest, at an annual rate based on the one-month LIBOR Borrowing Rate plus 2.75%.

Our loan and security agreements with East West Bank require us to maintain certain financial covenants, including a minimum current ratio and minimum annual EBITDA. As of December 31, 2014, we were in compliance with all covenants contained in these agreements.

As of December 31, 2014, our China subsidiary had two lines of credit facility with a China bank totaling $15.4 million, one line is U.S. currency based and the other is RMB currency based. As of December 31, 2014, we had a U.S. currency based loan of $1.1 million outstanding under various notes with three-month terms, maturing from February 2015 to March 2015. There were no outstanding balances under the RMB currency based credit facility as of December 31, 2014.

Our Taiwan location had an outstanding note payable with a financing company that matures on July 31, 2015.

In December 2013, our Taiwan location entered into two separate one year revolving credit facility agreements with Taiwan banks, for a total of $8.0 million. Borrowings under these credit facilities will be used for general corporate purposes. Our obligations under the credit facilities are secured by our $8.0 million cash deposit in a one-year CD with such banks. The two revolving lines of credit bear interest at a rate (which adjusts quarterly) equal to the Taiwan Time Deposit Interest Rate Index plus 0.41%, currently 1.78%, and at a base rate equal to TAIBOR plus 1%, currently 1.75%. As of December 31, 2014, $7.1 million was outstanding under these credit facilities.

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

Frequently, we also direct our banking partners to issue bank acceptance notes payable to our suppliers in China in exchange for accounts payable. Our China subsidiary's banks issue the notes to vendors and issue payment to vendors upon redemption. We owe the payable balance to the issuing bank. The notes payable are non-interest bearing and are generally due within nine months of issuance. As a condition of the notes payable lending arrangements, we are required to keep a compensating balance at the issuing banks that is a percentage of the total notes payable balance until the notes payable are paid by our China subsidiary. These balances are classified as restricted cash on our consolidated balance sheets. As of December 31, 2014, our restricted cash totaled $0.5 million, and our outstanding bank acceptance notes payable was $1.3 million.

Future liquidity needs

We believe that our existing cash and cash equivalents, and cash flows from our operating activities, will be sufficient to meet our anticipated cash needs for the next 12 to 24 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, the expansion of our manufacturing capacity and the continuing market acceptance of our products. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us, if at all. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

Contractual Obligations and Commitments

The following summarizes our contractual obligations as of December 31, 2014:

	Payments due by period (in thousands)				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Notes payable and long-term debt (1)	$ 29,918	$ 10,862	$ 17,264	$ 1,792	$ –
Operating leases (2)	14,504	926	2,542	1,979	9,056
Total commitments	$ 44,422	$ 11,788	$ 19,806	$ 3,771	$ 9,056

(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 of the obligations.

(2) We have entered into various non-cancellable operating lease agreements for our offices in Taiwan and the U.S.