OCLARO, INC.
Form 10-Q
November 08, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 29, 2018
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 000-30684

OCLARO, INC.
(Exact name of registrant as specified in its charter)

Delaware	20-1303994
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

225 Charcot Avenue, San Jose, California 95131
(Address of principal executive offices, zip code)
(408) 383-1400
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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" "smaller reporting company", and "emerging growth company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨
	Emerging growth company ¨

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If an emerging growth company, indicate by check mark if 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 Exchange Act):
Yes ¨ No x

171,609,087 shares of common stock were outstanding as of November 5, 2018

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

OCLARO, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	September 29, 2018	June 30, 2018
	(Thousands, except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$337,920	$245,688
Short-term investments	3,997	77,440
Accounts receivable, net of allowances for doubtful accounts of $1,458 and $1,393 as of September 29, 2018 and June 30, 2018, respectively	108,720	100,482
Inventories	89,779	106,678
Prepaid expenses and other current assets	36,178	35,175
Total current assets	576,594	565,463
Property and equipment, net	131,721	137,438
Other intangible assets, net	19	61
Deferred tax assets	17,192	16,625
Other non-current assets	1,514	1,212
Total assets	$727,040	$720,799
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$69,281	$68,221
Accrued expenses and other liabilities	36,321	41,686
Capital lease obligations, current	530	2,386
Total current liabilities	106,132	112,293
Deferred gain on sale-leaseback	4,962	5,193
Capital lease obligations, non-current	702	857
Other non-current liabilities	10,373	10,440
Total liabilities	122,169	128,783
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Preferred stock: 1,000 shares authorized; none issued and outstanding	—	—
Common stock: $0.01 par value per share; 275,000 shares authorized; 171,601 shares issued and outstanding at September 29, 2018 and 170,675 shares issued and outstanding at June 30, 2018	1,715	1,706
Additional paid-in capital	1,705,945	1,703,331
Accumulated other comprehensive income	42,550	42,547
Accumulated deficit	(1,145,339)	(1,155,568)
Total stockholders' equity	604,871	592,016
Total liabilities and stockholders' equity	$727,040	$720,799

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

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OCLARO, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands, except per share amounts)	
Revenues	$131,658	$155,598
Cost of revenues	86,064	92,894
Gross profit	45,594	62,704
Operating expenses:		
Research and development	16,162	16,435
Selling, general and administrative	16,389	14,866
Amortization of other intangible assets	42	152
Restructuring and acquisition-related expenses	800	—
Loss on disposal of property and equipment	777	22
Total operating expenses	34,170	31,475
Operating income	11,424	31,229
Other income (expense):		
Interest income (expense), net	200	434
(Loss) gain on foreign currency transactions, net	(193)	489
Other income (expense), net	1,357	574
Total other income (expense)	1,364	1,497
Income before income taxes	12,788	32,726
Income tax provision	2,559	6,237
Net income	$10,229	$26,489
Net income per share:		
Basic	$0.06	$0.16
Diluted	$0.06	$0.16
Shares used in computing net income per share:		
Basic	171,046	168,137
Diluted	173,127	170,849

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

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OCLARO, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands)	
Net income	$10,229	$ 26,489
Other comprehensive income:		
Unrealized gain on marketable securities	3	7
Currency translation adjustments	—	1,495
Total comprehensive income	$10,232	$ 27,991

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

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OCLARO, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands)	
Cash flows from operating activities:		
Net income	$10,229	$26,489
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred gain on sale-leaseback	(191)	(196)
Accretion of premiums on short-term investments	(54)	—
Depreciation and amortization	8,463	6,347
Change in deferred tax assets, net	(567)	5,745
Stock-based compensation expense	4,004	3,199
Loss on disposal of property and equipment	777	22
Other non-cash adjustments	40	—
Changes in operating assets and liabilities:		
Accounts receivable, net	(8,303)	1,787
Inventories	17,188	(1,523)
Prepaid expenses and other current assets	(1,003)	(5,737)
Other non-current assets	(302)	(735)
Accounts payable	1,271	11,746
Accrued expenses and other liabilities	(5,434)	121
Net cash provided by operating activities	26,118	47,265
Cash flows from investing activities:		
Purchases of property and equipment	(3,882)	(22,072)
Purchases of short-term investments	—	(74,871)
Maturities of short-term investments	73,500	25,500
Net cash provided by (used in) investing activities	69,618	(71,443)
Cash flows from financing activities:		
Proceeds from the exercise of stock options	256	325
Shares repurchased for tax withholdings on vesting of restricted stock units	(1,926)	(1,756)
Payments on capital lease obligations	(1,780)	(168)
Net cash used in financing activities	(3,450)	(1,599)
Effect of exchange rate on cash, cash equivalents and restricted cash	(54)	(1,522)
Net increase (decrease) in cash, cash equivalents and restricted cash	92,232	(27,299)
Cash, cash equivalents and restricted cash at beginning of period	245,688	219,987
Cash, cash equivalents and restricted cash at end of period	$337,920	$192,688
Supplemental disclosures of non-cash transactions:		
Unpaid property and equipment in accounts payable	$5,722	$5,934
Capital lease obligations incurred for purchases of property and equipment	206	—

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

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OCLARO, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
NOTE 1. BASIS OF PREPARATION
Basis of Presentation
Oclaro, Inc., a Delaware corporation, is sometimes referred to in this Quarterly Report on Form 10-Q as “Oclaro,” “we,” “us” or “our.”
The accompanying unaudited condensed consolidated financial statements of Oclaro as of September 29, 2018 and for the three months ended September 29, 2018 and September 30, 2017 have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Article 10 of Securities and Exchange Commission ("SEC") Regulation S-X, and include the accounts of Oclaro and all of our subsidiaries. Accordingly, they do not include all of the information and footnotes required by such accounting principles for annual financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of our consolidated financial position and results of operations have been included. The condensed consolidated results of operations for the three months ended September 29, 2018 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending June 29, 2019.
The condensed consolidated balance sheet as of June 30, 2018 has been derived from our audited financial statements as of such date, but does not include all disclosures required by U.S. GAAP. These unaudited condensed consolidated financial statements should be read in conjunction with our audited financial statements included in our Annual Report on Form 10-K for the year ended June 30, 2018 ("2018 Form 10-K").
Merger
On March 11, 2018, Lumentum Holdings Inc., a Delaware corporation (“Lumentum”), Oclaro, Prota Merger Sub, Inc., a Delaware corporation and a wholly owned subsidiary of Lumentum (“Merger Sub”), and Prota Merger, LLC, a Delaware limited liability company and a wholly owned subsidiary of Lumentum (“Merger Sub LLC”), entered into an Agreement and Plan of Merger (the “Merger Agreement”).
Pursuant to the terms of the Merger Agreement, the acquisition of Oclaro will be accomplished through a merger of Merger Sub with and into Oclaro (the “First Step Merger”) with Oclaro surviving the First Step Merger. As soon as reasonably practicable following the First Step Merger, Oclaro will merge with and into Merger Sub LLC with Merger Sub LLC continuing as the surviving entity and a wholly owned subsidiary of Lumentum (the “Second Step Merger,” and taken together with the First Step Merger, the “Merger”).
Pursuant to the terms of the Merger Agreement, and subject to the terms and conditions set forth therein, at the effective time of the First Step Merger (the “Effective Time”), each share of the common stock of Oclaro (the “Oclaro Common Stock”) issued and outstanding immediately prior to the Effective Time (other than (x) shares of Oclaro Common Stock owned by Lumentum, Oclaro, or any direct or indirect wholly owned subsidiary of Lumentum or Oclaro or (y) shares of Oclaro Common Stock owned by stockholders who have properly exercised and perfected appraisal rights under Delaware law, in each case immediately prior to the Effective Time, will be cancelled and extinguished and automatically converted into the right to receive the following consideration (collectively, the “Merger Consideration”):
(A) $5.60 in cash, without interest (the “Cash Consideration”), plus
(B) 0.0636 of a validly issued, fully paid and nonassessable share of the common stock of Lumentum, par value $0.001 per share (“Lumentum Common Stock”) (such ratio, the “Exchange Ratio”).
With regard to the Merger Consideration, if the aggregate number of shares of Lumentum Common Stock to be issued in connection with the Merger (including all Lumentum Common Stock which may be issued in the future pursuant to the conversion of Oclaro Options, Oclaro Restricted Stock Units, or Oclaro Restricted Stock (as defined below) would exceed 19.9 percent of the Lumentum Common Stock issued and outstanding immediately prior to the Effective Time (the “Stock Threshold”), (A) the Exchange Ratio will be reduced to the minimum extent necessary (rounded down to the nearest one thousandth) such that the aggregate number of shares of Lumentum Common Stock to be issued in connection with the Merger (including all shares of Lumentum Common Stock which may be issued after the

Effective Time pursuant to company compensatory awards) does not exceed the Stock Threshold and (B) the Cash Consideration for all purposes will be increased on a per share basis by an amount equal to $68.975, multiplied by the difference between the initial Exchange Ratio and the Exchange Ratio.

Each Oclaro restricted stock unit award (an “Oclaro RSU”) that does not become vested at the closing will be converted into a Lumentum restricted stock unit award (a “Lumentum RSU”) with the same terms and conditions, including vesting, that were applicable to such Oclaro RSU, except that the number of Lumentum shares subject to the Lumentum RSU will equal the product of (i) the number of Oclaro shares subject to such Oclaro RSU (with any performance milestones deemed achieved based on the maximum level of achievement) multiplied by (ii) the sum of (A) the Exchange Ratio plus (B) the quotient obtained by dividing the Cash Consideration by Lumentum's average closing price of the 10 trading days ending on the third trading day prior to the closing (such sum, the "Equity Award Exchange Ratio"), rounded down to the nearest whole share.

Each Oclaro stock option (an "Oclaro Option"), whether vested or unvested, will be converted into a Lumentum stock option (a "Lumentum Option") with the same terms and conditions, including vesting, that were applicable to such Oclaro Option, except that (i) the number of shares subject to the Lumentum Option will equal the product of (A) the number of Oclaro shares subject to such Oclaro Option multiplied by (B) the Equity Award Exchange Ratio, rounded down to the nearest whole share and (ii) the exercise price of the Lumentum Option will equal (A) the exercise price per share of the Oclaro Option divided by (B) the Equity Award Exchange Ratio, rounded up to the nearest whole cent. Notwithstanding the foregoing, any Oclaro Option that is held by an individual who is not an Oclaro employee as of immediately prior to the closing will be canceled and converted into the Merger Consideration for each net option share covered by such Oclaro Option, subject to applicable withholding taxes.

In addition, each Oclaro restricted stock award ("Oclaro Restricted Stock Award") and Oclaro RSU that becomes vested as of immediately prior to the closing (including each Oclaro Restricted Stock Award held by a non-employee director) will be converted into the right to receive the Merger Consideration in respect of each Oclaro share underlying such award, subject to applicable withholding taxes. Each Oclaro stock appreciation right ("Oclaro SAR") will be canceled and converted into the right to receive a cash amount equal to the product of (i) the number of Oclaro shares subject to the Oclaro SAR multiplied by (ii) the positive difference of (A) the cash equivalent value of the Merger Consideration less (B) the strike price of the Oclaro SAR, subject to applicable withholding taxes.

If Lumentum determines that the treatment of Oclaro equity awards described above would violate, in respect of the holder thereof, the applicable laws of a non-U.S. jurisdiction, Lumentum may treat such Oclaro equity award in a different manner so long as such treatment is no less favorable to the holder of such Oclaro equity award.

The Boards of Directors of Lumentum and Oclaro have unanimously approved the Merger and the Merger Agreement. The transaction is subject to customary closing conditions, including the absence of certain legal impediments, the expiration or termination of the required waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act") and under applicable anti-trust laws in China, the effectiveness of a registration statement on Form S-4 registering the shares of Lumentum common stock to be issued in connection with the Merger, and approval of the Merger Agreement by the holders of a majority of the outstanding shares of Oclaro Common Stock. The transaction is not subject to any financing condition. On April 4, 2018, the U.S. Federal Trade Commission granted early termination of the waiting period under the HSR Act. On July 10, 2018, Oclaro's stockholders approved the Merger Agreement.

The Merger Agreement contains customary representations, warranties and covenants of Lumentum, Oclaro, Merger Sub and Merger Sub LLC, including, (i) covenants by Oclaro concerning the conduct of its business in the ordinary course consistent with past practice during the interim period between the execution of the Merger Agreement and the consummation of the Merger, (ii) covenants by Lumentum concerning the conduct of its business in the ordinary course consistent with past practice during the interim period between the execution of the Merger Agreement and the consummation of the Merger, (iii) a covenant by Oclaro that, subject to certain exceptions, the Board of Directors of Oclaro will recommend to its shareholders adoption of the Merger Agreement, and (iv) a covenant that Oclaro will not solicit, initiate, or knowingly encourage, facilitate or induce the making of inquiry, offer or proposal that would reasonably be expected to lead to any Acquisition Proposal (as defined in the Merger Agreement). Further, the Merger Agreement prohibits us from paying dividends.

The Merger Agreement contains certain termination rights for both Lumentum and Oclaro and further provides that upon termination of the Merger Agreement under specified circumstances (including termination by Oclaro to accept a superior proposal), Oclaro may be required to pay Lumentum a termination fee of $63 million. The Merger Agreement further provides that upon termination of the Merger Agreement under specified circumstances relating to failure to obtain regulatory approvals, Lumentum may be required to pay Oclaro a termination fee of $80 million.

During the three months ended September 29, 2018, we recorded acquisition-related costs of $0.3 million in restructuring and acquisition-related expenses within our condensed consolidated statements of operations. During the three months ended September 30, 2017, we recorded no acquisition-related costs in restructuring and acquisition-related expenses.

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Termination of Denial Order and Reinstitution of ZTE's Export Privileges

On April 16, 2018, the U.S. Department of Commerce ("DOC") changed and reactivated its previously suspended denial order and suspended the export privileges of Zhongxing Telecommunications Equipment Corporation ("ZTE Corporation") and its subsidiary, ZTE Kangxun Telecommunications Ltd. ("ZTE Kangxun") (collectively, "ZTE") after determining that ZTE made false statements to the DOC related to senior employee disciplinary actions ("Denial Order"). On July 13, 2018, following approval of a settlement agreement between the DOC and ZTE and ZTE's payment of certain amounts to the DOC, the Denial Order was terminated and ZTE was removed from the DOC's Denied Persons List. During the pendency of the Denial Order, ZTE was prohibited from participating in any way in any transaction subject to the Export Administration Regulations ("EAR") and U.S. companies were restricted from exporting or re-exporting to or on behalf of ZTE any item subject to the EAR or engaging in any transaction to service any item subject to the EAR that has been or will be exported from the U.S. and which was owned, possessed or controlled by ZTE. During the pendency of the Denial Order, we ceased shipment of products to ZTE, which has been one of our significant customers. During the first quarter of our fiscal 2019, we resumed shipments of products to ZTE.

During the three months ended September 29, 2018, we recorded a $0.5 million net benefit related to inventory that was sold in the quarter that had previously been written-down because of the uncertainty of whether it would be sold to ZTE or re-allocated to other customers.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reported periods. Examples of significant estimates and assumptions made by management involve the valuation allowances for deferred tax assets, the fair value of stock-based compensation, the fair value of pension liabilities, estimates for allowances for doubtful accounts and valuation of excess and obsolete inventories. These judgments can be subjective and complex and consequently actual results could differ materially from those estimates and assumptions. Descriptions of the key estimates and assumptions are included in our 2018 Form 10-K.

Fiscal Years

We operate on a 52/53 week year ending on the Saturday closest to June 30. Our fiscal year ending June 29, 2019 will be a 52 week year, with the quarter ended September 29, 2018 being a 13 week quarterly period. Our fiscal year ended June 30, 2018 was a 52 week year, with the quarter ended September 30, 2017 being a 13 week quarterly period.

Reclassifications

For presentation purposes, we have reclassified certain prior period amounts to conform to the current period financial statement presentation, including an adjustment relating to an immaterial error of approximately $10.4 million, increasing cash flows from operations associated with changes in accounts payable and increasing cash flows used in investing activities associated with purchases of property and equipment, in our condensed consolidated statement of cash flows for the three months ended September 30, 2017. We determined that the adjustment did not have a material impact to our prior period condensed consolidated financial statements.

In connection with our adoption of Accounting Standards Update ("ASU") 2016-18, Statement of Cash Flows: Restricted Cash, we adjusted the beginning-of-period and end-of-period cash and cash equivalent balances within the condensed consolidated statement of cash flows for the three months ended September 30, 2017 to include restricted cash. The impact of this adoption was an increase of $0.4 million in net cash used in investing activities, an increase of $0.7 million to the beginning-of-period cash, cash equivalents and restricted cash balance and an increase of $0.3 million to the end-of-period cash, cash equivalents and restricted cash balance for the three months ended September 30, 2017.

None of these reclassifications affect our consolidated revenues, net income, cash and cash equivalents or stockholders' equity as previously reported.

Functional Currency

Effective October 1, 2017, the functional currency for our worldwide operations is the U.S. dollar. Prior to October 1, 2017, the functional currency for each of our foreign subsidiaries was the respective local currency for that subsidiary. The change in our functional currency is a result of significant changes in economic facts and circumstances, including (i) a re-organization of our operating environment, which includes consolidating and integrating our sales, supply chain and manufacturing organizations; (ii) a transition to centrally negotiating worldwide supplier contracts and capital expenditures in U.S. dollars; and (iii) a shift to recording all intercompany transactions in U.S. dollars.

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Translation adjustments reported prior to October 1, 2017, remain as a component of accumulated other comprehensive income in our condensed consolidated balance sheet. The translated values for any non-monetary assets and liabilities as of October 1, 2017 became the new accounting basis for those assets.
Effective October 1, 2017, monetary assets and liabilities denominated in currencies other than the U.S. dollar functional currency are re-measured each reporting period into U.S. dollars, with the resulting exchange gains and losses reported in (loss) gain on foreign currency transactions, net within our condensed consolidated statement of operations.

NOTE 2. RECENT ACCOUNTING STANDARDS

Recently Adopted Accounting Standards

Revenue Recognition

In May 2014 and May 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2014-09, Revenue from Contracts with Customers and ASU 2016-12, Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients, respectively. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes previous revenue recognition guidance. We adopted this guidance on July 1, 2018, the start to our first quarter of fiscal 2019, using the modified retrospective method. There was no cumulative catch-up adjustment upon adoption of this guidance.
Our revenue from contracts with customers is generated through the sale of products, which consists of a single performance obligation. We recognize revenue at a point in time in an amount that reflects the fair value of the consideration to be received for the products sold, net of sales tax and other tax amounts collected from customers for remittance to governmental authorities. We elected to account for shipping and handling activities as a fulfillment cost.
Our contracts with customers are typically comprised of a customer purchase order and/or an executed agreement. Our payment terms vary by customer and location, however, the time period between when revenue is recognized and when payment is due is not significant. Before accepting a new customer, we review publicly available information and credit rating databases to provide ourselves with reasonable assurance that the new customer will pay all outstanding amounts in accordance with our standard terms. For existing customers, we monitor historic payment patterns and we perform ongoing credit evaluations to assess whether we can expect payment in accordance with the terms set forth in the agreement under which the sale was made.
We satisfy the performance obligation and record revenues when transfer of control of our product has passed to the customer. We specify delivery terms in the agreement under which the sale was made and assess each shipment against those terms, and only recognize revenue when we are certain that the delivery terms have been met and transfer of control has occurred.
Our sales terms do not allow for a right of return, except for matters related to manufacturing defects, which are covered under our warranty. Our warranties are considered an assurance-only type of service.
See Note 11, Geographic Information, Product Groups, Market Applications and Customer Concentration Information, for a presentation of revenue disaggregated by geography, market application and product group.
We elected to apply the practical expedient to recognize the incremental costs of obtaining a contract, specifically sales commissions and other contract administration costs, when incurred because the amortization period for these costs is one year or less.

Cash Flows

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows: Restricted Cash to standardize the presentation of transfers between cash and restricted cash in the cash flow statement. We adopted this guidance in the first quarter of 2019, and as a result, restricted cash has been included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The following table provides a reconciliation of cash, cash equivalents and restricted cash reported within the condensed consolidated balance sheets for the periods indicated that sum to the total of the same such amounts shown in the condensed consolidated statement of cash flows:

	September 29, 2018	September 30, 2017
	(Thousands)	
Cash and cash equivalents	$337,920	$ 192,420
Restricted cash	—	268
Total cash, cash equivalents and restricted cash shown in the statement of cash flows	$337,920	$ 192,688

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Recent Accounting Standards Pending Adoption

In August 2018, the FASB issued ASU 2018-14, Compensation - Retirement Benefits - Defined Benefit Plans - General: Disclosure Framework, which amends the disclosure requirements for single-employer defined benefit plans, removing disclosures that are not considered cost-beneficial, clarifying the specific requirements of disclosures, and adding disclosure requirements identified as relevant. The guidance will be effective for us at the end of fiscal 2021, with early adoption permitted. We are currently evaluating the likely impact the implementation of this standard will have on our financial statements and footnote disclosures.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement: Disclosure Framework, which aims to improve the effectiveness of fair value measurement disclosures. The amendments ASU-2018-13 modify the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, based on the concepts in FASB Concepts Statement, Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements, including the consideration of costs and benefits. The guidance will be effective for us in the first quarter of fiscal 2021, with early adoption permitted. We are currently evaluating the likely impact the implementation of this standard will have on our financial statements and footnote disclosures.

In February 2016, the FASB issued ASU 2016-02, Leases, which requires recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. In July 2018, the FASB issued ASU 2018-11, Leases: Targeted Improvements, which provide entities with an additional (and optional) transition method to adopt the new lease requirements by allowing entities to initially apply the requirements by recognizing a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The guidance also provides lessors with a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component and, instead, to account for those components as a single component if certain conditions are met. This guidance will be effective for us in the first quarter of fiscal 2020, with early adoption permitted. We are currently evaluating the likely impact the implementation of this standard will have on our financial statements and footnote disclosures.

In February 2018, the FASB issued ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the TCJA. The guidance will be effective for us in the first quarter of fiscal 2020, with early adoption permitted. We are currently evaluating the likely impact the implementation of this standard will have on our financial statements and footnote disclosures.

NOTE 3. BALANCE SHEET DETAILS

Cash and Cash Equivalents

The following table provides details regarding our cash and cash equivalents at the dates indicated:

	September 29, 2018	June 30, 2018
	(Thousands)	
Cash and cash equivalents:		
Cash-in-bank	$64,686	$88,297
Money market funds	273,234	153,392
Commercial paper	—	3,999
	$337,920	$245,688

As of September 29, 2018, $49.3 million of the $337.9 million of our cash and cash equivalents was held by our foreign subsidiaries. If these funds are needed for our operations in the United States, we could be required to accrue and pay additional taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S., except for specific entities in China and Germany where we decided to exit certain businesses.

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Short-Term Investments

The following table provides details regarding our short-term investments at the dates indicated:

	September 29, 2018	June 30, 2018
	(Thousands)	
Short-term investments		
U.S. Treasury securities	$3,997	$31,939
Commercial paper	—	41,401
Corporate bonds	—	4,100
	$3,997	$77,440

Inventories

The following table provides details regarding our inventories at the dates indicated:

	September 29, 2018	June 30, 2018
	(Thousands)	
Inventories:		
Raw materials	$23,898	$30,488
Work-in-process	47,737	54,503
Finished goods	18,144	21,687
	$89,779	$106,678

Property and Equipment, Net

The following table provides details regarding our property and equipment, net at the dates indicated:

	September 29, 2018	June 30, 2018
	(Thousands)	
Property and equipment, net:		
Buildings and improvements	$12,086	$12,086
Plant and machinery	139,248	137,301
Fixtures, fittings and equipment	3,526	3,526
Computer equipment	22,420	22,721
	177,280	175,634
Less: Accumulated depreciation	(45,559)	(38,196)
	$131,721	$137,438

Property and equipment includes assets under capital leases of $1.2 million and $3.2 million at September 29, 2018 and June 30, 2018, respectively. Amortization associated with assets under capital leases is recorded in depreciation expense.

During the three months ended September 29, 2018, we recorded a loss on disposal of property and equipment of $0.8 million, related to the disposal of equipment related to certain legacy data communication products.

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Accrued Expenses and Other Liabilities

The following table presents details regarding our accrued expenses and other liabilities at the dates indicated:

	September 29, 2018	June 30, 2018
	(Thousands)	
Accrued expenses and other liabilities:		
Compensation and benefits related accruals	$13,684	$14,167
Warranty accrual	3,861	3,879
Purchase commitments in excess of future demand, current	3,097	6,321
Deferred rent	2,018	2,040
Other accruals	13,661	15,279
	$36,321	$41,686

Accumulated Other Comprehensive Income

The following table presents the components of accumulated other comprehensive income at the dates indicated:

	September 29, 2018	June 30, 2018
	(Thousands)	
Accumulated other comprehensive income:		
Currency translation adjustments	$42,626	$42,626
Unrealized loss on marketable securities	(1)	(4)
Japan defined benefit plan	(101)	(101)
Other	26	26
	$42,550	$42,547

NOTE 4. FAIR VALUE

We define fair value as the estimated price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining fair value measurements for assets and liabilities which are required to be recorded at fair value, we consider the principal or most advantageous market in which we would transact and the market-based risk measurements or assumptions that market participants would use in pricing the asset or liability, such as inherent risk, transfer restrictions and credit risk. We apply the following fair value hierarchy, which ranks the quality and reliability of the information used to determine fair values:

Level 1-	Quoted prices in active markets for identical assets or liabilities.
Level 2-	Inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices of identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets), or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
Level 3-	Unobservable inputs to the valuation methodology that are significant to the measurement of the fair value of the assets or liabilities.

Our cash equivalents and short-term investment instruments are generally classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of instruments valued based on quoted market prices in active markets include most money market funds, which are generally classified within Level 1 of the fair value hierarchy. The types of instruments valued based on other observable inputs include investment-grade corporate bonds, commercial paper, U.S. Treasury and agency securities, which are generally classified within Level 2 of the fair value hierarchy.

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Assets and Liabilities Measured at Fair Value on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are shown in the table below by their corresponding balance sheet caption and consisted of the following types of instruments at September 29, 2018 and June 30, 2018:

	Fair Value Measurement at September 29, 2018 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Thousands)			
Assets:				
Cash and cash equivalents: (1)				
Money market funds	$273,234	$ —	$ —	$273,234
Short-term investments:				
U.S. Treasury securities	—	3,997	—	3,997
Total assets measured at fair value	$273,234	$ 3,997	$ —	$277,231

(1) Excludes $64.7 million in cash held in our bank accounts at September 29, 2018.

	Fair Value Measurement at June 30, 2018 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Thousands)			
Assets:				

Cash and cash equivalents: (1)				
Money market funds	$153,392	$ —	$ —	$153,392
Commercial paper	—	3,999	—	3,999
Short-term investments:				
Commercial paper	—	41,401	—	41,401
Corporate bonds	—	4,100	—	4,100
U.S. Treasury securities	—	31,939	—	31,939
Total assets measured at fair value	$153,392	$ 81,439	$ —	$234,831

(1) Excludes $88.3 million in cash held in our bank accounts at June 30, 2018.

NOTE 5. POST-RETIREMENT BENEFITS

We maintain a defined contribution plan and a defined benefit plan that provides retirement benefits to our employees in Japan. We also contribute to a U.K. based defined contribution pension scheme for employees.

Japan Defined Contribution Plan

Under the defined contribution plan in Japan, contributions are provided based on grade level and totaled $0.1 million and $0.1 million for the three months ended September 29, 2018 and September 30, 2017, respectively. Employees can elect to receive the benefit as additional salary or contribute the benefit to the plan on a tax-deferred basis.

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Japan Defined Benefit Plan

Under the defined benefit plan in Japan (the “Japan Plan”), we calculate benefits based on an employee’s individual grade level and years of service. Employees are entitled to a lump sum benefit upon retirement or upon certain instances of termination.

As of September 29, 2018, there were no plan assets associated with the Japan Plan. As of September 29, 2018, there was $0.3 million in accrued expenses and other liabilities and $6.7 million in other non-current liabilities in our condensed consolidated balance sheet to account for the projected benefit obligations under the Japan Plan. Net periodic pension costs for the Japan Plan included the following:

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands)	
Service cost	$ 157	$ 157
Interest cost	5	5
Net periodic pension costs	$ 162	$ 162

We made $0.1 million in benefit payments under the Japan Plan during the three months ended September 29, 2018. We made no benefit payments during the three months ended September 30, 2017.

U.K. Defined Contribution Pension Scheme

Under the defined contribution pension scheme, employer contributions totaled $0.3 million and $0.3 million for the three months ended September 29, 2018 and September 30, 2017, respectively.

NOTE 6. COMMITMENTS AND CONTINGENCIES

Loss Contingencies

We are involved in various lawsuits, claims, and proceedings that arise in the ordinary course of business. We record a loss provision when we believe it is both probable that a liability has been incurred and the amount can be reasonably estimated.

Guarantees

We indemnify our directors and certain employees as permitted by law, and have entered into indemnification agreements with our directors and executive officers. We have not recorded a liability associated with these indemnification arrangements, as we historically have not incurred any material costs associated with such indemnification obligations. Costs associated with such indemnification obligations may be mitigated by insurance coverage that we maintain, however, such insurance may not cover any, or may cover only a portion of, the amounts we may be required to pay. In addition, we may not be able to maintain such insurance coverage in the future.

We also have indemnification clauses in various contracts that we enter into in the normal course of business, such as indemnifications in favor of customers in respect of liabilities they may incur as a result of purchasing our products should such products infringe the intellectual property rights of a third party. We have not historically paid out any material amounts related to these indemnifications; therefore, no accrual has been made for these indemnifications. See Litigation - Oyster Optics Litigation below for additional details.

Warranty Accrual

We generally provide a warranty for our products for twelve months to thirty-six months from the date of sale, although warranties for certain of our products may be longer. We accrue for the estimated costs to provide warranty services at the time revenue is recognized. Our estimate of costs to service our warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, our warranty costs would increase, resulting in a decrease in gross profit.

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The following table summarizes movements in the warranty accrual for the periods indicated:

	Three Months Ended September 29, 2018	September 30, 2017
	(Thousands)	
Warranty provision—beginning of period	$3,879	$ 4,124
Warranties issued	105	216
Warranties utilized or expired	(112)	(120)
Currency translation and other adjustments	(11)	51
Warranty provision—end of period	$3,861	$ 4,271

Capital Leases

In connection with our acquisition of Opnext on July 23, 2012, we assumed capital leases for certain capital equipment, which had lease terms that ranged from one to five years, and provided us with the option to purchase the equipment at the residual value upon expiration. For certain of these capital leases in Japan, we have entered into one year extensions. During the first quarter of fiscal 2019, we negotiated an early buyout of the remaining $2.0 million of these leases.

In October 2015, we entered into a capital lease agreement for certain capital equipment. The lease term is for 5 years, after which time the ownership of the equipment will transfer from the lessor to us. During the lease term, we will make twenty equal installments of principal and interest, payable quarterly. Interest on the capital lease will accrue at 1.15 percent per annum.

The following table shows the future minimum lease payments due under non-cancelable capital leases at September 29, 2018:

	Capital Leases
	(Thousands)
Fiscal Year Ending:	
2019 (remaining)	$ 419
2020	598
2021	258
2022	—
2023	—
Thereafter	—
Total minimum lease payments	1,275
Less amount representing interest	(43)
Present value of capitalized payments	1,232
Less: current portion	(530)
Long-term portion	$ 702

Purchase Commitments

We purchase components from a variety of suppliers and use contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with suppliers and contract manufacturers that either allow them to procure inventory based upon criteria as defined by us or establish the parameters defining our requirements. A significant portion of our reported purchase commitments arising from these agreements consist of firm, non-cancelable and unconditional commitments.

We record a liability for firm, non-cancelable and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory. As of September 29, 2018 and June 30, 2018, the liability for these purchase commitments was $3.1 million and $6.3 million, respectively, and was included in accrued expenses and other liabilities in our condensed consolidated balance sheets.

Malaysian Goods and Services Tax ("GST")

In February 2016, the Malaysian tax authorities preliminarily denied our Malaysia GST refund claims representing approximately $2.5 million. These claims were made in connection with the export of finished goods from our contract manufacturing partner's Malaysian facilities. We are currently appealing the denial of these claims, and believe that additional options may be available to us if we do not obtain a favorable resolution. Although we have taken action to minimize the impact of the GST with respect to our ongoing operations, we believe it is reasonably possible that, ultimately, we may not be able to recover some of these GST amounts. Of the $2.5 million in GST claims, we recorded $0.7 million in prepaid expenses and other current assets in our condensed consolidated balance sheet at September 29, 2018, net of reserves and certain offsetting payments from our contract manufacturing partner.

Litigation

Overview

In the ordinary course of business, we are involved in various legal proceedings, and we anticipate that additional actions will be brought against us in the future. The most significant of these proceedings are described below. These legal proceedings, as well as other matters, involve various aspects of our business and a variety of claims in various jurisdictions. Complex legal proceedings frequently extend for several years, and a number of the matters pending against us are at very early stages of the legal process. As a result, some pending matters have not yet progressed sufficiently through discovery and/or development of important factual information and legal issues to enable us to determine whether the proceeding is material to us or to estimate a range of possible loss, if any. Unless otherwise disclosed, we are unable to estimate the possible loss or range of loss for the legal proceedings described below. While it is not possible to accurately predict or determine the eventual outcomes of these items, an adverse determination in one or more of these items currently pending could have a material adverse effect on our results of operations, financial position or cash flows, and even if we are ultimately successful in defending these claims, such claims may be expensive to defend and could distract our management team from other important business matters.

Oyster Optics Litigation

On November 23, 2016, Oyster Optics LLC ("Oyster") filed a civil suit against Cisco Systems, Inc. ("Cisco") and British Telecommunications PLC ("BT"), in the U.S. District Court for the Eastern District of Texas, Marshall Division, Case No. 2:16-CV-01301. In the complaint, Oyster alleges that Cisco and BT infringed seven patents owned by Oyster, which patents allegedly relate to certain Cisco optical platform products, some of which may incorporate Oclaro components. Oyster subsequently dismissed its claim against BT without prejudice. In January 2017, Cisco requested that Oclaro indemnify and defend it in this litigation, pursuant to our commercial agreements with Cisco. In May 2017, Oclaro and Cisco preliminarily agreed to an allocation of the responsibilities for the costs of defense associated with Oyster's claims. However, due to the uncertainty regarding the infringement allegations that Oyster may present at trial and the resultant uncertainty regarding the number of Oclaro components that may be implicated by such infringement allegations, Oclaro and Cisco agreed to defer until the conclusion of the litigation the final determination of whether and to what extent Oclaro will indemnify Cisco for any amounts Cisco may be required to pay Oyster and Cisco's related defense costs. After discovery, Oyster's infringement case against Cisco involved claims of only one patent and did not involve Oclaro components that were the subject of our commercial agreements with Cisco. In June of 2018, Cisco communicated its determination that the Oyster litigation against it did not involve Oclaro. On October 25, 2018, the Court granted Oyster and Cisco's joint motion to stay all deadlines in their case; as a result, no trial date is currently set. On November 1, 2018, Oyster and Cisco jointly moved to sever "all claims not resolved by the Court's Order Granting Defendants' Motion for Partial Summary Judgment Regarding Their Release Defense (Dkt. 826, sealed) . . . including any possible supplement or clarification thereto." They also jointly moved for those new actions to be stayed and administratively closed pending the resolution of any appeals from Oyster's current litigation with Cisco. Oyster and Cisco also jointly moved on November 1st for entry of final judgment in favor of Cisco and against Oyster, indicating that "[a]ssuming the Court grants the parties' contemporaneously filed motion to sever, there are no remaining issues in the [Oyster-Cisco] litigation to be resolved." Between June and September of 2017, Cisco and Oclaro filed eleven Petitions for inter partes review with the U.S. Patent Office of claims in six of the patents that Oyster originally asserted against Cisco. The Patent Office eventually instituted inter partes review for eight of the

eleven Petitions involving claims of five of the six patents. Trials for the instituted Petitions are ongoing.
On November 24, 2016, Oyster also filed a civil suit against Coriant America Inc. (“Coriant”) in the U.S. District Court for the Eastern District of Texas, Marshall Division, Case No. 2:16-cv-01302. In the complaint against Coriant, Oyster alleges that Coriant has infringed the same seven patents that were asserted against Cisco. On May 18, 2017, Oyster’s case against Coriant was consolidated with cases that Oyster brought against other parties, including Cisco. On December 21, 2017, Coriant requested that Oclaro indemnify and defend it in this litigation, pursuant to our commercial agreements with Coriant. Oclaro has refused this request for reasons including that Oyster’s claims against Coriant do not clearly implicate Oclaro products and that Coriant’s request was not timely made. Coriant has stated its disagreement with this position. As a result, Oclaro may have further discussions with Coriant regarding Coriant’s request for defense and indemnification. Oyster and Coriant informed the Court on April 12,

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2018, that "all matters in controversy between the parties have been settled, in principle." On July 3, 2018, the Court granted a joint motion from Oyster and Coriant to dismiss their case with prejudice.

Oyster also filed a civil suit on November 24, 2016 against Ciena Corporation ("Ciena") in the U.S. District Court for the Eastern District of Texas, Marshall Division, Case No. 2:16-CV-01300. In the complaint against Ciena, Oyster alleges that Ciena has infringed the same seven patents that were asserted against Cisco. Oyster's case against Ciena was later transferred to the Northern District of California which granted a motion that Ciena filed to stay the case pending inter partes review of the Oyster patents. On June 1, 2018, the parties filed a joint status report reporting on the status of the inter partes review proceedings. Also on June 1, 2018, counsel for Oyster wrote the Court a letter indicating that because there are no further proceedings in the PTAB concerning one of the asserted patents, that Oyster requested that the litigation move forward as to the asserted claims of that patent only and that the Court set a scheduling conference. On June 4, 2018, the Court indicated that Oyster should file a noticed motion for any such relief and the case currently remains stayed. On October 16, 2017, Ciena requested that Oclaro indemnify and defend it in this litigation, pursuant to our commercial agreements with Ciena. Oclaro refused this request for reasons including that Oyster's claims against Ciena do not clearly implicate Oclaro products and that Ciena's request was not timely made. Ciena has stated its disagreement with this position. As a result, discussions with Ciena regarding Ciena's request for defense and indemnification have not completed.

Oclaro Merger Litigation

Following announcement of the execution of the Merger Agreement on March 12, 2018, seven lawsuits were filed by purported stockholders of Oclaro challenging its proposed acquisition by Lumentum, Inc. The first suit, a putative class action styled as Nicholas Neinast v. Oclaro, Inc., et al., No. 3:18-cv-03112-VC, was filed in the United States District Court for the Northern District of California on May 24, 2018, and was against Oclaro, its directors, Lumentum, Merger Sub, and Merger Sub LLC (the "Neinast Lawsuit"). Five additional suits, styled as Gerald F. Wordehoff v. Oclaro, Inc., et al., No. 5:18-cv-03148-NC (the "Wordehoff Lawsuit"), Walter Ryan v. Oclaro, Inc., et al., No. 3:18-cv-03174-VC (the "Ryan Lawsuit"), and Jayme Walker v. Oclaro, Inc., et al., No. 3:18-cv-03203 (the "Walker Lawsuit"), Kevin Garcia v. Oclaro, Inc., et al., No. 5:18-cv-03262-VKD (the "Garcia Lawsuit"), and Saisravan Bharadwaj Karri v. Oclaro, Inc., et al., No. 3:18-cv-03435-JD (the "Karri Lawsuit") were also filed in the United States District Court for the Northern District of California on, respectively, May 25, 2018, May 29, 2018, May 30, 2018, May 31, 2018 and June 9, 2018. Each of the lawsuits name Oclaro and its directors as defendants. The Ryan Lawsuit and the Karri Lawsuit, like the Neinast Lawsuit, were putative class actions. A seventh suit, a putative class action styled as Adam Franchi v. Oclaro, Inc., et al., Case 1:18-cv-00817-GMS, was filed in the United States District Court for the District of Delaware on May 30, 2018, and was against Oclaro, its directors, Lumentum, Merger Sub, and Merger Sub LLC (the "Franchi Lawsuit" and, with the Neinast Lawsuit, the Wordehoff Lawsuit, the Ryan Lawsuit, the Walker Lawsuit, the Garcia Lawsuit, and the Karri Lawsuit, the "Lawsuits").

The Lawsuits alleged that Oclaro and its directors violated Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder because the Proxy Statement/Prospectus was incomplete and misleading. The Lawsuits further alleged that Oclaro's directors violated Section 20(a) of the Exchange Act by failing to exercise proper control over the person(s) who violated Section 14(a) of the Exchange Act. The Neinast Lawsuit additionally alleged that Oclaro's directors breached fiduciary duties by entering into the Merger, and also names Lumentum, Merger Sub, and Merger Sub LLC as violators of Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder. The Franchi Lawsuit additionally named Lumentum, Merger Sub, and Merger Sub LLC as violators of Section 20(a) of the Exchange Act.

The Lawsuits sought, among other things, injunctive relief preventing the parties from consummating the merger, rescission of the transactions contemplated by the Merger Agreement should they be consummated, and litigation costs, including attorneys' fees. The Lawsuits also sought damages to be awarded to the plaintiff and any class if the Merger were consummated. In addition, the Wordehoff Lawsuit sought injunctive relief directing defendants to disseminate a true and complete proxy statement/prospectus and declaratory relief that defendants violated Sections 14(a) and/or 20(a) of the Exchange Act and Rule 14a-9 promulgated thereunder.

To avoid the risk of the Lawsuits delaying or adversely affecting the Merger and to minimize the costs, risks and uncertainties inherent in litigation, and without admitting any liability or wrongdoing and believing that the initial Proxy Statement/Prospectus disclosed all material information concerning the Merger and no supplemental disclosure was required under applicable law, Oclaro voluntarily filed with the SEC a supplement to the Proxy Statement/Prospectus on June 29, 2018.

Thereafter, on July 25, 2018, the plaintiff in the Garcia Lawsuit dismissed his action, with prejudice as to the individual plaintiff. The plaintiffs in the Neinast, Franchi, Wordehoff, and Ryan Lawsuits dismissed these actions, with prejudice as to the respective individual plaintiffs, on July 27, 2018. The plaintiff in the Walker Lawsuit dismissed her action, with prejudice as to the individual plaintiff, on August 14, 2018. At the time the other complaints were being dismissed, counsel for plaintiff in the remaining lawsuit, the Karri Lawsuit, stated his intention to file an amended complaint. On September 27, 2018, the Court rejected, without hearing,

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the Karri plaintiff's motion to be appointed lead counsel because plaintiff failed to follow the required notice procedure. Following this order, plaintiff renewed his public notice of filing of the lawsuit, but has taken no further action. If the Karri Lawsuit proceeds, Oclaro intends to defend the action vigorously.

NOTE 7. EMPLOYEE STOCK PLANS

Stock Incentive Plans

As of September 29, 2018, there were approximately 13.8 million shares of our common stock available for grant under the Fifth Amended and Restated 2001 Long-Term Stock Incentive Plan (the "Plan").

We generally grant restricted stock awards and restricted stock unit ("RSU") awards that vest over a one to four year service period, and in certain cases each may vest earlier based upon the achievement of specific performance-based objectives as set by our board of directors or the compensation committee of our board of directors. We no longer grant stock options.

We also have a minimal amount of stock appreciation rights ("SARs") outstanding as of September 29, 2018, which we assumed in connection with our acquisition of Opnext.

Performance-Based Restricted Stock Units ("PSUs")

In August 2017, our board of directors approved a grant of 1.1 million PSUs to certain executive officers with an aggregate estimated grant date fair value of $9.5 million. These PSUs have service- and performance-based vesting conditions. One-third of the PSUs will vest subject to the achievement of $700.0 million of revenue over any four consecutive quarters through the end of fiscal 2020, subject to service conditions; one-third of the PSUs will vest upon the achievement of $100.0 million of free cash flow (defined as adjusted EBITDA less capital expenditures) over any four consecutive quarters through the end of fiscal 2020, subject to service conditions; and one-third of the PSUs will vest upon the achievement of $800.0 million of revenue in any one fiscal year from 2018 through 2020 and upon achievement of $100.0 million of free cash flow over any four consecutive quarters through the end of fiscal 2020, subject to service conditions. Upon attaining each performance condition, the service-based vesting condition is satisfied for that tranche as to 1/3 of the PSUs on the first anniversary of the vesting commencement date, and with respect to 1/12 of the underlying shares each subsequent quarter, such that all PSUs for that tranche are fully vested on the third anniversary of the vesting commencement date. As of September 29, 2018, we determined that the achievement of the performance conditions associated with these PSUs was improbable. The performance conditions associated with these PSUs will be considered achieved upon the consummation of the merger with Lumentum.

In August 2016, our board of directors approved a grant of 0.8 million PSUs to certain executive officers with an aggregate estimated grant date fair value of $4.8 million. Subject to the achievement of an aggregate of $25.0 million or more of free cash flow (defined as adjusted EBITDA less capital expenditures) over any consecutive four fiscal quarters ending on or before June 27, 2020, as determined by our board of directors, these PSUs will vest contingent upon service conditions being met through August 10, 2020. On July 25, 2017, the compensation committee of our board of directors certified that the performance condition for these PSUs was achieved. As a result, these PSUs vested with respect to 25 percent of the shares subject to the PSUs on August 10, 2017, and with respect to 6.25 percent of the underlying shares each subsequent quarter over the following three years, subject to continuous service.

In August 2015, our board of directors approved a grant of 0.9 million PSUs to certain executive officers with an aggregate estimated grant date fair value of $2.5 million. Subject to the achievement of positive free cash flow (defined as adjusted EBITDA less capital expenditures) in any fiscal quarter ending prior to June 30, 2018, vesting of these PSUs is contingent upon service conditions being met through August 10, 2018. On October 29, 2015, the compensation committee of our board of directors certified that this performance condition was achieved during the first quarter of fiscal 2016. As a result, these PSUs vested with respect to 33.4 percent of the underlying shares on August 10, 2016, and will vest with respect to 8.325 percent of the underlying shares each subsequent quarter over the following two years, subject to continuous service.

Restricted Stock Units

In August 2018, our board of directors approved a long term incentive grant of 0.5 million RSUs to certain executive officers and 1.8 million RSUs to other employees, which vest over four years.
In August 2017, our board of directors approved a long term incentive grant of 0.6 million RSUs to certain executive officers and 1.6 million RSUs to other employees, which vest over four years.

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Stock Incentive Plan Activity

The following table summarizes the combined activity under all of our equity incentive plans for the three months ended September 29, 2018:

	Shares Available For Grant	Stock Options / SARs Outstanding	Weighted-Average Exercise Price	Time and Performance-based Restricted Stock Awards / Units Outstanding	Weighted-Average Grant Date Fair Value
	(Thousands)	(Thousands)		(Thousands)	
Balance at June 30, 2018	16,456	1,066	$ 7.75	6,586	$ 7.38
Granted	(3,157)	—	—	2,255	8.59
Exercised or released	3	(72)	6.90	(1,104)	6.63
Forfeited or expired	456	(378)	13.39	(55)	7.76
Balance at September 29, 2018	13,758	616	$ 4.38	7,682	$ 7.84

Supplemental disclosure information about our stock options and SARs outstanding as of September 29, 2018 is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value
	(Thousands)		(Years)	(Thousands)
Options and SARs exercisable	612	$ 4.40	3.3	$ 2,991
Options and SARs outstanding	616	$ 4.38	3.3	$ 3,018

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value, based on the closing price of our common stock of $8.94 on September 28, 2018, which would have been received by the option holders had all option holders exercised their options as of that date. There were approximately 0.5 million shares of common stock subject to in-the-money options which were exercisable as of September 29, 2018. We settle employee stock option exercises with newly issued shares of common stock.

NOTE 8. STOCK-BASED COMPENSATION

We recognize stock-based compensation expense in our condensed consolidated statement of operations related to all share-based awards, including grants of stock options, based on the grant date fair value of such share-based awards. The amounts included in cost of revenues and operating expenses for stock-based compensation were as follows:

	Three Months Ended September 29, 2018	September 30, 2017
	(Thousands)	
Stock-based compensation by category of expense:		
Cost of revenues	$562	$ 438
Research and development	1,067	867
Selling, general and administrative	2,375	1,894
	$4,004	$ 3,199
Stock-based compensation by type of award:		
Stock options	$8	$ 32
Restricted stock awards	4,285	3,464

Inventory adjustment to cost of revenues	(289)	(297)
	$4,004	$ 3,199

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Included in stock-based compensation for the three months ended September 29, 2018 and September 30, 2017 is approximately $0.3 million and $0.7 million, respectively, in stock-based compensation cost related to the issuance of PSUs granted in August 2015 and August 2016. We recorded no stock-based compensation expense related to the issuance of PSUs granted in August 2017 as we determined that the achievement of the performance conditions associated with these PSUs was not probable as of September 29, 2018. The amount of stock-based compensation expense recognized in any one period related to PSUs can vary based on the achievement or anticipated achievement of the performance conditions. If the performance conditions are not met or not expected to be met, no compensation cost would be recognized on the shares underlying the PSUs, and any previously recognized compensation expense related to those PSUs would be reversed.

As of September 29, 2018 and June 30, 2018, we capitalized $1.2 million and $0.9 million, respectively, of stock-based compensation in inventory.

As of September 29, 2018, we had minimal unrecognized stock-based compensation expense related to unvested stock options, that will be recognized over a weighted-average period of 0.2 years, and $46.9 million in unrecognized stock-based compensation expense related to unvested time-based and performance-based restricted stock awards that will be recognized over a weighted-average period of 2.7 years.

NOTE 9. INCOME TAXES

The income tax provision of $2.6 million and $6.2 million for the three months ended September 29, 2018 and September 30, 2017, respectively, relates primarily to our foreign operations.

The total amount of our unrecognized tax benefits as of September 29, 2018 and June 30, 2018, were approximately $3.1 million and $3.1 million, respectively. As of September 29, 2018, we had $2.3 million of unrecognized tax benefits that, if recognized, would affect our effective tax rate. While it is often difficult to predict the final outcome of any particular uncertain tax position, we believe that unrecognized tax benefits could decrease by approximately $1.1 million in the next twelve months.

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was signed into law. Among other things, the TCJA introduces new international tax provisions that will be effective in our fiscal 2019. including (i) a new provision designed to currently tax the global low-taxed income of our foreign subsidiaries, together with a deduction of up to 50 percent and a partial credit for foreign taxes incurred by the foreign subsidiaries; (ii) limitations on the deductibility of certain base eroding payments to foreign entities; and (iii) limitations on the use of foreign tax credits to reduce U.S. income tax liability. Our estimated fiscal 2019 annual global intangible low-tax income ("GILTI") inclusion income will be entirely offset by our net operating losses which are subject to a full valuation allowance. Accordingly, this inclusion does not impact our interim income tax provision. We do not expect the other tax law changes to have a material impact to the interim income tax provision.

Due to the complexity of the provision for the TCJA and the lack of the current guidance, under the guidance of Staff Accounting Bulletin 118, the accounting is incomplete and we have not estimated the GILTI impact on deferred taxes. Additionally, state and local authorities are reviewing federal conformity matters related to GILTI. Provisional amounts or adjustments to provisional amounts identified in the measurement period, would be included as an adjustment to tax expense or benefit from continuing operations in the period the amounts are determined. We have determined a reasonable estimate for the tax reform effects other than the impact of GILTI on our recognition of deferred tax assets, and reported the estimates as a provisional amount in our financial statements for which the accounting under ASC Topic 740 is completed. We will finalize the impact of the GILTI in fiscal year 2019.

Our financial statements do not provide for tax on undistributed earnings of our foreign subsidiaries intended to be permanently reinvested outside the U.S. within our foreign operations. At September 29, 2018, the amount of undistributed earnings of profitable subsidiaries is approximately $139.7 million. If repatriated to the U.S. following the enactment of the TCJA, the distribution would not result in material additional U.S. taxes. However, we estimate that an additional $1.3 million in foreign withholding and other taxes would be incurred at the time of distribution.

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NOTE 10. NET INCOME PER SHARE

Basic net income per share is computed using only the weighted-average number of shares of common stock outstanding for the applicable period, while diluted net income per share is computed assuming conversion of all potentially dilutive securities, such as stock options and unvested restricted stock units and awards during such period.

The following table presents the calculation of basic and diluted net income per share:

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands, except per share amounts)	
Net income	$10,229	$ 26,489
Weighted-average shares - Basic	171,046	168,137
Effect of dilutive potential common shares from:		
Stock options and stock appreciation rights	314	504
Restricted stock units and awards	1,767	2,208
Weighted-average shares - Diluted	173,127	170,849
Basic net income per share	$0.06	$ 0.16
Diluted net income per share	$0.06	$ 0.16

For the three months ended September 29, 2018 and September 30, 2017, we excluded 0.2 million and 0.6 million, respectively, underlying outstanding stock options, stock appreciation rights and unvested restricted stock awards from the calculation of diluted net income per share because their effect would have been anti-dilutive.

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NOTE 11. GEOGRAPHIC INFORMATION, PRODUCT GROUPS, MARKET APPLICATIONS AND CUSTOMER CONCENTRATION INFORMATION

Geographic Information

The following table shows revenues by geographic area based on the delivery locations of our products:

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands)	
Asia-Pacific:		
China	$50,804	$ 41,433
Thailand	19,384	18,075
Malaysia	4,124	2,087
Other Asia-Pacific	5,620	3,702
Total Asia-Pacific	$79,932	$ 65,297
Americas:		
United States	14,720	37,690
Mexico	25,732	29,486
Other Americas	331	5,231
Total Americas	$40,783	$ 72,407
EMEA:		
Italy	5,704	6,925
Germany	2,852	4,055
Other EMEA	1,374	4,816
Total EMEA	$9,930	$ 15,796
Japan	$1,013	$ 2,098
Total revenues	$131,658	$ 155,598

Product Groups

The following table sets forth revenues by product group:

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands)	
100 Gb/s + transmission modules	$107,386	$125,641
40 Gb/s and lower transmission modules	24,272	29,957
	$131,658	$155,598

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Market Applications

The following table sets forth revenues by market application:

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(Thousands)	
Data Communications/Client Side	$57,009	$ 75,078
Telecommunications/Line Side	74,649	80,520
	$131,658	$ 155,598

Significant Customers and Concentration of Credit Risk

For the three months ended September 29, 2018, four customers accounted for 10 percent or more of our revenues, representing approximately 16 percent, 15 percent, 14 percent and 12 percent of our revenues, respectively. For the three months ended September 30, 2017, five customers accounted for 10 percent or more of our revenues, representing approximately 17 percent, 11 percent, 11 percent, 10 percent and 10 percent of our revenues, respectively.

As of September 29, 2018, four customers accounted for 10 percent or more of our accounts receivable, representing approximately 16 percent, 12 percent, 12 percent and 11 percent of our accounts receivable, respectively. As of June 30, 2018, two customers accounted for 10 percent or more of our accounts receivable, representing approximately 22 percent and 14 percent of our accounts receivable, respectively.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements, within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, about our future expectations, plans or prospects and our business. You can identify these statements by the fact that they do not relate strictly to historical or current events, and contain words such as “anticipate,” “estimate,” “expect,” “forecast,” “project,” “intend,” “plan,” “believe,” “will,” “should,” “outlook,” “coul "objective," and other words of similar meaning in connection with discussion of future operating or financial performance. We have based our forward looking statements on our management's beliefs and assumptions based on information available to our management at the time the statements are made. There are a number of important factors that could cause our actual results or events to differ materially from those indicated by such forward-looking statements, including (i) the risk that our pending merger with Lumentum Holdings Inc. does not close, due to the failure of one or more conditions to closing, (ii) disruption from the merger making it more difficult to maintain our customer, supplier, key personnel and other strategic relationships, (iii) uncertainty as to the market value of the Lumentum merger consideration to be paid in the merger, (iv) the risk that required governmental approvals of the merger (including China antitrust approval) will not be obtained or that such approvals will be delayed beyond current expectations, (v) the risk of litigation in respect of either Oclaro or Lumentum or the merger, (vi) our dependence on a limited number of customers for a significant percentage of our revenues, (vii) competition and pricing pressure, (viii) our ability to effectively manage our inventory, (ix) the absence of long-term purchase commitments from many of our long-term customers, (x) our ability to meet or exceed our gross margin expectations, (xi) our ability to grow our revenues in the future by increasing the percentage of sales associated with new products, (xii) the effects of fluctuations in foreign currency exchange rates, (xiii) our ability to obtain governmental licenses and approvals for international trading activities or technology transfers, including export licenses, (xiv) our ability to timely develop, commercialize and ramp the production of new products to customer required volumes, (xv) the effect of tariffs or other restrictions on trade between the U.S. and China, (xvi) our ability to respond to evolving technologies, customer requirements and demands, and product design challenges, (xvii) our dependence on a limited number of suppliers and key contract manufacturers, (xviii) the impact of additional restructuring charges we may take in the future, (xix) the risks associated with delays, disruptions or quality control problems in manufacturing, (xx) our manufacturing yields, (xxi) our ability to conclude agreements with our customers on favorable terms, (xxii) our ability to maintain effective internal controls over financial reporting, (xxiii) fluctuations in our revenues, growth rates and operating results, (xxiv) changes in our effective tax rates or outcomes of tax audits or similar proceedings, (xxv) the impact of financial market and general economic conditions in the industries in which we operate and any resulting reduction in demand for our products, (xxvi) potential operating or reporting disruptions that could result from the implementation of our new enterprise resource planning system, and (xxvii) other factors described under the caption "Risk Factors" and elsewhere in the documents we periodically file with the SEC. We cannot guarantee any future results, levels of activity, performance or achievements. You should not place undue reliance on forward-looking statements. Moreover, we assume no obligation to update forward-looking statements or update the reasons actual results could differ materially from those anticipated in forward-looking statements, except as required by law. Several of the important factors that may cause our actual results to differ materially from the expectations we describe in forward-looking statements are identified in the sections captioned “Management's Discussion and Analysis of Financial Condition and Results of Operations” and "Risk Factors" in this Quarterly Report on Form 10-Q.

As used herein, “Oclaro,” “we,” “our,” and similar terms include Oclaro, Inc. and its subsidiaries, unless the context indicates otherwise.

OVERVIEW

We are one of the leading providers of optical components and modules for the long-haul, metro and data center markets. Leveraging over three decades of laser technology innovation and photonics integration, we provide differentiated solutions for optical networks and high-speed interconnects driving the next wave of streaming video,

cloud computing, application virtualization and other bandwidth-intensive and high-speed applications.
We have research and development ("R&D") facilities in China, Italy, Japan, United Kingdom and the United States, and fabrication facilities in China, Italy, Japan and the United Kingdom. We also have contract manufacturing sites in Asia, with design, sales and service organizations in most of the major regions around the world.
Our customers include: Amazon.com; Ciena Corporation; Cisco Systems, Inc.; Coriant GmbH; Google Inc.; Huawei Technologies Co. Ltd; InnoLight Technology Corporation; Microsoft Corporation; Nokia and ZTE Corporation.

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RECENT DEVELOPMENTS

Merger

On March 11, 2018, Lumentum Holdings Inc., a Delaware corporation ("Lumentum"), Oclaro, Prota Merger Sub, Inc., a Delaware corporation and a wholly owned subsidiary of Lumentum ("Merger Sub"), and Prota Merger, LLC, a Delaware limited liability company and a wholly owned subsidiary of Lumentum ("Merger Sub LLC"), entered into an Agreement and Plan of Merger (the "Merger Agreement").

Pursuant to the terms of the Merger Agreement, the acquisition of Oclaro will be accomplished through a merger of Merger Sub with and into Oclaro (the "First Step Merger") with Oclaro surviving the First Step Merger. As soon as reasonably practicable following the First Step Merger, Oclaro will merge with and into Merger Sub LLC with Merger Sub LLC continuing as the surviving entity and a wholly owned subsidiary of Lumentum (the "Second Step Merger," and taken together with the First Step Merger, the "Merger").

Pursuant to the terms of the Merger Agreement, and subject to the terms and conditions set forth therein, at the effective time of the First Step Merger (the "Effective Time"), each share of the common stock of Oclaro (the "Oclaro Common Stock") issued and outstanding immediately prior to the Effective Time (other than (x) shares of Oclaro Common Stock owned by Lumentum, Oclaro, or any direct or indirect wholly owned subsidiary of Lumentum or Oclaro or (y) shares of Oclaro Common Stock owned by stockholders who have properly exercised and perfected appraisal rights under Delaware law, in each case immediately prior to the Effective Time, will be cancelled and extinguished and automatically converted into the right to receive the following consideration (collectively, the "Merger Consideration"):

(A) $5.60 in cash, without interest (the "Cash Consideration"), plus

(B) 0.0636 of a validly issued, fully paid and nonassessable share of the common stock of Lumentum, par value $0.001 per share ("Lumentum Common Stock") (such ratio, the "Exchange Ratio").

With regard to the Merger Consideration, if the aggregate number of shares of Lumentum Common Stock to be issued in connection with the Merger (including all Lumentum Common Stock which may be issued in the future pursuant to the conversion of Oclaro Options, Oclaro Restricted Stock Units, or Oclaro Restricted Stock (as defined below) would exceed 19.9 percent of the Lumentum Common Stock issued and outstanding immediately prior to the Effective Time (the "Stock Threshold"), (A) the Exchange Ratio will be reduced to the minimum extent necessary (rounded down to the nearest one thousandth) such that the aggregate number of shares of Lumentum Common Stock to be issued in connection with the Merger (including all shares of Lumentum Common Stock which may be issued after the Effective Time pursuant to company compensatory awards) does not exceed the Stock Threshold and (B) the Cash Consideration for all purposes will be increased on a per share basis by an amount equal to $68.975, multiplied by the difference between the initial Exchange Ratio and the Exchange Ratio.

Each Oclaro restricted stock unit award (an "Oclaro RSU") that does not become vested at the closing will be converted into a Lumentum restricted stock unit award (a "Lumentum RSU") with the same terms and conditions, including vesting, that were applicable to such Oclaro RSU, except that the number of Lumentum shares subject to the Lumentum RSU will equal the product of (i) the number of Oclaro shares subject to such Oclaro RSU (with any performance milestones deemed achieved based on the maximum level of achievement) multiplied by (ii) the sum of (A) the Exchange Ratio plus (B) the quotient obtained by dividing the Cash Consideration by Lumentum's average closing price of the 10 trading days ending on the third trading day prior to the closing (such sum, the "Equity Award Exchange Ratio"), rounded down to the nearest whole share.

Each Oclaro stock option (an "Oclaro Option"), whether vested or unvested, will be converted into a Lumentum stock option (a "Lumentum Option") with the same terms and conditions, including vesting, that were applicable to such Oclaro Option, except that (i) the number of shares subject to the Lumentum Option will equal the product of (A) the number of Oclaro shares subject to such Oclaro Option multiplied by (B) the Equity Award Exchange Ratio, rounded down to the nearest whole share and (ii) the exercise price of the Lumentum Option will equal (A) the exercise price per share of the Oclaro Option divided by (B) the Equity Award Exchange Ratio, rounded up to the nearest whole cent. Notwithstanding the foregoing, any Oclaro Option that is held by an individual who is not an Oclaro employee as of immediately prior to the closing will be canceled and converted into the Merger Consideration for each net option share covered by such Oclaro Option, subject to applicable withholding taxes.

In addition, each Oclaro restricted stock award (“Oclaro Restricted Stock Award”) and Oclaro RSU that becomes vested as of immediately prior to the closing (including each Oclaro Restricted Stock Award held by a non-employee director) will be converted into the right to receive the Merger Consideration in respect of each Oclaro share underlying such award, subject to applicable withholding taxes. Each Oclaro stock appreciation right (“Oclaro SAR”) will be canceled and converted into the right to receive a cash amount equal to the product of (i) the number of Oclaro shares subject to the Oclaro SAR multiplied by (ii) the positive difference of (A) the cash equivalent value of the Merger Consideration less (B) the strike price of the Oclaro SAR, subject to applicable withholding taxes.

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If Lumentum determines that the treatment of Oclaro equity awards described above would violate, in respect of the holder thereof, the applicable laws of a non-U.S. jurisdiction, Lumentum may treat such Oclaro equity award in a different manner so long as such treatment is no less favorable to the holder of such Oclaro equity award.

The Boards of Directors of Lumentum and Oclaro have unanimously approved the Merger and the Merger Agreement. The transaction is subject to customary closing conditions, including the absence of certain legal impediments, the expiration or termination of the required waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act") and under applicable anti-trust laws in China, the effectiveness of a registration statement on Form S-4 registering the shares of Lumentum common stock to be issued in connection with the Merger, and approval of the Merger Agreement by the holders of a majority of the outstanding shares of Oclaro Common Stock. The transaction is not subject to any financing condition. On April 4, 2018, the U.S. Federal Trade Commission granted early termination of the waiting period under the HSR Act. On July 10, 2018, Oclaro's stockholders approved the Merger Agreement.

The Merger Agreement contains customary representations, warranties and covenants of Lumentum, Oclaro, Merger Sub and Merger Sub LLC, including, (i) covenants by Oclaro concerning the conduct of its business in the ordinary course consistent with past practice during the interim period between the execution of the Merger Agreement and the consummation of the Merger, (ii) covenants by Lumentum concerning the conduct of its business in the ordinary course consistent with past practice during the interim period between the execution of the Merger Agreement and the consummation of the Merger, (iii) a covenant by Oclaro that, subject to certain exceptions, the Board of Directors of Oclaro will recommend to its shareholders adoption of the Merger Agreement, and (iv) a covenant that Oclaro will not solicit, initiate, or knowingly encourage, facilitate or induce the making of inquiry, offer or proposal that would reasonably be expected to lead to any Acquisition Proposal (as defined in the Merger Agreement). Further, the Merger Agreement prohibits us from paying dividends.

The Merger Agreement contains certain termination rights for both Lumentum and Oclaro and further provides that upon termination of the Merger Agreement under specified circumstances (including termination by Oclaro to accept a superior proposal), Oclaro may be required to pay Lumentum a termination fee of $63 million. The Merger Agreement further provides that upon termination of the Merger Agreement under specified circumstances relating to failure to obtain regulatory approvals, Lumentum may be required to pay Oclaro a termination fee of $80 million.

Termination of Denial Order and Reinstitution of ZTE's Export Privileges

On April 16, 2018, the U.S. Department of Commerce ("DOC") changed and reactivated its previously suspended denial order and suspended the export privileges of Zhongxing Telecommunications Equipment Corporation ("ZTE Corporation") and its subsidiary, ZTE Kangxun Telecommunications Ltd. ("ZTE Kangxun") (collectively, "ZTE") after determining that ZTE made false statements to the DOC related to senior employee disciplinary actions ("Denial Order"). On July 13, 2018, following approval of a settlement agreement between the DOC and ZTE and ZTE's payment of certain amounts to the DOC, the Denial Order was terminated and ZTE was removed from the DOC's Denied Persons List. During the pendency of the Denial Order, ZTE was prohibited from participating in any way in any transaction subject to the Export Administration Regulations ("EAR") and U.S. companies were restricted from exporting or re-exporting to or on behalf of ZTE any item subject to the EAR or engaging in any transaction to service any item subject to the EAR that has been or will be exported from the U.S. and which was owned, possessed or controlled by ZTE. During the pendency of the Denial Order, we ceased shipment of products to ZTE, which has been one of our significant customers. During the first quarter of our fiscal 2019, we resumed shipments of products to ZTE.

During the three months ended September 29, 2018, we recorded a $0.5 million net benefit related to inventory that was sold in the quarter that had previously been written-down because of the uncertainty of whether it would be sold to ZTE or re-allocated to other customers.

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RESULTS OF OPERATIONS

The following table sets forth our condensed consolidated results of operations for the periods indicated, along with amounts expressed as a percentage of revenues, and comparative information regarding the absolute and percentage changes in these amounts:

	Three Months Ended					
	September 29, 2018		September 30, 2017		Change	Increase (Decrease)
	(Thousands)	%	(Thousands)	%	(Thousands)	%
Revenues	$131,658	100.0	$155,598	100.0	$(23,940)	(15.4)
Cost of revenues	86,064	65.4	92,894	59.7	(6,830)	(7.4)
Gross profit	45,594	34.6	62,704	40.3	(17,110)	(27.3)
Operating expenses:						
Research and development	16,162	12.3	16,435	10.6	(273)	(1.7)
Selling, general and administrative	16,389	12.4	14,866	9.6	1,523	10.2
Amortization of other intangible assets	42	—	152	0.1	(110)	(72.4)
Restructuring and acquisition-related expenses	800	0.6	—	—	800	n/m (1)
Loss on disposal of property and equipment	777	0.6	22	—	755	3,431.8
Total operating expenses	34,170	26.0	31,475	20.2	2,695	8.6
Operating income	11,424	8.7	31,229	20.1	(19,805)	(63.4)
Other income (expense):						
Interest income (expense), net	200	0.2	434	0.3	(234)	(53.9)
(Loss) gain on foreign currency transactions, net	(193)	(0.1)	489	0.3	(682)	n/m (1)
Other income (expense), net	1,357	1.0	574	0.4	783	136.4
Total other income (expense)	1,364	1.0	1,497	1.0	(133)	(8.9)
Income before income taxes	12,788	9.7	32,726	21.0	(19,938)	(60.9)
Income tax provision	2,559	1.9	6,237	4.0	(3,678)	(59.0)
Net income	$10,229	7.8	$26,489	17.0	$(16,260)	(61.4)

(1) Not meaningful.

Revenues

Revenues for the three months ended September 29, 2018 decreased by $23.9 million, or 15 percent, compared to the three months ended September 30, 2017. Compared to the three months ended September 30, 2017, revenues from sales of our 100 Gb/s + transmission modules decreased by $18.3 million, or 15 percent, primarily due to a decline in sales of our client side transceivers as well as our line side components; and revenues from sales of our 40 Gb/s and lower transmission modules decreased by $5.7 million, or 19 percent, primarily due to declining sales of certain legacy 40 Gb/s and 10 Gb/s products being gradually replaced by our newer higher speed products. This product mix shift reflects our continued focus on the market for higher speed products that are smaller in size and have lower power consumption.

For the three months ended September 29, 2018, four customers accounted for 10 percent or more of our revenues, representing approximately 16 percent, 15 percent, 14 percent and 12 percent of our revenues, respectively. For the three months ended September 30, 2017, five customers accounted for 10 percent or more of our revenues, representing approximately 17 percent, 11 percent, 11 percent, 10 percent and 10 percent of our revenues, respectively.

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Gross Profit

Gross profit is calculated as revenues less cost of revenues. Gross margin rate is gross profit reflected as a percentage of revenues.

Our gross margin rate was approximately 35 percent for the three months ended September 29, 2018, compared to 40 percent for the three months ended September 30, 2017. This decrease was primarily due to a weaker product mix predominantly related to the wind-down of 100G Datacom modules and fixed manufacturing costs on lower revenues, both contributing approximately 3 percentage points.

Our cost of revenues consists of the costs associated with manufacturing our products, and includes the purchase of raw materials, labor costs and related overhead, including stock-based compensation charges and the costs charged by our contract manufacturers for the products they manufacture for us. Charges for excess and obsolete inventory are also included in cost of revenues.

Research and Development Expenses

Research and development expenses were $16.2 million for the three months ended September 29, 2018, and were flat compared to $16.4 million for the three months ended September 30, 2017.

Research and development expenses consist primarily of salaries and related costs of employees engaged in research and design activities, including stock-based compensation charges related to those employees, costs of design tools and computer hardware, costs related to prototyping and facilities costs for certain research and development focused sites.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $16.4 million for the three months ended September 29, 2018, compared to $14.9 million for the three months ended September 30, 2017. The increase was primarily related to an increase of $0.9 million in professional fees and an increase of $0.5 million in stock-based compensation charges.

Selling, general and administrative expenses consist primarily of personnel-related expenses, including stock-based compensation charges related to employees engaged in sales, general and administrative functions, legal and professional fees, facilities expenses, insurance expenses and certain information technology costs.

Amortization of Other Intangible Assets

Amortization of other intangible assets decreased by $0.1 million during the three months ended September 29, 2018, as compared to the three months ended September 30, 2017. Based on the current level of our other intangible assets as of September 29, 2018, we expect our future amortization of intangible assets to be immaterial for fiscal 2019.

Restructuring and Acquisition-Related Expenses

During the three months ended September 29, 2018, we recorded restructuring and acquisition-related expenses of $0.8 million, representing $0.5 million in personnel-related costs and $0.3 million in acquisition-related costs in connection with professional fees associated with the Merger. During the first quarter of fiscal 2018, we did not incur any restructuring and acquisition-related expenses.

Loss on Disposal of Property and Equipment

During the three months ended September 29, 2018, we recorded a loss on disposal of property and equipment of $0.8 million, related to the disposal of equipment related to certain legacy data communication products. During the first quarter of fiscal 2018, we had a minimal loss on disposal of property and equipment.

Total Other Income (Expense)

Total other income (expense) was $1.4 million in income for the three months ended September 29, 2018 compared to $1.5 million in income for the three months ended September 30, 2017. This change in other income (expense) primarily related to a $0.7 million decrease in foreign currency transaction gains during the three months ended

September 29, 2018, as compared to the three months ended September 30, 2017, related to the revaluation of non-functional currency denominated balances in our U.K. and Japan subsidiaries; a $0.2 million decrease in interest income during the three months ended September 29, 2018; partially offset by a $0.8 million increase in other income principally related to investment income.

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Income Tax Provision

The income tax provision of $2.6 million and $6.2 million for the three months ended September 29, 2018 and September 30, 2017, respectively, relates primarily to our foreign operations.

The total amount of our unrecognized tax benefits as of September 29, 2018 and June 30, 2018, were approximately $3.1 million. As of September 29, 2018, we had $2.3 million of unrecognized tax benefits that, if recognized, would affect our effective tax rate. While it is often difficult to predict the final outcome of any particular uncertain tax position, we believe that unrecognized tax benefits could decrease by approximately $1.1 million in the next twelve months.

RECENT ACCOUNTING STANDARDS

See Note 2, Recent Accounting Standards, to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for information regarding the effect of new accounting pronouncements on our condensed consolidated financial statements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements contained elsewhere in this Quarterly Report on Form 10-Q, which have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”). The preparation of our financial statements requires us to make estimates and judgments that affect our reported assets and liabilities, revenues and expenses and other financial information. Actual results may differ significantly from those based on our estimates and judgments or could be materially different if we used different assumptions, estimates or conditions. In addition, our financial condition and results of operations could vary due to a change in the application of a particular accounting policy.

We identified our critical accounting policies in our Annual Report on Form 10-K for the year ended June 30, 2018 ("2018 Form 10-K") related to revenue recognition, inventory valuation, accounting for stock-based compensation and income taxes. It is important that the discussion of our operating results be read in conjunction with the critical accounting policies discussed in our 2018 Form 10-K.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows from Operating Activities

Net cash provided by operating activities for the three months ended September 29, 2018 was $26.1 million, primarily resulting from net income adjusted for non-cash items of $22.7 million and a $3.4 million increase in cash due to changes in operating assets and liabilities. The adjustment to net income for non-cash items consisted of $8.5 million in depreciation and amortization, $4.0 million of expense related to stock-based compensation, and $0.8 million related to the disposal of equipment related to certain legacy data communication products, partially offset by a $0.6 million adjustment to the deferred tax asset related to our Japan subsidiary, $0.2 million from the amortization of a deferred gain from a sales-leaseback transaction in Caswell, U.K. and $0.1 million in accretion of premiums on our marketable securities. The $3.4 million increase in cash due to changes in operating assets and liabilities was comprised of a $17.2 million decrease in inventories attributable to the timing of the shipment of inventory to our customers and the receipt of inventory from our vendors, and a $1.3 million increase in accounts payable largely attributable to the timing of purchases and payments to vendors, partially offset by a $8.3 million increase in accounts receivable attributable to timing of collections, a $5.4 million decrease in accrued expenses and other liabilities, a $1.0 million increase in prepaid expenses and other current assets primarily due to an increase in our non-trade receivables from our contract manufacturers, reflecting our higher revenues in the first quarter of fiscal 2019 as compared to the fourth quarter of fiscal 2018, and a $0.3 million increase in other non-current assets.

Net cash provided by operating activities for the three months ended September 30, 2017 was $47.3 million, primarily resulting from net income adjusted for non-cash items of $41.6 million and a $5.6 million increase in cash due to changes in operating assets and liabilities. The adjustment to net income for non-cash items consisted of a $6.3

million in depreciation and amortization, a $5.7 million adjustment to the deferred tax asset as a result of our utilization of net operating losses in Japan, and $3.2 million of expense related to stock-based compensation, partially offset by $0.2 million from the amortization of a deferred gain from a sales-leaseback transaction in Caswell, U.K. The $5.6 million increase in cash due to changes in operating assets and liabilities was comprised of a $11.7 million increase in accounts payable largely attributable to the timing of purchases and payments to vendors, a $1.8 million decrease in accounts receivable attributable to timing of collections, and a $0.1 million increase in accrued expenses and other liabilities, partially offset by a $5.7 million increase in prepaid expenses and other current assets primarily due to an increase in our non-trade receivables related to the increased volume of business going through our contract manufacturers, a $1.5 million increase in inventories resulting from the receipt of inventory intended for sale in future quarters, and a $0.7 million increase in other non-current assets.

Cash Flows from Investing Activities
Net cash provided by investing activities for the three months ended September 29, 2018 was $69.6 million, primarily consisting of $73.5 million of maturities of available-for-sale short-term investments, partially offset by $3.9 million used in capital expenditures.
Net cash used in investing activities for the three months ended September 30, 2017 was $71.4 million, primarily consisting of $74.9 million of purchases of available-for-sale short-term investments and $22.1 million used in capital expenditures, partially offset by $25.5 million of maturities of available-for-sale short-term investments.
Cash Flows from Financing Activities
Net cash used in financing activities for the three months ended September 29, 2018 was $3.5 million, primarily consisting of $1.8 million in payments on capital lease obligations, including negotiating an early buyout of a large portion of our outstanding capital leases in Japan, and $1.9 million related to shares repurchased for tax withholdings on vesting of restricted stock units, partially offset by $0.3 million in proceeds from the exercise of stock options.
Net cash used in financing activities for the three months ended September 30, 2017 was $1.6 million, primarily consisting of $1.8 million related to shares repurchased for tax withholdings on vesting of restricted stock units and $0.2 million in payments on capital lease obligations, partially offset by $0.3 million in proceeds from the exercise of stock options.
Future Cash Requirements
As of September 29, 2018, we held $341.9 million in cash, cash equivalents and short-term investments, comprised of $337.9 million in cash and cash equivalents, and $4.0 million of short-term investments; and we had working capital of $470.5 million.
Based on our current cash and cash equivalent balances, we believe that we have sufficient funds to support our operations through the next 12 months, including approximately $20.0 million to $30.0 million of capital expenditures that we expect to incur through the remainder of the current fiscal year.
In the event we need additional liquidity beyond our current expectations, such as to fund future growth or strengthen our balance sheet, we will explore additional sources of liquidity. These additional sources of liquidity could include one, or a combination, of the following: (i) issuing equity securities, (ii) incurring indebtedness secured by our assets, (iii) issuing debt and/or convertible debt securities, or (iv) selling product lines, other assets and/or portions of our business. Issuance of additional equity securities would dilute our existing investors and could contain terms that are senior to or that adversely impact our common stock. Incurring additional indebtedness or issuing debt and/or convertible debt securities would subject us to debt service expenses, and could subject us to restrictive covenants, potential events of default and other terms that could harm our business. There can be no guarantee that we will be able to raise additional funds on terms acceptable to us, or at all. Our Merger Agreement with Lumentum restricts our ability to issue securities, incur indebtedness and sell product lines and businesses.
For additional information on the risks we face related to future cash requirements, see Part II, Item 1A. Risk Factors under "We have a history of large operating losses. We may not be able to sustain profitability in the future and as a result we may not be able to maintain sufficient levels of liquidity," included elsewhere in this Quarterly Report on Form 10-Q.
As of September 29, 2018, $49.3 million of the $337.9 million of our cash and cash equivalents was held by our foreign subsidiaries. If these funds are needed for our operations in the United States, we could be required to accrue and pay additional taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S., except for specific entities in China and Germany where we decided to exit certain businesses.
Off-Balance Sheet Arrangements
We indemnify our directors and certain employees as permitted by law, and have entered into indemnification agreements with our directors and executive officers. We have not recorded a liability associated with these indemnification arrangements, as we historically have not incurred any material costs associated with such indemnification obligations. Costs associated with such indemnification obligations may be mitigated by insurance coverage that we maintain, however, such insurance may not cover any, or may cover only a portion of, the amounts we may be required to pay. In addition, we may not be able to maintain such insurance coverage, in whole or in part,

in the future.

We also have indemnification clauses in various contracts that we enter into in the normal course of business, such as indemnification in favor of customers in respect of liabilities they may incur as a result of purchasing our products should such products infringe the intellectual property rights of a third party. We have not historically paid out any material amounts related to these indemnifications; therefore, no accrual has been made for these indemnifications. See Note 6, Commitments and Contingencies for additional details.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our principal market risks are our exposure to changes in interest rates and certain exchange rates. We do not use risk sensitive instruments for trading purposes.

INTEREST RATES

We have financed our operations through a mixture of issuances of equity, capital leases and working capital. We have exposure to interest rate fluctuations on our money market funds, certain of our short-term investments and for amounts borrowed through our capital leases.

At September 29, 2018, we had $1.2 million due under our capital leases. An increase in our average interest rate by 1.0 percent would increase our annual interest expense in connection with our capital leases minimally.

We monitor our interest rate risk on our cash equivalents and short-term investment balances. At September 29, 2018, a 100 basis point increase or decrease in interest rates would reduce the market value of our cash equivalents and short-term investments minimally.

We believe our current interest rate risk is immaterial.

FOREIGN CURRENCY

As our business is multinational in scope, we are subject to fluctuations based upon changes in the exchange rates between the currencies in which we collect revenues and pay expenses. We expect that a majority of our revenues will be denominated in U.S. dollars, while a majority of our expenses will be denominated in the U.S. dollar, and to a lesser extent, the U.K. pound sterling and the Japanese yen. Fluctuations in the exchange rate between the U.S. dollar, the U.K. pound sterling, the Japanese yen, the Chinese yuan, the Euro and other currencies utilized by us to pay expenses, could affect our operating results. To the extent the exchange rate between the U.S. dollar and these currencies were to fluctuate more significantly than experienced to date, our exposure would increase.

Effective October 1, 2017, the functional currency for our worldwide operations is the U.S. dollar. Prior to October 1, 2017, the functional currency for each of our foreign subsidiaries was the respective local currency for that subsidiary. The change in our functional currency is a result of significant changes in economic facts and circumstances, including (i) a re-organization of our operating environment, which includes consolidating and integrating our sales, supply chain and manufacturing organizations; (ii) a transition to centrally negotiating worldwide supplier contracts and capital expenditures in U.S. dollars; and (iii) a shift to recording all intercompany transactions in U.S. dollars. Translation adjustments reported prior to October 1, 2017, remain as a component of accumulated other comprehensive income in our condensed consolidated balance sheet. The translated values for any non-monetary assets and liabilities as of October 1, 2017 became the new accounting basis for those assets.

Effective October 1, 2017, monetary assets and liabilities denominated in currencies other than the U.S. dollar functional currency are re-measured each reporting period into U.S. dollars, with the resulting exchange gains and losses reported in (loss) gain on foreign currency transactions, net within the condensed consolidated statement of operations..

As of September 29, 2018, certain of our foreign subsidiaries had $25.6 million in non-U.S. dollar denominated accounts payable, net of accounts receivable, related to sales to external customers and purchases from suppliers, and $12.2 million in non-U.S. dollar denominated cash accounts. It is estimated that a 10 percent fluctuation in the U.S. dollar relative to these other foreign currencies would lead to a profit of $1.3 million (U.S. dollar weakening), or loss of $1.3 million (U.S. dollar strengthening) on the translation of these balances, which would be recorded as a gain or loss on foreign currency transactions in our condensed consolidated statement of operations.

HEDGING PROGRAM

Periodically, we enter into foreign currency forward contracts in an effort to mitigate a portion of our exposure to fluctuations between the U.S. dollar and the Japanese yen and between the U.S. dollar and the U.K. pound sterling. We do not currently hedge our exposure to the Chinese yuan or the Euro, but we may in the future if conditions warrant. Under certain circumstances, foreign currency forward contracts can have an adverse effect on our financial condition.

During the three months ended September 29, 2018, we did not enter into any foreign currency forward exchange contracts. During the three months ended September 30, 2017, we entered into foreign currency forward exchange contracts, which expired in the same fiscal quarter in which they were established. In connection with these foreign currency hedges, during the three months ended September 30, 2017, we recorded a $0.1 million gain on foreign currency transactions within our condensed consolidated statement of operations.

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As of September 29, 2018, we did not have any outstanding foreign currency forward exchange contracts.

BANK LIQUIDITY RISK

As of September 29, 2018, we had approximately $64.7 million of unrestricted cash (excluding money market funds) in operating accounts that are held with domestic and international financial institutions. These cash balances could be lost or become inaccessible if the underlying financial institutions fail or if they are unable to meet the liquidity requirements of their depositors and they are not supported by the national government of the country in which such financial institution is located. Notwithstanding, to date, we have not incurred any losses and have had full access to our operating accounts. See Note 3, Balance Sheet Details. We believe any failures of domestic and international financial institutions could impact our ability to fund our operations in the short term.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 29, 2018. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the 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. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We previously reported a material weakness in internal control over financial reporting related to the identification and recording of foreign currency transaction gains and losses, which was described in Item 9A of our Annual Report on From 10-K for the year ended June 30, 2018. We have implemented corrective actions for this material weakness, which includes enhanced analytical and review-based controls over the identification and recording of foreign currency transaction gains and losses. These remediation activities have not been operational for a sufficient period of time to enable us to properly test the effectiveness of these new controls and determine them to be effective. As a result of the above factors, our Chief Executive Officer and Chief Financial Officer concluded that, as of September 29, 2018, our disclosure controls and procedures were not effective.

Except as noted in the preceding paragraphs, there was no change in our internal control over financial reporting during the three months ended September 29, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION
ITEM 1. LEGAL PROCEEDINGS
Overview
In the ordinary course of business, we are involved in various legal proceedings, and we anticipate that additional actions will be brought against us in the future. The most significant of these proceedings are described below. These legal proceedings, as well as other matters, involve various aspects of our business and a variety of claims in various jurisdictions. Complex legal proceedings frequently extend for several years, and a number of the matters pending against us are at very early stages of the legal process. As a result, some pending matters have not yet progressed sufficiently through discovery and/or development of important factual information and legal issues to enable us to determine whether the proceeding is material to us or to estimate a range of possible loss, if any. Unless otherwise disclosed, we are unable to estimate the possible loss or range of loss for the legal proceedings described below. While it is not possible to accurately predict or determine the eventual outcomes of these items, an adverse determination in one or more of these items currently pending could have a material adverse effect on our results of operations, financial position or cash flows, and even if we are ultimately successful in defending these claims, such claims may be expensive to defend and could distract our management team from other important business matters.
Oyster Optics Litigation
On November 23, 2016, Oyster Optics LLC (“Oyster”) filed a civil suit against Cisco Systems, Inc. (“Cisco”) and British Telecommunications PLC (“BT”), in the U.S. District Court for the Eastern District of Texas, Marshall Division, Case No. 2:16-CV-01301. In the complaint, Oyster alleges that Cisco and BT infringed seven patents owned by Oyster, which patents allegedly relate to certain Cisco optical platform products, some of which may incorporate Oclaro components. Oyster subsequently dismissed its claim against BT without prejudice. In January 2017, Cisco requested that Oclaro indemnify and defend it in this litigation, pursuant to our commercial agreements with Cisco. In May 2017, Oclaro and Cisco preliminarily agreed to an allocation of the responsibilities for the costs of defense associated with Oyster’s claims. However, due to the uncertainty regarding the infringement allegations that Oyster may present at trial and the resultant uncertainty regarding the number of Oclaro components that may be implicated by such infringement allegations, Oclaro and Cisco agreed to defer until the conclusion of the litigation the final determination of whether and to what extent Oclaro will indemnify Cisco for any amounts Cisco may be required to pay Oyster and Cisco’s related defense costs. After discovery, Oyster’s infringement case against Cisco involved claims of only one patent and did not involve Oclaro components that were the subject of our commercial agreements with Cisco. In June of 2018, Cisco communicated its determination that the Oyster litigation against it did not involve Oclaro. On October 25, 2018, the Court granted Oyster and Cisco’s joint motion to stay all deadlines in their case; as a result, no trial date is currently set. On November 1, 2018, Oyster and Cisco jointly moved to sever "all claims not resolved by the Court’s Order Granting Defendants’ Motion for Partial Summary Judgment Regarding Their Release Defense (Dkt. 826, sealed) . . . including any possible supplement or clarification thereto." They also jointly moved for those new actions to be stayed and administratively closed pending the resolution of any appeals from Oyster's current litigation with Cisco. Oyster and Cisco also jointly moved on November 1st for entry of final judgment in favor of Cisco and against Oyster, indicating that "[a]ssuming the Court grants the parties' contemporaneously filed motion to sever, there are no remaining issues in the [Oyster-Cisco] litigation to be resolved." Between June and September of 2017, Cisco and Oclaro filed eleven Petitions for inter partes review with the U.S. Patent Office of claims in six of the patents that Oyster originally asserted against Cisco. The Patent Office eventually instituted inter partes review for eight of the eleven Petitions involving claims of five of the six patents. Trials for the instituted Petitions are ongoing.
On November 24, 2016, Oyster also filed a civil suit against Coriant America Inc. (“Coriant”) in the U.S. District Court for the Eastern District of Texas, Marshall Division, Case No. 2:16-cv-01302. In the complaint against Coriant, Oyster alleges that Coriant has infringed the same seven patents that were asserted against Cisco. On May 18, 2017, Oyster’s case against Coriant was consolidated with cases that Oyster brought against other parties, including Cisco. On December 21, 2017, Coriant requested that Oclaro indemnify and defend it in this litigation, pursuant to our commercial agreements with Coriant. Oclaro has refused this request for reasons including that Oyster’s claims against Coriant do not clearly implicate Oclaro products and that Coriant’s request was not timely made. Coriant has stated its

disagreement with this position. As a result, Oclaro may have further discussions with Coriant regarding Coriant's request for defense and indemnification. Oyster and Coriant informed the Court on April 12, 2018, that "all matters in controversy between the parties have been settled, in principle." On July 3, 2018, the Court granted a joint motion from Oyster and Coriant to dismiss their case with prejudice.

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Oyster also filed a civil suit on November 24, 2016 against Ciena Corporation (“Ciena”) in the U.S. District Court for the Eastern District of Texas, Marshall Division, Case No. 2:16-CV-01300. In the complaint against Ciena, Oyster alleges that Ciena has infringed the same seven patents that were asserted against Cisco. Oyster’s case against Ciena was later transferred to the Northern District of California which granted a motion that Ciena filed to stay the case pending inter partes review of the Oyster patents. On June 1, 2018, the parties filed a joint status report reporting on the status of the inter partes review proceedings. Also on June 1, 2018, counsel for Oyster wrote the Court a letter indicating that because there are no further proceedings in the PTAB concerning one of the asserted patents, that Oyster requested that the litigation move forward as to the asserted claims of that patent only and that the Court set a scheduling conference. On June 4, 2018, the Court indicated that Oyster should file a noticed motion for any such relief and the case currently remains stayed. On October 16, 2017, Ciena requested that Oclaro indemnify and defend it in this litigation, pursuant to our commercial agreements with Ciena. Oclaro refused this request for reasons including that Oyster's claims against Ciena do not clearly implicate Oclaro products and that Ciena's request was not timely made. Ciena has stated its disagreement with this position. As a result, discussions with Ciena regarding Ciena’s request for defense and indemnification have not completed.

Oclaro Merger Litigation

Following announcement of the execution of the Merger Agreement on March 12, 2018, seven lawsuits were filed by purported stockholders of Oclaro challenging its proposed acquisition by Lumentum, Inc. The first suit, a putative class action styled as Nicholas Neinast v. Oclaro, Inc., et al., No. 3:18-cv-03112-VC, was filed in the United States District Court for the Northern District of California on May 24, 2018, and was against Oclaro, its directors, Lumentum, Merger Sub, and Merger Sub LLC (the “Neinast Lawsuit”). Five additional suits, styled as Gerald F. Wordehoff v. Oclaro, Inc., et al., No. 5:18-cv-03148-NC (the “Wordehoff Lawsuit”), Walter Ryan v. Oclaro, Inc., et al., No. 3:18-cv-03174-VC (the “Ryan Lawsuit”), and Jayme Walker v. Oclaro, Inc., et al., No. 3:18-cv-03203 (the “Walker Lawsuit”), Kevin Garcia v. Oclaro, Inc., et al., No. 5:18-cv-03262-VKD (the “Garcia Lawsuit”), and Saisravan Bharadwaj Karri v. Oclaro, Inc., et al., No. 3:18-cv-03435-JD (the “Karri Lawsuit”) were also filed in the United States District Court for the Northern District of California on, respectively, May 25, 2018, May 29, 2018, May 30, 2018, May 31, 2018 and June 9, 2018. Each of the lawsuits name Oclaro and its directors as defendants. The Ryan Lawsuit and the Karri Lawsuit, like the Neinast Lawsuit, were putative class actions. A seventh suit, a putative class action styled as Adam Franchi v. Oclaro, Inc., et al., Case 1:18-cv-00817-GMS, was filed in the United States District Court for the District of Delaware on May 30, 2018, and was against Oclaro, its directors, Lumentum, Merger Sub, and Merger Sub LLC (the “Franchi Lawsuit” and, with the Neinast Lawsuit, the Wordehoff Lawsuit, the Ryan Lawsuit, the Walker Lawsuit, the Garcia Lawsuit, and the Karri Lawsuit, the “Lawsuits”).

The Lawsuits alleged that Oclaro and its directors violated Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder because the Proxy Statement/Prospectus was incomplete and misleading. The Lawsuits further alleged that Oclaro’s directors violated Section 20(a) of the Exchange Act by failing to exercise proper control over the person(s) who violated Section 14(a) of the Exchange Act. The Neinast Lawsuit additionally alleged that Oclaro’s directors breached fiduciary duties by entering into the Merger, and also names Lumentum, Merger Sub, and Merger Sub LLC as violators of Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder. The Franchi Lawsuit additionally named Lumentum, Merger Sub, and Merger Sub LLC as violators of Section 20(a) of the Exchange Act.

The Lawsuits sought, among other things, injunctive relief preventing the parties from consummating the merger, rescission of the transactions contemplated by the Merger Agreement should they be consummated, and litigation costs, including attorneys’ fees. The Lawsuits also sought damages to be awarded to the plaintiff and any class if the Merger were consummated. In addition, the Wordehoff Lawsuit sought injunctive relief directing defendants to disseminate a true and complete proxy statement/prospectus and declaratory relief that defendants violated Sections 14(a) and/or 20(a) of the Exchange Act and Rule 14a-9 promulgated thereunder.

To avoid the risk of the Lawsuits delaying or adversely affecting the Merger and to minimize the costs, risks and uncertainties inherent in litigation, and without admitting any liability or wrongdoing and believing that the initial Proxy Statement/Prospectus disclosed all material information concerning the Merger and no supplemental disclosure was required under applicable law, Oclaro voluntarily filed with the SEC a supplement to the Proxy Statement/Prospectus on June 29, 2018.

Thereafter, on July 25, 2018, the plaintiff in the Garcia Lawsuit dismissed his action, with prejudice as to the individual plaintiff. The plaintiffs in the Neinast, Franchi, Wordehoff, and Ryan Lawsuits dismissed these actions, with prejudice as to the respective individual plaintiffs, on July 27, 2018. The plaintiff in the Walker Lawsuit dismissed her action, with prejudice as to the individual plaintiff, on August 14, 2018. At the time the other complaints were being dismissed, counsel for plaintiff in the remaining lawsuit, the Karri Lawsuit, stated his intention to file an amended complaint. On September 27, 2018, the Court rejected, without hearing, the Karri plaintiff's motion to be appointed lead counsel because plaintiff failed to follow the required notice procedure. Following this order, plaintiff renewed his public notice of filing of the lawsuit, but has taken no further action. If the Karri Lawsuit proceeds, Oclaro intends to defend the action vigorously.

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ITEM 1A. RISK FACTORS

Investing in our securities involves a high degree of risk. The risks described below are not the only ones facing us. Additional risks not currently known to us or that we currently believe are immaterial also may impair our business, operations, liquidity and stock price materially and adversely. You should carefully consider the risks and uncertainties described below in addition to the other information included or incorporated by reference in this Quarterly Report on Form 10-Q. If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer. In that case, the trading price of our common stock could fall and you could lose all or part of your investment.

Risks Related to the Lumentum Acquisition

Failure to complete the Merger could negatively affect the share prices and the future business and financial results of Oclaro.

If the Merger is not completed, the ongoing businesses of Oclaro may be adversely affected. Additionally, if the Merger is not completed and the Merger Agreement is terminated, in certain circumstances Oclaro may be required to pay Lumentum a termination fee of $63.0 million. In addition, Oclaro has incurred and will continue to incur significant transaction expenses in connection with the Merger regardless of whether the Merger is completed. Furthermore, Oclaro may experience negative reactions from the financial markets, including negative impacts on its stock price, or negative reactions from its customers, suppliers, other business partners and employees, should the Merger not be completed.

The foregoing risks, or other risks arising in connection with the failure to consummate the Merger, including the diversion of management attention from conducting the business of Oclaro and its subsidiaries and pursuing other opportunities during the pendency of the Merger, may have a material adverse effect on the businesses, operations, financial results and stock price of Oclaro. Oclaro could also be subject to litigation related to any failure to consummate the Merger or any related action that could be brought to enforce a party’s obligations under the Merger Agreement.

The Merger is subject to a number of conditions, some of which are outside of the parties’ control, and, if these conditions are not satisfied, the Merger Agreement may be terminated and the Merger may not be completed.

The Merger Agreement contains a number of conditions that must be fulfilled to complete the Merger. These conditions include, among other customary conditions, the required approval of Oclaro’s stockholders to complete the Merger, absence of laws, orders, judgments and injunctions that enjoin or otherwise prohibit consummation of the Merger in any jurisdiction that is material to the business or operations of Oclaro or Lumentum, receipt of certain antitrust approvals in the United States and the People’s Republic of China, approval by NASDAQ for listing of the shares of Lumentum common stock to be issued in the Merger, accuracy of representations and warranties of the parties subject to the applicable standard provided by the Merger Agreement, no event occurring that had or would reasonably be expected to have a “Material Adverse Effect” (as defined in the Merger Agreement) on Lumentum or Oclaro, compliance by the parties with their obligations in the Merger Agreement in all material respects and the effectiveness of the registration statement relating to the shares of Lumentum common stock to be issued in connection with the Merger. On April 4, 2018, the U.S. Federal Trade Commission granted early termination of the waiting period under the HSR Act. On July 10, 2018, Oclaro's stockholders approved the Merger Agreement.

The required satisfaction of the foregoing conditions could delay the completion of the Merger for a significant period of time or prevent it from occurring. Any delay in completing the Merger could cause Lumentum not to realize some or all of the benefits that the parties expect Lumentum to achieve following the Merger. Further, there can be no assurance that the conditions to closing will be satisfied or waived or that the Merger will be completed.

In addition, if the Merger is not completed by December 11, 2018, which deadline will be automatically extended to March 11, 2019 if the closing is delayed due to certain conditions to closing relating to antitrust laws not being satisfied, either Lumentum or Oclaro may choose to terminate the Merger Agreement. Lumentum or Oclaro may also elect to terminate the Merger Agreement in certain other circumstances, and the parties can mutually decide to terminate the Merger Agreement at any time prior to the closing, before or after approval of the Merger Agreement by

Oclaro's stockholders, as applicable.

The business relationships of Oclaro and its subsidiaries may be subject to disruption due to uncertainty associated with the Merger, which could have an adverse effect on the results of operations, cash flows and financial position of Oclaro and, following the completion of the Merger, the combined company.

Parties with which Oclaro and its subsidiaries do business may be uncertain as to the effects on them of the Merger and related transactions, including with respect to current or future business relationships with Oclaro, its subsidiaries or the combined company. These relationships may be subject to disruption as customers, suppliers and other persons with whom Oclaro has a business relationship may delay or defer certain business decisions or might decide to terminate, change or renegotiate their relationships with Oclaro, or consider entering into business relationships with parties other than Oclaro, its subsidiaries or the combined company. These disruptions could have an adverse effect on the results of operations, cash flows and financial position of Oclaro.

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The risk, and adverse effect, of any disruption could be exacerbated by a delay in completion of the Merger or termination of the Merger Agreement.

Uncertainties associated with the Merger may cause a loss of management personnel and other key employees of Oclaro, which could adversely affect the future business and operations of Oclaro.

In some of the fields in which Oclaro operates, there are only a limited number of people in the job market who possess the requisite skills, and it may be increasingly difficult for Oclaro to hire personnel during the pendency of the Merger. Current and prospective employees of Oclaro may experience uncertainty about their roles with the combined company following the Merger, which may materially adversely affect the ability of Oclaro to attract and retain key personnel during the pendency of the Merger. In addition, key employees may depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with the combined company following the Merger. The loss of services of certain senior management or key employees of Oclaro or the inability to hire new personnel with the requisite skills could restrict the ability of Oclaro to develop new products or enhance existing products in a timely manner, to sell products to customers or to effectively manage the business of Oclaro. Also, the business, financial condition and results of operations of Oclaro could be materially adversely affected by the loss of any of its key employees, by the failure of any key employee to perform in his or her current position, or by Oclaro’s inability to attract and retain skilled employees.

The Merger Agreement contains provisions that limit Oclaro’s ability to pursue alternatives to the Merger which could discourage a potential competing acquiror of Oclaro from making an alternative transaction proposal and, in specified circumstances, could require Oclaro to pay a termination fee to Lumentum.

The Merger Agreement provides that Oclaro shall not, and requires Oclaro to refrain from authorizing or knowingly permitting its representatives to, solicit, participate in negotiations with respect to or approve or recommend any third-party proposal for an alternative transaction, subject to exceptions set forth in the Merger Agreement relating to the receipt of certain unsolicited offers.

These provisions could discourage a potential third-party acquiror or merger partner that might have an interest in acquiring all or a significant portion of Oclaro or pursuing an alternative transaction from considering or proposing such a transaction, even if it were prepared to pay consideration with a higher per share cash or market value than the consideration in the Merger, or might result in a potential third-party acquiror or merger partner proposing to pay a lower price to Oclaro’s stockholders than it might otherwise have proposed to pay because of the added expense of the termination fee that may become payable in certain circumstances.

Additionally, if the Merger Agreement is terminated and Oclaro determines to seek another business combination, Oclaro may not be able to negotiate a transaction with another party on terms comparable to, or better than, the terms of the Merger.

The Merger is subject to the expiration of applicable waiting periods under, and the receipt of approvals, consents or clearances from, antitrust regulatory authorities in the United States and China that may impose conditions that could have an adverse effect on Lumentum or Oclaro or, if not obtained, could prevent completion of the Merger.

Before the Merger may be completed, any waiting period (or extension thereof) applicable to the Merger must have expired or been terminated, and any approvals, consents or clearances required in connection with the Merger must have been obtained, in each case, under the HSR Act and under the antitrust and competition laws of China. In deciding whether to grant the required regulatory approval, consent or clearance, the relevant governmental entities will consider the effect of the Merger on competition within their relevant jurisdiction, and other considerations they may deem appropriate. On April 4, 2018, the U.S. Federal Trade Commission granted early termination of the waiting period under the HSR Act, which satisfies the closing conditions related to receipt of antitrust approval in the United States under the Merger Agreement.

Under the Merger Agreement, Lumentum and Oclaro have agreed to use their reasonable best efforts to obtain any waivers, consents, or approvals required to effect the Merger (subject to certain limitations) and therefore may be required to comply with certain conditions or limitations imposed by governmental antitrust authorities. However, there can be no assurance that antitrust regulators will not impose unanticipated conditions, terms, obligations or restrictions. In addition, Oclaro cannot provide assurance that any such conditions, terms, obligations or restrictions

will not result in the delay or abandonment of the Merger.
Until the completion of the Merger or the termination of the Merger Agreement in accordance with its terms, in consideration of the agreements made by the parties in the Merger Agreement, Oclaro is prohibited from entering into certain transactions and taking certain actions that might otherwise be beneficial to Oclaro and its stockholders.
Until the earlier of the Effective Time and the termination of the Merger Agreement, the Merger Agreement restricts Oclaro from taking specified actions without the consent of Lumentum, and requires Oclaro to generally operate in the ordinary course of business consistent with past practices. These restrictions may prevent Oclaro from making appropriate changes to its businesses, retaining its workforce, paying dividends or pursuing attractive business opportunities that may arise prior to the completion of the Merger.

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Litigation against Oclaro, or the members of Oclaro’s Board of Directors, could prevent or delay the completion of the Merger or result in the payment of damages following completion of the Merger.

While Oclaro believes that any claims that have been and may be asserted by purported stockholder plaintiffs related to the Merger are and would be without merit, the results of any such potential legal proceedings are difficult to predict and could delay or prevent the Merger from becoming effective in a timely manner. Moreover, any litigation could be time consuming and expensive, could divert Oclaro’s management’s attention away from its regular business and, if any lawsuit is adversely resolved against Oclaro or members of the Oclaro’s Board of Directors (each of whom Oclaro is required to indemnify pursuant to indemnification agreements), could have a material adverse effect on Oclaro’s financial condition.

One of the conditions to closing of the Merger is the absence of any order or law by a court or other governmental entity in any jurisdiction that is material to the business or operations of Oclaro or Lumentum that prohibits, enjoins or makes illegal the closing of the Merger. Consequently, if a settlement or other resolution is not reached in any lawsuit that is filed and a claimant secures injunctive or other relief prohibiting, delaying or otherwise adversely affecting Lumentum’s and/or Oclaro’s ability to complete the Merger, then such injunctive or other relief may prevent the Merger from becoming effective in a timely manner or at all. See also Part II, Item 1, Legal Proceedings, "Oclaro Merger Litigation" in this Form 10-Q.

Risks Related to Our Business

We depend on a limited number of customers for a significant percentage of our revenues and the loss of a major customer could have a materially adverse impact on our financial condition.

Historically, we have generated most of our revenues from a limited number of customers. Our dependence on a limited number of customers is due to the fact that the optical telecommunications and data communications systems industries are dominated by a small number of large companies. These companies in turn depend primarily on a limited number of major telecommunications carriers and data center customers to purchase their products that incorporate our optical components. The industry in which our customers operate is subject to a trend of consolidation. To the extent this trend continues, we may become dependent on even fewer customers to maintain and grow our revenues.

During the fiscal years ended June 30, 2018, July 1, 2017 and July 2, 2016, our three largest customers accounted for 42 percent, 50 percent and 44 percent of our revenues, respectively. Because we rely on a limited number of customers for a significant percentage of our revenues, a decrease in demand for our products from any of our major customers for any reason (including due to data center and telecom market conditions, customer inventory buildup, catastrophic events, changes in network architecture, government action, financial viability or otherwise) could have a material adverse impact on our financial condition and results of operations. For example, we were unable to ship products for an extended period of time to one of our largest customers, ZTE, as discussed in our risk factor in this Form 10-Q, "The inability to obtain government licenses and approvals for desired international trading activities or technology transfers, including export licenses, may impact the profitable operation of our business."

The markets in which we operate are highly competitive, which could result in lost sales and lower revenues.

The market for optical components and modules is highly competitive and this competition could result in our existing customers moving their orders to our competitors. We are aware of a number of companies that have developed or are developing optical component products, including tunable lasers, pluggable components, modulators and subsystems, among others, that compete directly with our current and proposed product offerings.

Certain of our competitors may be able to more quickly and effectively:

- develop or respond to new technologies or technical standards;
- react to changing customer requirements and expectations;
- devote needed resources to the development, production, promotion and sale of products;
- attain high manufacturing yields on new product designs; and
- deliver competitive products at lower prices.

Some of our current competitors, as well as some of our potential competitors in adjacent industries such as semiconductors and data communications, have longer operating histories, greater name recognition, broader customer relationships, product offerings and industry alliances and substantially greater financial, technical and marketing resources than we do. Our competitors and new Chinese companies are establishing manufacturing operations in China and other Asian countries to take advantage of comparatively low manufacturing costs, which could enable them to reduce their costs and lower their prices, making their products more competitive than ours.

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In addition, network equipment manufacturers and service providers may decide to design and manufacture the optical module and subsystems portions of their products in-house, rather than outsourcing to companies like us. This type of product disaggregation could result in lower revenues and materially and adversely affect our business.

All of these risks may be increased if the market were to further consolidate through mergers or other business combinations between our competitors. We may not be able to compete successfully with our competitors and aggressive competition in the market may result in lower prices for our products, fewer design wins and/or decreased gross margins. Any such development could have a material adverse effect on our business, financial condition and results of operations.

Our results of operations may suffer if we do not effectively manage our inventory, and we may continue to incur inventory-related charges.

We need to manage our inventory of component parts and finished goods effectively to meet changing customer requirements and demand. Some of our products and supplies have in the past, and may in the future, become obsolete or be deemed excess while in inventory due to rapidly changing customer specifications or a decrease in customer demand. We also have exposure to contractual liabilities to our contract manufacturers for inventories purchased by them on our behalf, based on our forecasted requirements, which may become excess or obsolete. Our inventory balances also represent an investment of cash. To the extent our inventory turns are slower than we anticipate based on historical practice, our cash conversion cycle extends and more of our cash remains invested in working capital. If we are not able to manage our inventory effectively, we may need to write down the value of some of our existing inventory or write off non-saleable or obsolete inventory. We have from time to time incurred significant inventory-related charges. Any such charges we incur in future periods could materially and adversely affect our results of operations and our cash flow.

Many of our long-term customer contracts do not commit customers to specified buying levels, and our customers may decrease, cancel or delay their buying levels at any time with little or no advance notice to us.

Many of our customers typically purchase our products pursuant to individual purchase orders or contracts that do not contain purchase commitments. Some customers provide us with their expected forecasts for our products several months in advance, but these customers may decrease, cancel or delay purchase orders already in place, including on short notice, and the impact of any such actions may be intensified given our dependence on a small number of large customers. If any of our major customers decrease, stop or delay purchasing our products for any reason, our business and results of operations would be harmed. Cancellation or delays of such orders may result in excess and obsolete inventory and charges therefor and cause us to fail to achieve our short-term and long-term financial and operating goals.

We may not be able to maintain or improve gross margin levels.

We may not be able to maintain or improve our gross margins, due to slow introductions of new products, pricing pressure from increased competition, the failure to effectively reduce the cost of existing products, the failure to improve our product mix, the potential for future macroeconomic or market volatility reducing sales volumes, changes in customer demand (including a change in product mix between different areas of our business) or other factors. Our gross margins can also be adversely impacted for reasons including, but not limited to, manufacturing costs that we are not able to decrease in proportion to any decrease in selling price; unfavorable production yields or variances; increases in costs of input parts and materials; the timing of movements in our inventory balances; warranty costs and related returns; changes in foreign currency exchange rates; and possible exposure to inventory reserves. Any failure to maintain, or improve, our gross margins will adversely affect our financial results, including our goals to maintain profitability and sustainable cash flow from operations.

Sales of older legacy products continue to represent a significant percentage of our total revenues and, if we do not increase the percentage of sales associated with new products, our revenues and gross margins may not grow in the future or could decline.

The markets for our products are characterized by changing technology and continuing process development. The future of our business will depend in large part upon the continuing relevance of our technological capabilities, and our ability to introduce new products that address our customers' requirements for more cost-effective and higher bandwidth solutions. We must also develop these new technologies and products on a cost-effective basis in order to effectively compete with our competitors. Our inability to successfully launch or sustain new or next generation programs or product features that anticipate or adequately address future market trends and market transitions in a timely manner could materially adversely affect our revenues, gross margins and financial results. We may also encounter competition from new or revised technologies that render our products less profitable or obsolete in our chosen markets, and our operating results may suffer. Furthermore, we cannot assure you that we will introduce new or next generation products in a timely manner, these products will gain market acceptance, or new product revenues will increase at a rate sufficient to replace declining legacy product revenues, and failure to do so could materially affect our operating results.

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As a result of our global operations, our business is subject to currency fluctuations that may adversely affect our results of operations.
Our financial results have been and will continue to be materially impacted by foreign currency fluctuations. At certain times in our history, declines in the value of the U.S. dollar versus the U.K. pound sterling and the Japanese yen have had a major negative effect on our margins and our cash flow. A portion of our expenses are denominated in U.K. pound sterling and Japanese yen and substantially all of our revenues are denominated in U.S. dollars. Fluctuations in the exchange rate between these currencies and, to a lesser extent, other currencies in which we collect revenues and/or pay expenses could have a material effect on our future operating results. For example, on June 23, 2016, the U.K. citizens voted in a referendum to exit the European Union, which resulted in a sharp decline in the value of the British pound, which may impact our future manufacturing overhead and operating expenses. Also during fiscal year 2017, the Japanese yen depreciated approximately 10 percent relative to the U.S. dollar, impacting our manufacturing overhead and operating expenses. If the U.S. dollar appreciates or depreciates relative to the U.K. pound sterling and/or Japanese yen in the future, our future operating results may be materially impacted. Additional exposure may occur should the exchange rate between the U.S. dollar and the Chinese yuan or the Euro vary more significantly than they have to date.
We periodically engage in currency hedging transactions in an effort to cover some of our exposure to U.S. dollar to U.K. pound sterling and Japanese Yen currency fluctuations, and we may be required to convert currencies to meet our obligations. Our hedging contracts currently do not exceed 90 days. These transactions may not operate to fully hedge our exposure to currency fluctuations, and under certain circumstances, these transactions could have an adverse effect on our financial condition.
The inability to obtain government licenses and approvals for desired international trading activities or technology transfers, including export licenses, may impact the profitable operation of our business.
Many of our present and future business activities are subject to licensing by the United States government under the Export Administration Act, the Export Administration Regulations ("EAR") and other laws, regulations and requirements governing international trade and technology transfer. For example, on April 16, 2018, the U.S. Department of Commerce ("DOC") changed and reactivated its previously suspended denial order and suspended the export privileges of Zhongxing Telecommunications Equipment Corporation ("ZTE Corporation") and its subsidiary, ZTE Kangxun Telecommunications Ltd. ("ZTE Kangxun") (collectively, "ZTE") after determining that ZTE made false statements to the DOC related to senior employee disciplinary actions ("Denial Order"). On July 13, 2018, following approval of a settlement agreement between the DOC and ZTE and ZTE's payment of certain amounts to the DOC, the Denial Order was terminated and ZTE was removed from the DOC's Denied Persons List. During the pendency of the Denial Order, ZTE was prohibited from participating in any way in any transaction subject to the EAR and U.S. companies were restricted from exporting or re-exporting to or on behalf of ZTE any item subject to the EAR or engaging in any transaction to service any item subject to the EAR that has been or will be exported from the U.S. and which was owned, possessed or controlled by ZTE. During this period, we ceased shipment of products to ZTE, which has been one of our significant customers. In addition, we cannot predict whether the export sanctions and financial penalties imposed on ZTE by the DOC will have a negative impact on future orders of our products by ZTE, which could have an adverse effect on our financial situation.
As previously reported, on March 6, 2016, the DOC had amended the EAR and imposed additional licensing restrictions on exports of certain products to ZTE. In response to the DOC's action, we temporarily ceased shipment of products to ZTE at that time as well. The DOC created a temporary general license on March 24, 2016 applicable to exports to ZTE, after which time we resumed shipments of products to ZTE. The DOC subsequently granted several extensions, before issuing a final rule on March 29, 2017 in connection with the settlement by ZTE and the U.S. government of certain administrative and criminal charges, eliminating the additional licensing restrictions imposed on ZTE.

In the future, the DOC may impose denial orders, sanctions or licensing restrictions on ZTE again or on other customers with whom we conduct business if they violate the EAR or other export laws. Any future action by the U.S.

government that precludes us from shipping products to ZTE or to other customers may have a material adverse impact on our revenues and results of operations.

We also presently manufacture products in other countries that either do or may require licenses from time to time. The operation of our business may require the continuity of these licenses and may require further licenses and approvals for future products in these and other countries. However, there is no certainty to the continuity of these licenses, nor that further desired licenses and approvals may be obtained. The failure to obtain or retain such licenses may materially harm our revenues and results of operations.

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We may not be able to ramp the production of our new products to customer required volumes, which could result in delayed or lost revenue.
Many of our new product samples for metro, data center and long haul communication applications have been well received by our existing and prospective customers. These newer generation products typically will have greater functionality and a smaller footprint, resulting in more complexity in the manufacturing process. This increased complexity may result in lower manufacturing yields or more difficulty manufacturing them in volume. If we experience large demand for these products and are unable to manufacture them in sufficient volume, we would fall short of our planned output and revenue targets as we move from low volume sampling to manufacturing for commercial production. In addition, a production ramp for certain products can include a manufacturing transition between two or more locations which carries an inherent risk of delay. Our failure to satisfy our customers' demand could result in lost sales or our customers postponing or canceling orders or seeking alternative suppliers for these products, which would materially harm our revenues and adversely affect our results of operations.
Significant tariffs or other restrictions applied to goods traded between the United States and China could materially and adversely affect our business and results of operations.

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 against foreign imports of certain materials. More specifically, since March 2018, the U.S. and China have applied tariffs to certain of each other’s exports. Three rounds of U.S. tariffs on imports from China have become effective in July 2018, August 2018 and September 2018, respectively the “U.S. Tariffs on China Imports”). Most of our products are produced outside of China and are not subject to the U.S. Tariffs on China Imports. A limited number of our products have a China country of origin, but these products are not currently subject to the U.S. Tariffs on China Imports. Even though the current duties on imports into the U.S. from China are not being imposed on our products, it is possible new tariffs will be imposed that could affect imports of our products, or that our business will be impacted by existing and new tariffs or retaliatory trade measures taken by China or other countries in response to existing or future tariffs, causing us to raise prices or make changes to our operations, any of which could materially harm our revenue or operating results.
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 us. Furthermore, imposition of tariffs could cause a decrease in the sales of our products to customers located in China or other customers selling to Chinese end users, which would directly impact our business.
Customer requirements for new products are increasingly challenging, which could lead to significant executional risk in designing and manufacturing such products.
Across the entire network, our customers are demanding increased performance from our products, at lower prices and in smaller and lower power designs. These requirements stretch the capabilities of our optical chips, packages and electronics to the limit of technical feasibility. In addition, these demands are often customer specific, leading to numerous product variations and increased costs. If one of these customers fails to qualify our products or there is a delay in qualification, we may incur additional expenses and our revenues may be harmed. In addition, if one of these customers fails to purchase the products we anticipate, we may not be able to sell this customized inventory to other customers, resulting in inventory obsolescence. We enter our new product introduction process with clear performance and cost goals. Because of the complexity of design requirements, executing on these goals is becoming increasingly difficult and less predictable. In addition, some of our suppliers of in feed components are increasingly designing their products at the same time we are designing our own products. Any delays these suppliers may experience in designing and producing these components could also cause delays in the introduction of our new products utilizing these components. These difficulties could result in product sampling delays and/or missing targets on key specifications and customer requirements, leading to design losses and reduced sales opportunities. Our failure to meet our customers' technical and performance requirements for these products could result in our customers seeking alternative suppliers for these products, or increased costs to us, either of which would adversely affect our results of

operations.

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We depend on a limited number of suppliers and key contract manufacturers who could disrupt our business if they stopped, decreased, delayed or were unable to meet our demand for shipments of their products or manufacturing of our products.
We depend on a limited number of suppliers of raw materials and equipment used to manufacture our products. We currently also depend on a limited number of contract manufacturers, principally Fabrinet in Thailand, Venture Corporation Limited ("Venture") in Malaysia, Toyo in Japan and Thailand, and eLASER in Taiwan, to manufacture certain of our products. Some of these suppliers are also our competitors, and others are our sole sources for certain materials and equipment. We typically have not entered into long-term agreements with our suppliers other than Fabrinet and Venture. As a result, these suppliers generally may stop supplying us materials and equipment at any time. Our reliance on a sole supplier or limited number of suppliers could result in delivery problems, reduced control over product pricing and quality, and an inability to identify and qualify another supplier in a timely manner. Some of our suppliers that may be small or under-capitalized may experience financial difficulties that could prevent them from supplying us materials and equipment. In addition, our suppliers, including our sole source suppliers, may experience manufacturing delays or shut downs due to earthquakes, floods, fires, labor unrest, political unrest, trade disputes or other events.
Any supply deficiencies relating to the quality or quantities of materials or equipment we use to manufacture our products could materially and adversely affect our ability to ramp the production of new products, our ability to fulfill customer orders, and our results of operations. Lead times for the purchase of certain materials and equipment from suppliers have increased and in some cases have limited our ability to rapidly respond to increased demand, and may continue to do so in the future. To the extent we introduce additional contract manufacturing partners, introduce new products with new partners and/or move existing internal or external production lines to new partners, we could experience supply disruptions during the transition process. In addition, due to our customers' requirements relating to the qualification of our suppliers and contract manufacturing facilities and operations, we cannot quickly enter into alternative supplier relationships, which prevents us from being able to respond immediately to adverse events affecting our suppliers. Any transition to a new supplier could result in lost or delayed sales if our customers fail to qualify these new supply sources on a timely basis, or at all.

We have significant operations in China, which exposes us to risks inherent in doing business in China.
A significant portion of our assembly and test operations, chip-on-carrier operations and manufacturing and supply chain management operations are concentrated in our facility in Shenzhen, China. In addition, we have research and development related activities in Shenzhen, China. To be successful in China we will need to:

- qualify our manufacturing lines and the products we produce in Shenzhen, as required by our customers; and
- attract and retain qualified personnel to operate our Shenzhen facility.

We cannot assure you that we will be able to achieve these objectives.
Employee turnover in China is high due to the intensely competitive and fluid market for skilled labor. To operate our Shenzhen facility under these conditions, we need to continue to hire direct manufacturing personnel, administrative personnel and technical personnel; obtain and retain required legal authorization to hire such personnel; and incur the time and expense to hire and train such personnel.
Operations in China are subject to greater political, legal and economic risks than our operations in other countries. In particular, the political, legal and economic climate in China, both nationally and regionally, is fluid and unpredictable. For example, we have been subject to commercial litigation in China initiated by a former supplier. For a description of this lawsuit, see Part I, Item 3, Legal Proceedings, "Raysung Commercial Litigation," in our 2016 Annual Report on Form 10-K. Further, personal privacy, cyber security, and data protection are becoming increasingly significant issues in China. To address these issues, the Standing Committee of the National People's Congress promulgated the Cyber Security Law of the People's Republic of China (the "Cyber Security Law"), which took effect on June 1, 2017. The Cyber Security Law sets forth various requirements relating to the collection, use, storage, disclosure and security of data, among other things. Various Chinese agencies are expected to issue additional regulations in the future to define these requirements more precisely. These requirements may increase our costs of

compliance. We cannot assure you that we will be able to comply with all of these regulatory requirements. Any failure to comply with the Cyber Security Law and the relevant regulations and policies, could result in additional cost and liability to us or restrictions on our ability to operate in China and could adversely affect our business and results of operations. Additionally, increased costs to comply with, and other burdens imposed by, the Cyber Security Law and relevant regulations and policies that are applicable to the businesses of our suppliers, vendors and other service providers, as well as our customers, could adversely affect our business and results of operations.

Our ability to operate in China may be adversely affected by changes in Chinese laws and regulations such as those related to, among other things, taxation, import and export tariffs, environmental regulations, land use rights, intellectual property, currency controls, employee benefits, cyber security and other matters. In addition, we may not obtain or retain the requisite legal permits to continue to operate in China, and costs or operational limitations may be imposed in connection with obtaining and complying with such permits.

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We intend to continue to export the products manufactured at our Shenzhen facility. Under current regulations, upon application and approval by the relevant governmental authorities, we will not be subject to certain Chinese taxes and will be exempt from certain duties on imported materials that are used in the manufacturing process and subsequently exported from China as finished products. However, Chinese trade regulations are subject to frequent change, and we may become subject to other forms of taxation and duties in China or may be required to pay export fees in the future, particularly if the status of the free trade zone in Shenzhen changes in the future. In the event that we become subject to new forms of taxation or export fees in China, our expenses would increase and our business and results of operations could be materially adversely affected. We may also be required to expend greater amounts than we currently anticipate in connection with increasing production at our Shenzhen facility. Any one of the factors cited above, or a combination of them, could result in unanticipated costs or interruptions in production, which could materially and adversely affect our business.

In the future we may incur significant additional restructuring charges that could adversely affect our results of operations.

In the past we have enacted a series of restructuring plans and cost reduction plans designed to reduce our manufacturing overhead and our operating expenses that have resulted in significant restructuring charges.

For instance, while we incurred minimal restructuring charges in fiscal years 2017 and 2016, during fiscal year 2015, we incurred $2.5 million in restructuring charges in connection with the transition of certain portions of our Shenzhen, China assembly and test operations to Venture. In addition, during fiscal year 2015, we incurred $4.0 million in restructuring charges in connection with the restructuring plan we initiated in the first quarter of fiscal year 2014 to simplify our operating footprint, reduce our cost structure and focus our research and development investment in the optical communications market where we can leverage our core competencies.

We cannot assure you that we will not incur additional restructuring charges in the future. Significant additional restructuring charges could materially and adversely affect our operating results in the periods that they are incurred and recognized. In addition, such charges could require significant cash commitments that may adversely affect our cash balances.

Delays, disruptions or quality control problems in manufacturing could result in delays in product shipments to customers and could adversely affect our business.

We may experience delays, disruptions or quality control problems in our manufacturing operations or the manufacturing operations of our subcontractors. As a result, we could incur additional costs that would adversely affect our gross margins, and our product shipments to our customers could be delayed beyond the shipment schedules requested by our customers, which could harm our relationship with our customers and would negatively affect our revenues, competitive position and reputation. Furthermore, even if we are able to deliver products to our customers on a timely basis, we may be unable to recognize revenues at the time of delivery based on our revenue recognition policies.

We may experience low manufacturing yields.

Manufacturing yields depend on a number of factors, including the volume of production due to customer demand and the nature and extent of changes in specifications required by customers for which we perform design-in work. Higher volumes due to demand for a fixed, rather than continually changing, design generally results in higher manufacturing yields, whereas lower volume production generally results in lower yields. In addition, lower yields may result, and have in the past resulted, from commercial shipments of products prior to full manufacturing qualification to the applicable specifications. Changes in manufacturing processes required as a result of changes in product specifications, changing customer needs, introduction of new product lines and changes in contract manufacturers have historically caused, and may in the future cause, significantly reduced manufacturing yields, resulting in low or negative margins on those products. Moreover, an increase in the rejection rate of products during the quality control process, before, during or after manufacture, results in lower gross margins from lower yields and additional rework costs. Finally, manufacturing yields and margins can also be lower if we receive or inadvertently use defective or contaminated materials from our suppliers. Any reduction in our manufacturing yields will adversely affect our gross margins and could have a material impact on our operating results.

In order to remain competitive, we have been in the past and may be in the future required to agree to customer terms and conditions that may have an adverse effect on our financial condition and operating results.

Many of our customers have significant purchasing power and, accordingly, have requested more favorable terms and conditions, including extended payment terms, than we typically provide. In order for us to remain competitive, we may be required to accommodate these requests, which may include granting terms that affect the timing of our receipt of cash. As a result, these more favorable customer terms may have a material adverse effect on our financial condition and results of operations.

We may record additional impairment charges that will adversely impact our results of operations.
As of September 29, 2018, we had $131.7 million of property and equipment, net on our condensed consolidated balance sheet. If we make changes in our business strategy or if market or other conditions adversely affect our business operations, we may be forced to record an impairment charge related to these assets, which would adversely impact our results of operations. If impairment has occurred, we will be required to record an impairment charge for the difference between the carrying value of the assets and the implied fair value of the assets in the period in which such determination is made. The testing for impairment requires us to make significant estimates about the future performance and cash flows of our business, as well as other assumptions. These estimates can be affected by numerous factors, including changes in economic, industry, or market conditions, changes in underlying business operations, future reporting unit operating performance, changes in competition, or changes in technologies. Any changes in key assumptions, or actual performance compared with those assumptions, about our business and its future prospects or other assumptions could affect the fair value of one or more reporting units, and result in an impairment charge.
We have identified a material weakness in our internal control over financial reporting of foreign currency transaction gains and losses which, if not remediated, could adversely affect our stock price.
Our controls over the identification and recording of foreign currency transaction gains and losses were not designed and operating effectively. As described under Part II, Item 9A, Controls and Procedures, of our Annual Report on Form 10-K filed on August 23, 2018, our management concluded that the deficiency constitutes a material weakness in our internal control over financial reporting, which was not effective as of June 30, 2018 and September 29, 2018. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of our annual or interim consolidated financial statements will not be prevented or detected on a timely basis. Although we have developed and are implementing a plan to remediate this material weakness and believe, based on our evaluation to date, that this material weakness will be remediated during the second quarter of fiscal year 2019, we cannot assure you that this will occur within the contemplated timeframe. Moreover, we cannot assure you that we will not identify additional material weaknesses in our internal control over financial reporting in the future. If we are unable to remediate the material weakness, our ability to record, process and report financial information accurately, and to prepare financial statements within the time periods specified by the rules and forms of the Securities and Exchange Commission, could be adversely affected. The occurrence of or our failure to remediate the material weakness may adversely affect the market price of our common stock and any other securities we may issue.
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. Slower growth rates in China and for some of our client side transceivers may also cause our results to fluctuate. For example, revenues for the three months ended June 30, 2018 were reduced as a result of our cessation of shipments to ZTE following the DOC's re-imposition of export sanctions on ZTE, and we cannot guarantee the levels at which ZTE will resume ordering our products now that sanctions have been lifted. See our risk factor in this Form 10-Q, "The inability to obtain government licenses and approvals for desired international trading activities or technology transfers, including export licenses, may prevent the profitable operation of our business."
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 new markets, including data communications, industrial, research, consumer and biotechnology markets. Purchase

decisions by our customers are also impacted by the capital expenditure plans of the global telecom carriers and hyper scale data centers, which tend to be the primary customers of our customers. 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. Because our business is capital intensive, we may not be able to decrease our expenses in the short term to adjust to significant fluctuations in our revenues, which can have a significant adverse impact on our operating results.

We have a complex multinational tax structure, and changes in effective tax rates or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.
We have a complex multinational tax structure with multiple types of intercompany transactions, and our allocation of profits and losses through our intercompany transfer pricing agreements is subject to review by the Internal Revenue Service and other tax authorities. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws, regulations, accounting principles or interpretations thereof. In addition, we are also subject to periodic examination of our income tax returns and related transfer pricing documentation by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these examinations will not have an adverse effect on our operating results and financial condition.
We are also exposed to changes in tax law which can impact our current and future year's tax provision.
We continue to assess the impact of the recently enacted H.R.1, commonly referred to as the Tax Cuts and Jobs Act, and the Finance (No. 2) Act 2017 in the United Kingdom (together, the “New Tax Laws”) as well as any future regulations implementing the New Tax Laws and any interpretations of the New Tax Laws. The effect of those regulations and interpretations, as well as any additional tax reform legislation in the United States, United Kingdom or elsewhere, could have a material adverse effect on our business, financial condition and results of operations by, among other things, decreasing the value of our deferred tax asset and/or requiring us to recognize a deferred tax liability for non-U.S. earnings. See Note 9 to the condensed consolidated financial statements, Income Taxes, in this Quarterly Report on Form 10-Q. If, in the future, we are required to reduce the value of our deferred tax asset or record a deferred tax liability, we may be required to record a corresponding charge to current earnings, which could have a material adverse effect on our financial condition and results of operations in the period in which it is recorded.
Our business and results of operations may be negatively impacted by financial market conditions and general economic conditions in the industries in which we operate, and such conditions may increase the other risks that affect our business.
During the 2008 financial crisis and its aftermath, the world’s financial markets experienced significant turmoil, resulting in reductions in available credit, increased costs of credit, extreme volatility in security prices, potential changes to existing credit terms, and rating downgrades of investments. In the past, due to these conditions, many of our customers reduced their spending plans, leading them to draw down their existing inventory and reduce orders for our products. It is possible that changes in current economic conditions could result in similar setbacks in the future, and that some of our customers could as a result reduce production levels of existing products, defer introduction of new products or place orders and accept delivery for products for which they do not pay us due to their economic difficulties or other reasons. In the past, financial market volatility has materially and adversely affected the market conditions in the industries in which we operate, and has had a material adverse impact on our revenues. Our suppliers may also be adversely affected by economic conditions that may impact their ability to provide important components used in our manufacturing processes on a timely basis, or at all. To a large degree, orders from many of our customers are dependent on demand from telecom carriers and hyper scale data centers around the world. Telecom carrier capital expenditure plans and execution can also be adversely impacted, both in terms of total spend and in determination of areas of investment within network infrastructures, by global and regional macroeconomic conditions. In addition, the recent imposition of tariffs by the United States, China and the European Union, and possible additional trade restrictions, may have an adverse impact on our customers, suppliers and the economies of the countries where we operate. We are unable to predict the likely occurrence, severity or duration of any potential future disruption in financial markets or adverse economic conditions in the U.S. and other countries, but the longer the duration the greater the risks we face in operating our business.
Changes to our enterprise resource planning system and other key software applications could cause unexpected problems to occur and disrupt the management of our business.

We recently completed an upgrade to our enterprise resource planning (“ERP”) system, and other management information systems, which are critical to the operational, accounting and financial functions of our company. We have invested $14.4 million towards our ERP system, and significant management attention and resources will continue to be used to facilitate training and full implementation of this system. We have experienced, and may continue to experience, operating or reporting disruptions during the course of utilizing and fine-tuning our ERP system, including limitations on our ability to deliver and bill for customer shipments, project our inventory requirements, manage our supply chain, maintain current and complete books and records, maintain an effective internal control environment and meet external reporting deadlines. We may also decide to modify or enhance our internal control processes as a result of gaining further experience operating our ERP system. These changes or other difficulties could materially and adversely impact our ability to manage our business as well as the accuracy and timely reporting of our operating results.

We may undertake divestitures of portions of our business, such as the divestiture of our Komoro Business, Zurich Business and our Amplifier Business, that require us to continue providing substantial post-divestiture transition services and support, which may cause us to incur unanticipated costs and liabilities and adversely affect our financial condition and results of operations.

From time to time, we consider divestitures of product lines or portions of our assets in order to streamline our business, focus on our core operations and raise cash. For example, on October 27, 2014, we sold our Komoro Business to Ushio Opto Semiconductors, Inc. ("Ushio Opto"). In addition, on September 12, 2013, we sold our Zurich Business to II-VI and on November 1, 2013, we sold our Amplifier Business to II-VI (See Note 3, Business Combinations and Dispositions, in our 2016 Annual Report, for further details). In connection with these divestitures, we entered into transition service, manufacturing service and supply agreements with both Ushio and II-VI to facilitate the ownership transition, collectively referred to as “transition agreements.” In order to perform under these transition agreements, we have been required to continue operating certain facilities, dedicate certain manufacturing capacity and maintain certain supplier agreements that have added additional costs and delayed our ability to fully restructure our operations to efficiently focus on our core ongoing business. If we fail to perform under any of these transition agreements, or if we do not successfully execute the restructuring of our operations after our transition agreement obligations have been fulfilled, our financial condition and results of operations could be harmed.

Our intellectual property rights may not be adequately protected.

Our future success will depend, in large part, upon our intellectual property rights, including patents, copyrights, design rights, trade secrets, trademarks and know-how. We maintain an active program of identifying technology appropriate for patent protection. Our practice is to require employees and consultants to execute non-disclosure and proprietary rights agreements upon commencement of employment or consulting arrangements. These agreements acknowledge our exclusive ownership of all intellectual property developed by the individuals during their work for us and require that all proprietary information disclosed will remain confidential. Although such agreements may be binding, they may not be enforceable in full or in part in all jurisdictions and any breach of a confidentiality obligation could have a negative effect on our business and our remedy for such breach may be limited.

Our intellectual property portfolio is an important corporate asset. The steps we have taken and may take in the future to protect our intellectual property may not adequately prevent misappropriation or ensure that others will not develop competitive technologies or products. We cannot assure you that our competitors will not successfully challenge the validity of our patents or design products that avoid infringement of our proprietary rights with respect to our technology. There can be no assurance that other companies are not investigating or developing other similar technologies, any patents will be issued from any application pending or filed by us, or, if patents are issued, the claims allowed will be sufficiently broad to deter or prohibit others from marketing similar products. In addition, we cannot assure you that any patents issued to us will not be challenged, invalidated or circumvented, or that the rights under those patents will provide a competitive advantage to us or that our products and technology will be adequately covered by our patents and other intellectual property. Further, the laws of certain regions in which our products are or may be developed, manufactured or sold, including Asia-Pacific, Southeast Asia and Latin America, may not be enforceable to protect our products and intellectual property rights to the same extent as the laws of the United States, the United Kingdom and continental European countries. This is especially relevant since we have transferred our assembly and test operations and chip-on-carrier operations, including certain engineering-related functions, to Shenzhen, China, and have completed the transition of portions of these assembly and test operations to Venture in Malaysia. If we are unable to adequately protect our intellectual property rights, this may impede the development of new technologies and products, and our financial condition and operating results could be materially and adversely affected.

If our customers do not qualify our manufacturing lines or the manufacturing lines of our subcontractors for volume shipments, our operating results could suffer.

Most of our customers do not purchase products, other than limited numbers of evaluation units, prior to qualification of the manufacturing line for volume production. Our existing manufacturing lines, as well as each new manufacturing line, must pass through varying levels of qualification with our customers. Our manufacturing lines have passed our qualification standards, as well as our technical standards. However, our customers also require that our manufacturing lines pass their specific qualification standards and that we, and any subcontractors that we may use, be registered under international quality standards. In addition, we have in the past encountered, and may in the future encounter, quality control issues as a result of relocating or changing our manufacturing lines or introducing new products to fill production. We may be unable to obtain customer qualification of our manufacturing lines or we may experience delays in obtaining customer qualification of our manufacturing lines. If we introduce new contract manufacturing partners and move any production lines from existing internal or external facilities, the new production lines will likely need to be re-qualified with our customers. Any delays or failure to obtain qualifications would harm our operating results and customer relationships.

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

Cyber attacks have become more prevalent and much harder to detect and defend against. Companies, including in our industry, have been increasingly subject to a wide variety of security incidents, cyber attacks 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 maintain sensitive data on our networks, including our 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 may be subject to computer viruses, denial of service attacks, ransomware and other forms of cyber terrorism, unauthorized access by hackers or may be breached due to operator error, malfeasance or other system 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 intellectual property, 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. Cyber attacks, such as computer viruses or other forms of cyber terrorism, may disrupt access to our network or storage applications. Such disruptions could result in delays or cancellations of customer orders or the production or shipment of our products. Further, cyber attacks 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.

Privacy concerns and compliance with domestic or foreign privacy laws and regulations may increase our expenses, result in legal or regulatory proceedings against us and may harm our business.

In the ordinary course of our business, we maintain sensitive personal data on our networks, including confidential information relating to our customers, employees and business partners. Global privacy legislation, enforcement, and policy activity are rapidly expanding and creating a complex compliance regulatory environment regarding the collection, use, storage and disclosure of such information. These laws and regulations are still evolving and are likely to be in flux and subject to uncertain interpretation for the foreseeable future. For example, various Chinese agencies are expected to issue additional regulations in the future to further define the requirements of the new Chinese Cyber Security Law, which took effect on June 1, 2017. For additional information regarding the new Cyber Security Law, see “We have significant operations in China, which exposes us to risks inherent in doing business in China.” Additionally, the European Union's General Data Protection Regulation (the “GDPR”), which comprehensively reforms the EU’s data protection laws, took effect on May 25, 2018. The GDPR imposes strict data protection requirements that may necessitate changes to our business practices to comply with the new requirements or to address the concerns of our customers or business partners relating to the GDPR. The GDPR also includes severe financial penalties for non-compliance. Complying with any new regulatory requirements could force us to incur substantial expenses or require us to change our business practices in a manner that could harm our business and any non-compliance may result in lawsuits, regulatory fines, or other actions or liability. Our business may also be harmed if these privacy-related laws or any newly adopted privacy-related laws are interpreted or implemented in a manner that is inconsistent from country to country and inconsistent with our current policies and practices, or those of our customers or business partners.

Costs to comply with rapidly changing global privacy-related laws and regulations and to implement related data protection measures could be significant. We may also have to change the manner in which we contract with our business partners, store and transfer information and otherwise conduct our business, which could increase our costs and harm our financial results. In addition, even inadvertent failure to comply with federal, state, or international privacy-related or data protection laws and regulations could result in proceedings against us by governmental entities or others, resulting in fines, penalties, restrictions on or prohibitions on our operations in certain jurisdictions, increased compliance costs and other adverse effects.

Our products may infringe the intellectual property rights of others, which could result in materially expensive litigation or require us to obtain a license to use the technology from third parties, or we may be prohibited from selling certain products in the future.

Companies in the industry in which we operate frequently are sued or receive informal claims of patent infringement or infringement of other intellectual property rights. We have, from time to time, received such claims, including from competitors and from companies that have substantially more resources than us. For example, see Part I, Item 3, Legal Proceedings, "Furukawa Patent Litigation," in our 2014 Annual Report.

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Third parties may in the future assert claims against us concerning our existing products or with respect to future products under development, or with respect to products that we may acquire through acquisitions. We have entered into and may in the future enter into indemnification obligations in favor of some customers that could be triggered upon an allegation or finding that we are infringing other parties' proprietary rights. For example, see Part II, Item 1, Legal Proceedings, "Oyster Optics Litigation," in this Quarterly Report on Form 10-Q. Satisfaction of any such indemnification obligations to our customers could be costly and materially adversely affect our operating results. If we do infringe a third party's rights, we may need to negotiate with holders of those rights in order to obtain a license to those rights or otherwise settle any infringement claim. We have from time to time received notices from third parties alleging infringement of their intellectual property and where appropriate have entered into license agreements with those third parties with respect to that intellectual property. Any license agreements that we wish to enter into the future with respect to intellectual property rights may not be available to us on commercially reasonable terms, or at all. We may not in all cases be able to resolve allegations of infringement through licensing arrangements, settlement, alternative designs or otherwise. We may take legal action to determine the validity and scope of the third-party rights or to defend against any allegations of infringement. Holders of intellectual property rights could become more aggressive in alleging infringement of their intellectual property rights and we may be the subject of such claims asserted by a third party. In the course of pursuing any of these means or defending against any lawsuits filed against us, we could incur material legal fees and related costs. The amount of time required to resolve these types of lawsuits, particularly patent-related litigation, is unpredictable and these actions may divert management's attention from the day-to-day operation of our business and consume our resources, which could materially and adversely affect our business, results of operations and cash flows. Due to the competitive nature of our industry, it is unlikely that we could increase our prices to cover such costs. In addition, such claims could result in significant penalties or injunctions that could prevent us from selling some of our products in certain markets or result in settlements or judgments that require payment of significant royalties or damages.

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

Certain companies in the telecommunications, data communications and optical components markets in which we sell our products have experienced frequent litigation regarding patent and other intellectual property rights. Numerous patents in these industries are held by others, including academic institutions and our competitors. Optical component suppliers may seek to gain a competitive advantage or other third parties, inside or outside our market, may seek an economic return on their intellectual property portfolios by making infringement claims against us. We currently license certain intellectual property from third parties, and in the future, we may need to obtain license rights to patents or other intellectual property held by others in order to conduct our business. Unless we are able to obtain such licenses on commercially reasonable terms, patents or other intellectual property held by others could be used to inhibit or prohibit our production and sale of existing products and our development of new products for our markets. Licenses granting us the right to use third-party technology may not be available on commercially reasonable terms, or 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 operating results. In addition, in the event we are granted such a license, it is likely such license would be non-exclusive and other parties, including competitors, may be able to utilize such technology. Our larger 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. In addition, our larger competitors may be able to buy such technology and preclude us from licensing or using such technology.

We generate a significant portion of our revenues internationally and therefore are subject to additional risks associated with the extent of our international operations.

For the fiscal years ended June 30, 2018, July 1, 2017 and July 2, 2016, 15 percent, 14 percent and 15 percent of our revenues, respectively, were derived from sales to customers located in the United States and 85 percent, 86 percent and 85 percent of our revenues, respectively, were derived from sales to customers located outside the United States. We are subject to additional risks related to operating in foreign countries, including:

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- currency fluctuations, which could result in increased operating expenses;
- changes in national infrastructure development priorities and associated capital budgets;
- trade restrictions, including restrictions imposed by the United States government on trading with parties in foreign countries, particularly with respect to China;
- difficulty in enforcing or adequately protecting our intellectual property;
- ability to hire qualified candidates;
- foreign income, value added and customs taxes;
- greater difficulty in accounts receivable collection and longer collection periods;

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- political, legal and economic instability in foreign markets;
- foreign regulations;
- changes in, or impositions of, legislative or regulatory requirements;
- transportation delays;
- epidemics and illnesses;
- terrorism and threats of terrorism;
- work stoppages and infrastructure problems due to adverse weather conditions or natural disasters;
- work stoppages related to employee dissatisfaction; and
- the effective protections of, and the ability to enforce, contractual arrangements.

Any of these risks, or any other risks related to our foreign operations, could materially adversely affect our business, financial condition and results of operations.

We may face product liability claims.

Despite quality assurance measures, defects may occur in our products. The occurrence of any defects in our products could give rise to liability for damages caused by such defects, including consequential damages. Such defects could, moreover, impair market acceptance of our products and harm our reputation. Both could have a material adverse effect on our business and financial condition. In addition, we may assume product warranty liabilities related to companies we acquire, which could have a material adverse effect on our business and financial condition. In order to help mitigate the risk of liability for damages, we carry product liability insurance and errors and omissions insurance. We cannot assure you, however, that this insurance would adequately cover our costs arising from any product liability-related issues with our products or otherwise.

If we fail to attract and retain key personnel, our business could suffer.

Our future success depends, in part, on our ability to attract and retain key personnel, including executive management. Competition for highly skilled technical personnel is extremely intense and we continue to face difficulty identifying and hiring qualified engineers in many areas of our business and in various geographic locations. We may not be able to hire and retain such personnel at compensation levels consistent with our existing compensation and salary structure. Volatility or lack of performance in the trading price of our common stock may also affect our ability to attract and retain qualified personnel because job candidates and existing employees often emphasize the value of the stock awards they receive in connection with their employment when considering whether to accept or continue employment. If the perceived value of our stock awards is low or declines, it may harm our ability to recruit and retain highly skilled employees. Our future success also depends on the continued contributions of our executive management team and other key management and technical personnel, each of whom would be difficult to replace. The loss of services of these or other executive officers or key personnel or the inability to continue to attract qualified personnel could have a material adverse effect on our business.

At times, the market price of our common stock has fluctuated significantly.

The market price of our common stock has been, and is likely to continue to be, highly volatile. For example, during fiscal year 2018, the market price of our common stock ranged from a low of $5.61 per share to a high of $10.49 per share. Many factors could cause the market price of our common stock to rise and fall.

In addition to the matters discussed in other risk factors included in our public filings, some of the events that could impact our stock price are:

- fluctuations in our financial condition and results of operations, including our gross margins and cash flow;
- changes in our business, operations or prospects;
- hiring or departure of key personnel;
- new contractual relationships with key suppliers or customers by us or our competitors;
- proposed acquisitions and dispositions by us or our competitors;
- financial results or projections that fail to meet public market analysts' expectations and changes in stock market analysts' recommendations regarding us, other optical technology companies or the telecommunication industry in general;
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future sales of common stock, or securities convertible into, exchangeable or exercisable for common stock, including in connection with acquisitions or other strategic transactions;

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- adverse judgments or settlements obligating us to pay damages;
- acts of war, terrorism, or natural disasters;
- industry, domestic and international market and economic conditions, including sovereign debt issues in certain parts of the world and related global macroeconomic issues;
- low trading volume in our stock;
- developments relating to patents or property rights; and
- government regulatory changes.

In connection with certain of our past acquisitions and the conversion of our convertible notes, we have issued shares of our common stock. The issuance of these shares has diluted our existing stockholders and their subsequent sale could potentially have a negative impact on our stock price.

Our shares of common stock have experienced substantial price and volume fluctuations, in many cases without any direct relationship to our operating performance. An outgrowth of this market volatility is the significant vulnerability of our stock price to any actual or perceived fluctuation in the strength of the markets we serve, regardless of the actual consequence of such fluctuations. As a result, the market price for our stock is highly volatile. These broad market and industry factors have caused the market price of our common stock to fluctuate, and may in the future cause the market price of our common stock to fluctuate, regardless of our actual operating performance.

We are not restricted from issuing additional shares of our common stock, including securities that are convertible into or exchangeable for, or that represent the right to receive, shares of our common stock. Issuances of shares of our common stock or convertible securities, including outstanding options and warrants, will dilute the ownership interest of our stockholders.

We have a history of large operating losses. We may not be able to sustain profitability in the future and as a result we may not be able to maintain sufficient levels of liquidity.

We have historically incurred losses and negative cash flows from operations since our inception. As of September 29, 2018, we had an accumulated deficit of $(1,145.3) million. Although we achieved income from continuing operations during the years ended June 30, 2018, July 1, 2017 and July 2, 2016, we incurred losses from continuing operations for the year ended June 27, 2015 of $48.2 million.

As of September 29, 2018, we held $341.9 million in cash, cash equivalents and short-term investments, comprised of $337.9 million in cash and cash equivalents, and $4.0 million in short-term investments; and we had working capital, including cash, of $470.5 million. At September 29, 2018, we had debt of $1.2 million, consisting of capital leases.

The optical communications industry is subject to significant fluctuations. In order to remain competitive we incur substantial costs associated with research and development, qualification, production capacity and sales and marketing activities in connection with products that may be purchased, if at all, long after we have incurred such costs. In addition, the rapidly changing industry in which we operate, the length of time between developing and introducing a product to market, frequent changing customer specifications for products, customer cancellations of products or orders, intense competition, and general down cycles in the industry, among other things, make our prospects difficult to evaluate. As a result of these factors, it is possible that we may not (i) generate sufficient positive cash flow from operations; (ii) raise funds through the issuance of equity, equity-linked or convertible debt securities; (iii) be able to enter into new loan agreements in the future, draw advances under such agreements or repay any such amounts; (iv) conclude additional strategic dispositions or similar transactions; or (v) otherwise have sufficient capital resources to meet our future capital or liquidity needs. There are no guarantees we will be able to generate additional financial resources beyond our existing balances.

We have a large amount of intercompany balances with our China entities which may be subject to taxes and penalties when we try to pay them down or collect them.

Payments for goods and services into and out of China are subject to numerous and over-lapping government regulation with respect to foreign exchange controls, banking controls, import and export controls, and taxes. We have been operating in China for an extended period of time and have accumulated significant intercompany balances with our related entities. Our ability to repay or collect these balances may be restricted by Chinese laws and, as a result, we may be unable to successfully pay down or collect on these balances. As a consequence, we may be assessed additional taxes in China if we are unable to claim bad debt deductions or incur debt forgiveness income from the cancellation of these intercompany balances. Additionally, if we are found not to have complied with the various local laws surrounding cross border payments, we may incur penalties and fines for non-compliance. Any such taxes, penalties and/or fines could be significant in amount and, as a result, could have a material adverse effect on our financial condition, including our cash and cash equivalent balances.

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We have been named as a party to derivative action lawsuits in the past, and we may be named in additional litigation in the future, which would require significant management time and attention and result in significant legal expenses and could result in an unfavorable outcome which could have a material and adverse effect on our business, financial condition, results of operations and cash flows.

When the market price of a stock experiences a sharp decline, as has happened to us in the past, holders of that stock have often brought securities class action litigation against the company that issued the stock. Several securities class action lawsuits have been filed against us and certain of our current and former officers and directors in the past. Other class action lawsuits have been initiated in the past against Opnext, us and certain of our respective current and former officers and directors as purported derivative actions. The securities class action complaints alleged violations of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the Securities and Exchange Commission (the "SEC"). Each purported derivative complaint alleged, among other things, counts for breaches of fiduciary duty, waste, and unjust enrichment. The courts approved the settlement of these lawsuits and the settlements became final in December 2014. For a description of these lawsuits, see Part II, Item 1, Legal Proceedings, "Class Action and Derivative Litigation" in our Quarterly Report on Form 10-Q filed on February 5, 2015. If new litigation of this type were to be initiated in the future, such litigation would likely divert the time and attention of our management and could cause us to incur significant expense in defending against the litigation. We could also be responsible for the advancement or reimbursement of significant legal fees of our current and former officers and directors to whom we may owe indemnity obligations. In addition, if any such suits were resolved in a manner adverse to us, the damages we could be required to pay may be substantial and could have a material and adverse impact on our results of operations and our ability to operate our business.

Because we do not intend to pay dividends, stockholders will benefit from an investment in our common stock only if it appreciates in value.

We have never declared or paid any dividends on our common stock. We anticipate that we will retain any future earnings to support operations and to finance the development of our business and do not expect to pay cash dividends in the foreseeable future. In addition, the Merger Agreement prohibits us from paying dividends. As a result, the success of an investment in our common stock will depend entirely upon any future appreciation in its value. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased their shares.

We are subject to anti-corruption laws in the jurisdictions in which we operate, including the U.S. Foreign Corrupt Practices Act, or the FCPA, and the U.K. Bribery Act. Our failure to comply with these laws could result in penalties which could harm our reputation and have a material adverse effect on our business, results of operations and financial condition.

We are subject to the FCPA, the U.K. Bribery Act and other anti-corruption laws that generally prohibit companies and their intermediaries from making improper payments to foreign officials for the purpose of obtaining or keeping business and/or other benefits, along with various other anti-corruption laws. Although we have implemented policies and procedures designed to ensure that we, our employees and other intermediaries comply with the FCPA and other anti-corruption laws to which we are subject, there is no assurance that such policies or procedures will work effectively all of the time or protect us against liability under the FCPA or other laws for actions taken by our employees and other intermediaries with respect to our business or any businesses that we may acquire. We have manufacturing operations in China and other jurisdictions, many of which pose elevated risks of anti-corruption violations, and we export our products for sale internationally. This puts us in frequent contact with persons who may be considered “foreign officials” under the FCPA, resulting in an elevated risk of potential FCPA violations. If we are not in compliance with the FCPA and other laws governing the conduct of business with government entities (including local laws), we may be subject to criminal and civil penalties and other remedial measures, which could have an adverse impact on our business, financial condition, results of operations and liquidity. Any investigation of any potential violations of the FCPA or other anti-corruption laws by U.S. or foreign authorities could harm our reputation and have an adverse impact on our business, financial condition and results of operations.

In the future we may need to access the capital markets to raise additional equity, which could dilute our shareholder base.

We may need additional liquidity beyond our current expectations, such as to fund future growth, strengthen our balance sheet or to fund the cost of restructuring activities or acquisitions, and will continue to explore other sources of additional liquidity. These additional sources of liquidity could include one, or a combination, of the following: (i) issuing equity securities, (ii) incurring indebtedness secured by our assets, (iii) issuing debt and/or convertible debt securities, or (iv) 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. In addition, the Merger Agreement restricts our ability to issue equity securities, incur indebtedness or sell our product lines and businesses.

If we raise funds through the issuance of equity, or equity-linked or convertible debt securities, our stockholders may be significantly diluted, and these newly-issued securities may have rights, preferences or privileges senior to those of securities held by existing stockholders. For example, we raised funds in a public offering of our common stock in September 2016, which diluted our existing

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stockholder base. If we raise funds in the future through the issuance of debt instruments, such as we did in February 2015 when we issued convertible notes and December 2012 when we issued exchangeable bonds, we will incur debt servicing costs and the agreements governing such debt instruments may contain covenant restrictions that limit our ability to, among other things: (i) incur additional debt, assume obligations in connection with letters of credit, or issue guarantees; (ii) create liens; (iii) make certain investments or acquisitions; (iv) enter into transactions with our affiliates; (v) sell certain assets; (vi) redeem capital stock or make other restricted payments; (vii) declare or pay dividends or make other distributions to stockholders; and (viii) merge or consolidate with any entity. (See Note 6, Credit Line and Notes, in our 2016 Annual Report, for further details). The exchangeable bonds issued in 2012 and the convertible notes issued in 2015 were subsequently exchanged for common stock and, in the case of the convertible notes issued in 2015, a cash payment. We cannot assure you that additional financing will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, if and when needed, our ability to fund our operations, develop or enhance our products, make acquisitions or otherwise respond to competitive pressures and operate effectively could be significantly limited.

We may have to incur substantially more debt in the future, which may subject us to restrictive covenants that could limit our ability to operate our business.

In the future, we may incur additional indebtedness through arrangements such as credit agreements or term loans that may impose restrictions and covenants that limit our ability to respond appropriately to market conditions, make capital investments or take advantage of business opportunities. In addition, any debt arrangements we may enter into would likely require us to make regular interest payments, which would adversely affect our results of operations.

Prior to our acquisition of Opnext, Opnext licensed its intellectual property to Hitachi and its wholly owned subsidiaries without restriction. In addition, Hitachi is free to license certain of Hitachi's intellectual property that Opnext used in its business to any third party, including competitors, which could harm our business and operating results.

Opnext was initially created as a stand-alone entity by acquiring certain assets of Hitachi through various transactions. In connection with these transactions, Opnext acquired a number of patents and know-how from Hitachi, but also granted Hitachi and its wholly owned subsidiaries a perpetual right to continue to use those patents and know-how, as well as other patents and know-how that Opnext developed during a period which ended in July 2011 (or October 2012 in certain cases). This license back to Hitachi is broad and permits Hitachi to use this intellectual property for any products or services anywhere in the world, including licensing this intellectual property to our competitors. Additionally, while significant intellectual property owned by Hitachi was assigned to Opnext when Opnext was formed, Hitachi retained and only licensed to Opnext the intellectual property rights to underlying technologies used in both Opnext products and the products of Hitachi. Under the agreement, Hitachi remains free to license these intellectual property rights to the underlying technologies to any party, including competitors. The intellectual property that has been retained by Hitachi and that can be licensed in this manner does not relate solely or primarily to one or more of Opnext's products, or groups of products; rather, the intellectual property that was licensed to Opnext by Hitachi is used across a broad portion of our product portfolio. Competition from third parties using the underlying technologies retained by Hitachi could harm our business, financial condition and results of operations.

Our business and operating results may be adversely affected by natural disasters or other catastrophic events beyond our control.

Our business and operating results are vulnerable to natural disasters, such as earthquakes, fires, tsunami, volcanic activity and floods, as well as other events beyond our control such as power loss, telecommunications failures and uncertainties arising out of terrorist attacks in the United States and armed conflicts overseas. For example, in the latter three quarters of fiscal year 2012, our results of operations were materially and adversely impacted by the flooding in Thailand. Additionally, our corporate headquarters and a portion of our research and development and manufacturing operations are located in Silicon Valley, California, and select manufacturing facilities are located in Japan. These regions in particular have been vulnerable to natural disasters, such as the 2011 earthquake and subsequent tsunami that occurred in Japan, and the April 2016 earthquakes that took place on the island of Kyushu in Japan. The occurrence of any of these events could pose physical risks to our property and personnel, which may adversely affect our ability to produce and deliver products to our customers. Although we presently maintain insurance against certain of these events, we cannot be certain that our insurance will be adequate to cover any damage sustained by us or by our customers.

Our business involves the use of hazardous materials, and we are subject to environmental and import/export laws and regulations that may expose us to liability and increase our costs.

We handle hazardous materials as part of our manufacturing activities. Consequently, our operations are subject to environmental laws and regulations governing, among other things, the use and handling of hazardous substances and waste disposal. We may incur costs to comply with current or future environmental laws. As with other companies engaged in manufacturing activities that involve hazardous materials, a risk of environmental liability is inherent in our manufacturing activities, as is the risk that our facilities will be shut down in the event of a release of hazardous waste, or that we would be subject to extensive monetary liabilities. The costs associated with environmental compliance or remediation efforts or other environmental liabilities could adversely affect our business. Under applicable European Union regulations, we, along with other electronics component manufacturers, are prohibited from using lead and certain other hazardous materials in our products. We could lose business or face product returns if we fail to maintain these requirements properly.

In addition, the sale and manufacture of certain of our products require on-going compliance with governmental security and import/export regulations. We may, in the future, be subject to investigation which may result in fines for violations of security and import/export regulations. Furthermore, any disruptions of our product shipments in the future, including disruptions as a result of efforts to comply with governmental regulations, could adversely affect our revenues, gross margins and results of operations.

The disclosure requirements related to the “conflict minerals” provision of the Dodd-Frank Act may limit our supply and increase our costs for certain metals used in our products and could affect our reputation with customers or shareholders.

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the SEC adopted a rule requiring public companies to disclose the use of specified minerals, known as conflict minerals, that are necessary to the functionality or production of products manufactured or contracted to be manufactured. The rule could affect sourcing at competitive prices and availability in sufficient quantities of certain minerals used in the manufacturing of our products. The number of suppliers who provide conflict-free minerals may be limited. In addition, there may be material costs associated with complying with the disclosure requirements, such as costs related to the due diligence process of determining the source of certain minerals used in our products, as well as costs of possible changes to products, processes, or sources of supply as a consequence of such verification activities. As our supply chain is complex and we use contract manufacturers for some of our products, we may not be able to sufficiently verify the origins of the relevant minerals used in our products through the due diligence procedures that we implement, which may harm our reputation. If we cannot determine that our products exclude conflict minerals sourced from the DRC or adjoining countries, some of our customers may discontinue, or materially reduce, purchases of our products, which could negatively affect our results of operations.

We can issue shares of preferred stock that may adversely affect your rights as a stockholder of our common stock.

Our certificate of incorporation authorizes us to issue up to 1.0 million shares of preferred stock with designations, rights and preferences determined from time-to-time by our Board of Directors. Accordingly, our Board of Directors is empowered, without stockholder approval, to issue preferred stock with dividend, liquidation, conversion, voting or other rights superior to those of holders of our common stock. For example, an issuance of shares of preferred stock could:

- adversely affect the voting power of the holders of our common stock;
- make it more difficult for a third-party to gain control of us;
- discourage bids for our common stock at a premium;
- limit or eliminate any payments that the holders of our common stock could expect to receive upon our liquidation; or
- otherwise adversely affect the market price of our common stock.

We may in the future issue shares of authorized preferred stock at any time.

Delaware law and our charter documents contain provisions that could discourage or prevent a potential takeover, even if such a transaction would be beneficial to our stockholders.

Some provisions of our certificate of incorporation and bylaws, as well as provisions of Delaware law, may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These include provisions:

- authorizing the Board of Directors to issue preferred stock;
- prohibiting cumulative voting in the election of directors;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder actions by written consent;

- creating a classified Board of Directors pursuant to which our directors are elected for staggered three-year terms;
- permitting the Board of Directors to increase the size of the board and to fill vacancies;
- requiring a super-majority vote of our stockholders to amend our bylaws and certain provisions of our certificate of incorporation; and

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- establishing advance notice requirements for nominations for election to the Board of Directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

We are subject to the provisions of Section 203 of the Delaware General Corporation Law which limit the right of a corporation to engage in a business combination with a holder of 15 percent or more of the corporation’s outstanding voting securities, or certain affiliated persons. We do not currently have a stockholder rights plan in place.

Although we believe that these charter and bylaw provisions, and provisions of Delaware law, provide an opportunity for the board to assure that our stockholders realize full value for their investment, they could have the effect of delaying or preventing a change of control, even under circumstances that some stockholders may consider beneficial.

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ITEM 6. EXHIBITS

Exhibit Number	Description of Exhibit
2.1	Agreement and Plan of Merger, dated as of March 11, 2018, by and among Lumentum Holdings Inc., Prota Merger Sub, Inc., Prota Merger, LLC and Oclaro, Inc. (previously filed as Exhibit 2.1 to Registrant's Current Report on Form 8-K filed on March 12, 2018 and incorporated herein by reference.)
31.1 (1)	Certification of Chief Executive Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2 (1)	Certification of Chief Financial Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1 (1)	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350.
32.2 (1)	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

(1) Filed herewith.

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SIGNATURE

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

OCLARO, INC.
(Registrant)

November 8, 2018 By: /s/ GREG DOUGHERTY
Greg Dougherty
Chief Executive Officer
(Principal Executive Officer)

November 8, 2018 By: /s/ PETE MANGAN
Pete Mangan
Chief Financial Officer
(Principal Financial Officer)