FARMERS & MERCHANTS BANCORP INC
Form 10-Q/A
November 05, 2012
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

Amendment No. 1

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2012

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 0-14492

FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

OHIO	**34-1469491**
(State or other jurisdiction of	**(I.R.S Employer**
incorporation or organization)	**Identification No.)**
307 North Defiance Street, Archbold, Ohio	**43502**
(Address of principal executive offices)	**(Zip Code)**

(419) 446-2501

Registrant s telephone number, including area code

(Former name, former address and former fiscal year, if changed since last report.)

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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes ¨ No

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

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

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

Indicate the number of shares of each of the issuers classes of common stock, as of the latest practicable date:

Common Stock, No Par Value	4,689,258
Class	Outstanding as of October 24, 2012

Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q/A

FARMERS & MERCHANTS BANCORP, INC.

INDEX

** The interactive data file (XBRL) exhibit is only available electronically. You can obtain copies of these files electronically at the SEC s website at www.sec.gov. The files are also available on the Farmers and Merchants State Bank s website at www.fm-bank.com under the shareholder s information tab.

Table of Contents

EXPLANATORY NOTE

This Quarterly Report on Form 10-Q/A is being filed for the purpose of correcting information contained in Part I, Item 2 of the Registrant s Form 10-Q for the quarterly period ended September 30, 2012, which was originally filed with the Securities and Exchange Commission on October 29, 2012 (the Original Filing). Specifically, the amendments correct tabular information regarding Registrant s: (1) regulatory capital ratios as of September 30, 2012 on page 22; (2) yields earned and rates paid on the respective average balances of the Registrant s earning assets and liabilities for each of the periods ended September 30, 2012 and September 30, 2011, which tables appear on page 23; and (3) changes in period to period interest income and expense attributable to fluctuations in volumes and rates, which tables appear on page 23. In addition, textual disclosures on pages 22 and 23 have been revised to correct the period to period decrease in overall asset yield of 42 basis points and the period to period decrease in cost of funds of 27 basis points.

Except as described above, no other changes have been made to the Original Filing, and all other items of the Original Filing are unaffected by this Form 10-Q/A. As a consequence, such items have not been included in this Form 10-Q/A. The Original Filing continues to speak as of the date of the Original Filing, and the Registrant has not updated the disclosures contained therein to reflect any events which occurred at a date subsequent to the Original Filing.

Table of Contents

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

Farmers & Merchants Bancorp, Inc. (Company) is a bank holding company incorporated under the laws of Ohio in 1985. Our primary subsidiary, The Farmers & Merchants State Bank (Bank) is a community bank operating in Northwest Ohio since 1897. We report our financial condition and net income on a consolidated basis and we report only one segment.

Our executive offices are located at 307 North Defiance Street, Archbold, Ohio 43502, and our telephone number is (419)446-2501.

The Bank s primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Williams and Wood and in the Indiana counties of DeKalb and Steuben. The commercial banking business in this market is highly competitive with approximately 17 other depository institutions currently doing business in the Bank s primary market. In our banking activities, we compete directly with other commercial banks, credit unions and farm credit services and savings and loan institutions in each of their operating localities. In a number of locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of service provided. On December 31, 2007, the Bank acquired the Knisely Bank of Indiana, expanding its market with the addition of offices in Butler and Auburn, Indiana, both located in DeKalb County. An additional office was opened in the summer of 2008 in Angola, Indiana, located in Steuben County. On July 9, 2010 the Bank purchased a branch office in Hicksville, Ohio shortening the distance between our Ohio and Indiana offices. Construction has begun on the Bank s 20th full service office located in Waterville, Lucas County, Ohio. A second quarter 2013 opening is planned.

For a discussion of the general development of the Company s business throughout 2012, please see the portion of Management s Discussion and Analysis of Financial Condition and Results of Operations captioned 2012 in Review .

The Bank s primary service area, Northwest Ohio and Northeast Indiana, continued to experience high unemployment. After reaching a high of 11% unemployment for Ohio in March, 2010, the unemployment rate decreased in each of the ensuing months in Ohio and closed July 2012 at 7.7% for Ohio. Indiana declined through May 2012; however Indiana increased during June and July to end at 8.2%. National and State unemployment reports for July 2012, show a slight improvement while the majority of the market areas served by the Company have rates higher than the State averages as of July 2012. The agricultural industry continued its strong performance in 2011 evidenced by strengthened financial statements. Automotive showed improvement with car dealers in our marketing area ending with more profitable numbers than in recent years. Overall, business profits are improving, however borrowing activity remains sluggish and loan balances declined during the quarter. New 1-4 family residential and construction remain weak while refinancing activity remains brisk.

The Farmers & Merchants State Bank engages in general commercial banking and savings business. Their activities include commercial, agricultural and residential mortgage, consumer and credit card lending activities. Because the Bank s offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such things as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for such items as autos, trucks, recreational vehicles, motorcycles, etc.

The Bank also provides checking account services, as well as savings and time deposit services such as a certificates of deposits. In addition ATM s (Automated Teller Machines) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for IRA s (Individual Retirement Accounts) and HSA s (Health Savings Accounts). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and ACH file transmittal. In addition the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services.

The Bank s underwriting policies exercised through established procedures facilitates operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank s practice has been not to promote innovative, unproven credit products which will not be in the best interest of the Bank or its customers. The Bank does offer a hybrid mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank s adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank does also retain the servicing on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by these agencies. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

The Bank does not have a program to fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that target borrowers who pose a significantly higher risk of default than traditional retail banking customers.

Following are the characteristics and underwriting criteria for each major type of loan the Bank offers:

Commercial Real Estate Construction, purchase, and refinance of business purpose real estate. Risks include loan amount in relation to construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower s ability to repay in orderly fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer s ability to repay in a changing rate environment before granting loan approval.

Agricultural Real Estate Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the repayment source and is therefore subject to the financial success of the farm operation.

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

INTRODUCTION (Continued)

Consumer Real Estate Purchase, refinance, or equity financing of one to four family owner occupied dwelling. Success in repayment is subject to borrower s income, debt level, character in fulfilling payment obligations, employment, and others.

Commercial/Industrial Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of profit projections, financial leverage, economic trends, management ability, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer s ability to repay in a changing rate environment before granting loan approval.

Agricultural Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re-finance of capital assets such as machinery and equipment, and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmers ability to hedge their position by the use of the future contracts. The risk related to weather is often mitigated by requiring federal crop insurance.

Consumer Funding for individual and family purposes. Success in repayment is subject to borrower s income, debt level, character in fulfilling payment obligations, employment, and others.

Industrial Development Bonds Funds for public improvements in the Bank s service area. Repayment ability is usually based on the continuance of the taxation revenue as the source of repayment.

All loan requests are reviewed as to credit worthiness and are subject to the Bank s underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank s Loan Policy. In addition, credit scores of principal borrowers are reviewed and an approved exception from an additional officer is required should a credit score not meet the Bank s Loan Policy guidelines.

Consumer Loans:

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.

Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods of lost wages or death.

Boats, campers, motorcycles, RV s and Motor Coaches range from 80%-90% based on age of vehicle.

1st or 2nd mortgages on 1-4 family homes range from 75%-90% with in-house first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.

Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

Commercial/Agriculture/Real Estate:

Maximum LTVs range from 70%-80% depending on type.

Accounts Receivable:

Up to 80% LTV.

Inventory:

Agriculture:

Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%.

Commercial:

Maximum LTV of 50% on raw and finished goods.

Used vehicles, new recreational vehicles and manufactured homes not to exceed (NTE) 80% LTV.

Equipment:

New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.

Restaurant equipment up to 35% of market value.

Heavy trucks, titled trailers, NTE 75% LTV and aircraft up to 75% of appraised value.

We also provide checking account services, as well as savings and time deposit services such as certificates of deposits. In addition ATM s are provided at our Ohio offices in Archbold, Wauseon, Stryker, West Unity, Bryan, Delta, Napoleon, Montpelier, Swanton, Defiance, and Perrysburg, along with ones at our Auburn and Angola, Indiana offices. Two ATM s are located at Sauder Woodworking Co., Inc., a major employer in Archbold. Additional locations in Ohio are at Northwest State Community College, Archbold; Community Hospitals of Williams County, Bryan; Fairlawn Haven Wyse Commons, Archbold; R&H Restaurant, Fayette; Delta Eagles; Sauder Village, Archbold; Fulton County Health Center, Wauseon; downtown Defiance; and a mobile trailer ATM. In Indiana, four additional ATM s are located at St. Joe; at Kaiser s Supermarket and Therma-Tru in Butler; and at DeKalb Memorial Hospital in Auburn.

F&M Investment Services, the brokerage department of the Bank, opened for business in April, 1999. Securities are offered through Raymond James Financial Services Inc.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956 and regulated by the Federal Reserve. Our subsidiary bank is in turn regulated and examined by the Ohio Division of Financial Institutions, and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations.

At September 30, 2012, we had 247 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be excellent.

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATION (Continued)

2012 IN REVIEW

The Company s 2012 performance results continued to be bolstered by gains on sales from real estate loans. The third quarter had more noninterest income generated from the consumer real estate portfolio as compared to second quarter s developing more from the agricultural real estate segment. Pressure continues on the net interest margin though the dollars were just $118 thousand lower for the quarter than the same period period last year. A lower net interest position is also evident on the income statement in the year-to-date figures. Asset quality continued to improve.

All rates remain low and are expected to remain low throughout 2013. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield while modestly increasing the duration of the investment portfolio. As of September 30, 2012, the favorable gain produced from the sale of securities was $199 thousand. Most of the securities sold were agencies maturing in a shorter time period than the securities that were purchased to replace them. As of September 30, 2011, the favorable gain was at $504 thousand and the majority of securities sold were out of state municipals and agencies. The Bank was able to continue to capitalize on the steepness of the yield curve and the unrealized market gain position at the start of 2012. The market value of the security portfolio remains high as evidenced by the high comprehensive income reported on the income statement. Additional opportunity to se1l investment securities for a gain remains.

During the first quarter of 2011, the Bank received a payoff on a large nonaccrual loan. The collection of which included over $600 thousand of interest and a reimbursement of over $300 thousand in legal fees. The collection process took almost three years to complete. This boost to income is evident throughout from net interest margin, improved asset quality to lower non-interest expense. It also offset tightening margins due to soft loan demand and high liquidity caused from higher deposit growth. As was expected, 2012 numbers, as they relate to interest earnings, were lower in yield than 2011 without an additional large influx of nonaccrual interest collection. The yield has been lower though overall net income is higher. The Bank has been able to realize improvement as a result of a lower loan provision requirement. As compared to a year ago, provision expense was $1.1 million lower for the first nine months. This contributed to ROA and ROE remaining higher than a year ago.

Noninterest income was significantly higher than a year ago, not only for the quarter but also in terms of year-to-date. Customer service fees were $1.5 million higher as of September 30, 2012 compared to the same period 2011. An increase in mortgage servicing rights due to the high volume of consumer mortgage activity, increased debit card usage by our customers and the service fees generated from our secondary agricultural real estate loans, were the main drivers of the improvement. All remain strong and are expected to contribute to improved earnings for the fourth quarter.

Consumer and agricultural real estate loan sales in the secondary market provided a $1.4 million boost to non interest income so far in 2012 as compared to 2011. This activity is also predicted to continue through the fourth quarter of 2012 as customers seek to lock in long term fixed rates.

A large amount of write-downs and losses on the sale of other real estate owned (ORE) hampered 2011 as compared to the same time period 2012. The balance in ORE is at $3.1 million which is $737.5 thousand lower as of September 30, 2012 compared to September 30, 2011. While September 30, 2012 recognized $474.9 thousand in write-downs and losses from sales of ORE, as of September 30, 2011, the Bank had recognized $999.6 thousand in a compilation of write-downs and losses on ORE. This impact is evidenced in the higher non-interest income for nine months ended 2012.

The impact of new legislation, such as Patient Protection and Affordable Care Act and Dodd-Frank Wall Street Reform and Consumer Protection Act (Collectively, Financial Reform legislation), weighs heavily on the minds of bankers along with their customers during its implementation. Legislation has impacted the collection of fees related to discretionary overdraft protection since the second half of 2011. The cost is hidden by the growth in the number of checking accounts from which fees are generated. The growth masks the total loss as actual dollars collected for the first three quarters of 2012 as compared to 2011 is only down by $4.7 thousand. The increase in the average number of checking accounts however is 3.1 thousand. Taking the income generated per account at the 2011 level and multiplying by the higher number of checking accounts, reveals an additional cost or loss of revenue of $180.5 thousand for 2012 has occurred.

Another concern stemming from the impact of new legislation relates to debit card interchange fees. Currently the regulation for banks has a carve out for banks under $10 billion in assets as it relates to those fees. This may help to maintain the debit card program through the remainder of 2012. In terms of revenue, the increase in number of checking accounts mentioned above and customers increased usage of the debit card has enabled the Bank to earn $444.2 thousand more in interchange and ATM fees in three quarters 2012 as compared to the same period 2011. This explains our primary concern at this point on the impact of future revenue and expenses and how quickly it will be felt should the carve out provide only short term relief.

The majority of the Bank s commercial borrowers have experienced slight improvement, although a few still lag. As the economic recovery remains fragile and consumer confidence remains at lower levels, consumer sensitive industries and the retail sector may continue to experience pressures as well. Drought conditions existed in the majority of the market area we service. Crop insurance and two previous years of strong yields should lessen any negative impact on our agricultural portfolio. Though yields may be down, prices are higher than a year ago which helps lessen the financial impact.

The Company remains strong, stable and well capitalized and has the capacity to continue to cover the increased costs of doing business in a tough economy and is seeking good loans to improve profitability. The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the industry in which it operates. At times the application of these principles requires Management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)

originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation of its Mortgage Servicing Rights and Other Real Estate Owned (OREO) as the accounting areas that require the most subjective or complex judgments, and as such have the highest possibility of being subject to revision as new information becomes available.

The ALLL represents management s estimate of credit losses inherent in the Bank s loan portfolio at the report date. The estimate is a composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion.

The Bank s ALLL methodology captures trends in leading, current, and lagging indicators which will have a direct affect on the Bank s allocation amount. Trends in such leading indicators as delinquency, unemployment, changes in the Bank s service area, experience and ability of staff, regulatory trends, and credit concentrations are referenced. A current indicator such as the total Watch List loan amount to Capital, and a lagging indicator such as the charge off amount are referenced as well. A matrix is formed by loan type from these indicators that is responsive in making ALLL adjustments.

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest expense in proportion to, and over the period of, the estimated future servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to the amortized cost. Impairment is deter- mined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum. Fees received for servicing loans owned by investors are based on a percentage of the outstanding monthly principal balance of such loans and are included in operating income as loan payments are received. Costs of servicing loans are charged to expense as incurred. The Bank utilizes a third party vendor to estimate the fair value of their mortgage servicing rights which utilizes national prepayment speeds in its calculations.

MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

In comparing the balance sheet of September 30, 2012 to that of December 31, 2011, the liquidity of the Bank has decreased by approximately $13.5 million, yet remains strong with the funds being moved from cash, short-term Bank deposits, Federal Funds sold to a higher yielding security portfolio. The Bank has taken advantage of the Federal Reserve paying interest on its operational account and placed $25.9 million in the investment portfolio. The Bank may use these excess funds to fund new loan growth. During the nine months of 2012, net loans have decreased just under $15 million.

Overall, cash and cash equivalents decreased almost $13.5 million and securities increased $25.9 million over yearend 2011. The Company s increase in investments was due to the lack of any significant loan growth. The Company has an unsecured borrowing capacity of $45 million through correspondent banks and over $156.9 million of unpledged securities which may be sold or used as collateral. The strength of the security portfolio is shown in the tables to follow. With the exception of stock, all of the Bank s security portfolio is categorized as available for sale and as such is recorded at market value. The charts that follow do not include stock.

Investment securities will at times depreciate to an unrealized loss position. The Bank utilizes the following criteria to assess whether or not an impaired security is other than temporary. No one item by itself will necessarily signal that a security should be recognized as other than temporary impairment.

1. The fair value of the security has significantly declined from book value.

2. A down grade has occurred that lowers the credit rating to below investment grade (below Baa3 by Moody and BBB- by Standard and Poors).

3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.

4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.

5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The amount of the write down shall be included in earnings as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value. The recovery in fair value shall be recognized in earnings when the security is sold. The first table is presented by category of security and length of time in a

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued)

continuous loss position. Municipalities may be more likely to be in a loss position greater than 12 months due to their length to maturity and are not indicative of an issue with safety and soundness of the municipality. The Bank currently does not hold any securities with other than temporary impairment.

As the chart below shows, there was only minor amounts of securities in a loss position as of September 30, 2012.

	(In Thousands)			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$	$	$	$
U.S. Government agency	(3)	5,009		
Mortgage-backed securities	(3)	5,013		
State and local governments	(6)	1,244		

The following chart shows the breakdown of the unrealized gain or loss associated within each category of the investment portfolio as of September 30, 2012.

	(In Thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
Available-for-Sale:				
U.S. Treasury	$ 30,806	$ 705	$	$ 31,511
U.S. Government agency	188,747	4,314	(3)	193,058
Mortgage-backed securities	56,384	1,698	(3)	58,079
State and local governments	66,377	4,436	(6)	70,807
	$ 342,314	$ 11,153	$ (12)	$ 353,455

The following table shows the maturity schedule of the security portfolio.

	(In Thousands) September 30, 2012	
	Amortized Cost	Fair Value
One year or less	$ 34,743	$ 34,951
After one year through five years	175,611	180,617
After five years through ten years	64,251	66,895
After ten years	11,325	12,913
Subtotal	$ 285,930	$ 295,376
Mortgage Backed Securities	56,384	58,079

Total	$ 342,314	$ 353,455

Management feels confident that liquidity needs can easily be funded from an orderly runoff of the investment portfolio.

As previously stated, net loans show a decrease of $15 million for the nine months ended September 30, 2012. $639 thousand was charged-off during the nine month period indicating the total decrease was not due to charged-offs. The balance of the decrease in loans was due to the pay down, payoff or refinancing of loans. Loan sales into the secondary market has also impacted the consumer and agricultural real estate portfolios. During the year almost $98.8 million of these sales occurred with only $99.3 million of the loans originated in the same period. Agricultural real estate accounted for just over a third of the activity with 1-4 family representing the majority. Both portfolios include a large portion of refinancing. The trend of decreasing loan balances is not unique to this year as the chart to follow shows the trend during the last three years.

The chart below shows the breakdown of the loan portfolio by category less deferred loan fees and costs as of September 30 for the last three years.

	(In Thousands)		
	September 2012 Amount	September 2011 Amount	September 2010 Amount
Commercial Real Estate	$ 198,856	$ 201,167	$ 215,142
Agricultural Real Estate	32,221	31,806	35,820
Consumer Real Estate	81,041	80,607	88,721
Commercial and Industrial	100,126	112,542	117,625
Agricultural	56,581	54,134	58,057
Consumer, Overdrafts and other loans	21,052	23,861	29,267
Industrial Development Bonds	4,127	1,347	2,182
Total Loans	$ 494,004	$ 505,464	$ 546,814

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued)

The Commercial and Industrial portfolio shows the largest decrease of $12.4 million in balance as of September 30, 2012 compared to September 30, 2011. Agricultural real estate shows a slight increase of $415 thousand which may switch positions next quarter as additional sales are scheduled to occur before yearend. Overall, loans decreased $11.5 million as compared to the same period last year and $41.4 million as compared to September 20, 2010.

Overall, total assets of the Company decreased $2.0 million from December 31, 2011 to September 30, 2012.

Deposits decreased $4.6 million with the largest decrease of $13.7 million in the time deposits. The largest increase in the deposit portfolio of $13.4 million was in the savings portfolio due to the introduction of the KASASA Saver program. The mix of the portfolio continued to transition to a higher level of core deposits as a result primarily of the Bank s offering of a high interest bearing transaction account along with an increase in health savings accounts. In 2010, the Bank strengthened its line of deposit products by adding additional products which added additional options to its already highly successful Reward Checking, which was renamed KASASA Cash. The additional options include KASASA Saver, KASASA Giver and KASASA ITunes. KASASA Saver, whose product utilizes a higher yielding rate than the Bank s regular saving account, is the reason behind the retention and increase of dollars in savings. These continue to be the deposits of choice and attract not only new money from existing customers but new customers to the Bank.

The Certificate of Deposit (COD) portfolio has decreased $13.7 million during the first nine months of 2012; outpacing the increase in savings and noninterest bearing checking, which is why the Bank continues to decrease the cost of funds. This is demonstrated below in the section of this MD&A captioned MATERIAL CHANGES IN RESULTS OF OPERATION - Interest Expense .

The Bank paid off $13.2 million in FHLB advances which had matured during 2011 and made principal payments and payoffs totaling $5.1 million so far in 2012. A $5 million advance bearing an interest rate of 4.84% matured in September which the Bank paid off. This too should lower the cost of funds. Securities sold under agreement to repurchase increased $2.4 million during the first nine months of 2012 as compared to yearend.

Capital increased $4.9 million from year-end during the nine months of 2012. Positive earnings and an increase in accumulated other comprehensive income are the factors behind the increase. Comprehensive income increased $972 thousand which encompassed the shift of $199 thousand from unrealized gain to realized gain with the sale of securities. Dividends paid were equivalent to the same period last year while dividends declared increased approximately $47 thousand.

The Company continues to be well-capitalized in accordance with Federal regulatory capital requirements as the capital ratios below show:

Primary Ratio	10.80%
Tier I Leverage Ratio	10.51%
Risk Based Capital Tier I	16.66%
Total Risk Based Capital	17.56%
Stockholders Equity/Total Assets	11.95%

MATERIAL CHANGES IN RESULTS OF OPERATIONS

Comparison of Results of Operation for nine month periods ended September 30, 2011 and 2012

Interest Income

Annualized interest income and yield on earning assets is down in 2012 as compared to September 30, 2011. While the average total earning assets were only slightly higher by 2.4% or $19.7 million than the prior year, the decrease in interest income resulted primarily from the transition of the Company s earning assets from high yield to lower yield assets. 2011 was also boosted by the large collection of nonaccrual interest collected in the first quarter. As the table that follows confirms, the shift of funds within the interest earning portfolios from loans to investments and the collection of nonaccrual interest in 2011 caused a lower September 2012 yield in loans, thereby causing lower interest income. The increased volume in the security portfolio did offset the loss in interest income due to rate changes. However, the portfolio continues to have calls due to the low rate environment. Prepayment speeds remain high on mortgage-backed securities.

Overall, interest income from loans was down $2.1 million in comparing the nine months ended September 30, 2012 to same period 2011 which accounts for the overall drop in interest income of almost the same amount. This emphasizes the impact of declining loan balances and the need to find good loans with which to rebuild the portfolio. The overall asset yield decreased 42 basis points between the two periods.

The yields on tax-exempt securities and the portion of tax-exempt IDB loans included in loans have been tax adjusted based on a 34% tax rate in the charts to follow.

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Therefore, the Company determined that there is sufficient positive evidence to conclude that it is more likely than not that it will utilize its U.S. deferred tax assets. As a result of the valuation allowance release, a deferred tax asset of $11.9 million is reflected on the accompanying condensed consolidated balance sheet as of September 30, 2016. The related $11.9 million effect on the accompanying condensed consolidated statement of operations for the fiscal period ended September 30, 2016 is a non-cash income tax benefit.

The Company’s income tax expense and resulting effective tax rate are based upon the respective estimated annual effective tax rates applicable for the respective periods adjusted for the effects of items required to be treated as discrete to the period, including changes in the aforementioned valuation allowance, stock option expenses due to disqualifying disposition of incentive stock options, changes in tax laws, changes in estimated exposures for uncertain tax positions and other items.

Recent Accounting Pronouncements

In March 2016, the FASB issued ASU No. 2016-09, *Improvements to Employee Share-Based Payment Accounting,* to simplify several aspects of accounting for share-based payment transactions, including the following areas: accounting for excess tax benefits and tax deficiencies; classifying excess tax benefits on the statement of cash flows; accounting for forfeitures; classifying awards that permit share repurchases to satisfy statutory tax withholding requirements; classifying tax payments on behalf of employees on the statement of cash flows; and, for nonpublic entities only, determining the expected term and electing the intrinsic value measurement alternative for stock option awards. The new guidance is effective for public business entities in fiscal years beginning after December 15, 2016, and in the interim periods within those fiscal years. The guidance requires a mix of prospective, modified retrospective and retrospective transition. The Company is evaluating the impact of the accounting standard on its financial statements.

9

On February 25, 2016, the FASB released Accounting Standards Update (ASU) No. 2016-02, *Leases* to complete its project to overhaul lease accounting. The ASU codifies ASC 842, Leases, which will replace the guidance in ASC 840. The new guidance will require lessees to recognize most leases on the balance sheet for capital and operating leases. The new guidance is effective for public business entities in fiscal years beginning after December 15, 2018. The Company is evaluating the impact of the accounting standard on its financial statements.

The FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.* The new guidance is intended to improve the recognition and measurement of financial instruments. The ASU affects public and private companies, not-for-profit organizations, and employee benefit plans that hold financial assets or owe financial liabilities. The new guidance is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of the accounting standard on its financial statements.

The FASB issued ASU No. 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes* during November 2015*,* which simplifies the presentation of deferred income taxes. This ASU provides presentation requirements to classify deferred tax assets and liabilities as noncurrent in a statement of financial position. The standard is effective for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is permitted for any interim and annual financial statements that have not yet been issued. The ASU may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company early adopted this standard effective December 31, 2015 on a retrospective basis which resulted in a reclassification of our net current deferred tax asset to the net non-current deferred tax asset as of December 31, 2015. The adoption of this ASU had no impact on the balance sheet or income statement as the Company had a full valuation allowance as of December 31, 2015.

The FASB issued ASU No. 2015-11, *Inventory* in July 2015 to require entity to measure inventory at the lower of cost or market. Market could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. The Company early adopted this ASU which had no material impact on the financial statements.

In April 2015, the FASB issued ASU No. 2015-03, *Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs,* which requires the presentation of debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. ASU 2015-03 does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The Company early adopted this ASU which had no material impact on the financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606).* The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company continues to evaluate the impact of the accounting standard on its financial statements. The Company plans to adopt the new standards after December 15, 2017.

Note 3. Fair Value of Financial Instruments

The following table presents a summary of the Company's financial instruments measured at fair value on a recurring basis for the periods indicated (in thousands):

	As of September 30, 2016				As of December 31, 2015			
	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)	Total
Assets:								
Cash and cash equivalents	$55,907	$–	$ –	$55,907	$28,074	$–	$ –	$28,074
Restricted cash	4,285	–	–	4,285	4,719	–	–	4,719
Short term investments	47	–	–	47	7,886	–	–	7,886
Total assets	$60,239	$–	$ –	$60,239	$40,679	$–	$ –	$40,679
Liabilities:								
Bank acceptance payable	–	3,231	–	3,231	–	2,998	–	2,998
Total liabilities	$–	$3,231	$ –	$3,231	$–	$2,998	$ –	$2,998

The carrying value amounts of accounts receivable, prepaid expenses and other current assets, accounts payable, accrued expenses and other current liabilities approximate fair value because of the short-term maturity of these instruments. The carrying value of the term loans approximate fair value due to the variable interest rates.

Note 4. Earnings Per Share

Basic net income per share has been computed using the weighted-average number of shares of common stock outstanding during the period. Diluted net income per share has been computed using the weighted-average number of shares of common stock and dilutive potential common shares from stock options and restricted stock units/awards outstanding during the period.

The following table sets forth the computation of the basic and diluted net income (loss) per share for the periods indicated (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Numerator:				
Net income	$17,736	$2,700	$17,009	$8,114
Denominator:				
Weighted average shares used to compute net income per share				
Basic	17,151	15,869	17,058	15,220
Effective of dilutive securities	1,210	825	897	965
Diluted	18,361	16,694	17,954	16,185
Net income per share				
Basic	$1.03	$0.17	$1.00	$0.53
Diluted	$0.97	$0.16	$0.95	$0.50

There were no securities that were excluded from the computation of diluted net income per share.

Note 5. Inventories

Inventories, net of inventory writedowns, consist of the following for the periods indicated (in thousands):

	September 30, 2016	December 31, 2015
Raw materials	$ 7,326	$ 22,240
Work in process and sub-assemblies	28,852	30,766
Finished goods	18,741	13,232
	$ 54,919	$ 66,238

The lower of cost or market adjustment expensed for inventory for the three months ended September 30, 2016 and 2015 was $0.9 million for each period. The lower of cost or market adjustment expensed for inventory for the nine months ended September 30, 2016 and 2015 was $2.8 million and $2.2 million, respectively.

Note 6. Property, Plant & Equipment

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

	September 30, 2016	December 31, 2015
Land improvements	$ 863	$ 863
Building and improvements	67,716	27,255
Machinery and equipment	105,723	88,882
Furniture and fixtures	4,323	2,422
Computer equipment and software	6,526	5,615
Transportation equipment	244	294
	185,395	125,331
Less accumulated depreciation and amortization	(47,095)	(37,970)
	138,300	87,361
Construction in progress	1,115	21,237
Land	1,101	1,101
Property, plant and equipment, net	$ 140,516	$ 109,699

For the three months ended September 30, 2016 and 2015, depreciation expense of property, plant and equipment was $3.6 million and $2.3 million, respectively. For the nine months ended September 30, 2016 and 2015, depreciation expense of property, plant and equipment was $9.6 million and $6.4 million, respectively.

Included in depreciation expense was $2.1 million and $1.4 million recorded as cost of sales for the three months ended September 30, 2016 and 2015, respectively. Included in depreciation expense was $6.0 million and $3.8 million recorded as cost of sales for the nine months ended September 30, 2016 and 2015, respectively.

At September 30, 2016 and December 31, 2015, there was $167,000 and $121,000 of capitalized interest recorded in construction in progress and building, respectively.

Note 7. Intangible Assets, net

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

	September 30, 2016		
	Gross Amount	**Accumulated amortization**	**Intangible assets, net**
Patents	$5,894	$(1,893)	$4,001
Trademarks	14	(11)	3
Total intangible assets, net	$5,908	$(1,904)	$4,004

	December 31, 2015		
	Gross Amount	**Accumulated amortization**	**Intangible assets, net**
Patents	$5,446	$(1,551)	$3,895
Trademarks	14	(9)	5
Total intangible assets, net	$5,460	$(1,560)	$3,900

For the three months ended September 30, 2016 and 2015, amortization expense for intangible assets, included in general and administrative expenses on the income statement, was $115,000 and $104,000, respectively. For the nine months ended September 30, 2016 and 2015, amortization expense for intangible assets, included in general and administrative expenses on the income statement, was $337,000 and $305,000, respectively.

The remaining weighted average amortization period for intangible assets is approximately 9 years.

12

Note 8. Notes Payable and Long-Term Debt

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

	September 30, 2016	December 31, 2015
Revolving line of credit with a U.S. bank up to $40,000 with interest at LIBOR plus 2%, maturing June 30, 2018	$ 30,000	$ 23,000
Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 2%, maturing July 31, 2019	3,208	4,150
Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 2%, maturing June 30, 2020	9,750	2,000
Construction loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 2% maturing January 26, 2022	21,826	8,588
Revolving line of credit with a Taiwan bank up to $10,333 with interest based on the bank's corporate interest rate index plus 1.5%, or 1.70% maturing on November 30, 2016	6,303	2,588
Revolving line of credit with a Taiwan bank up to $6,600 with interest at Taiwan deposit index plus 0.41% or LIBOR plus 1.7% maturing on February 6, 2017	2,204	4,475
Revolving line of credit with a Taiwan bank up to $6,000 with interest at Taiwan Time Deposit Interest Rate Index plus 1% or LIBOR plus 1% maturing on November 27, 2016	1,983	3,407
Revolving line of credit with the Taiwan branch of a China bank up to $10,000 with interest at LIBOR plus 1.5% or Taiwan Interbank Offered Rate plus 0.9% , maturing March 15, 2017	6,856	9,418
Note payable to a finance company due in monthly installments with 4.5% interest, maturing May 27, 2018 and June 30, 2018	3,521	4,851
Note payable to a finance company due in monthly installments with 4% interest, maturing March 31, 2019	6,642	–
Revolving line of credit with a China bank up to $13,300 with interest of 3.15% for 3-month term	–	2,428
Total	92,293	64,905
Less current portion	(25,092)	(30,908)
Non-current portion	$ 67,201	$ 33,997

Bank Acceptance Notes Payable		
Bank acceptance notes issued to vendors with a zero percent interest rate, a 30% guarantee deposit of $730, and maturity dates ranging from October 2016 to January 2017	3,231	2,998

The current portion of long-term debt is the amount payable within one year of the balance sheet date of September 30, 2016. The one-month London Interbank Offered Rate (LIBOR) was 0.4939% on September 30, 2016.

Maturities of long-term debt are as follows for the future one-year periods ending September 30 (in thousands):

2017	$25,092
2018	8,137
2019	36,181
2020	3,681
2021	700
2022 thereafter	18,502
Total outstanding	$92,293

13

On June 24, 2016, the Company entered into a First Amendment to its Credit Agreement with East West Bank and Comerica Bank ("First Amendment"), a second lien deed of trust, multiple security agreements and promissory notes evidencing two credit facilities and a term loan originally entered into on June 30, 2015. The First Amendment increased the Company's revolving lines of credit from $25 million to $40 million, which mature on June 30, 2018, and retains a $10.0 million term loan maturing on June 30, 2020. The First Amendment also provides for an additional $10.0 million equipment term loan with a one year drawdown period commencing on April 1, 2016 and maturing five years from the closing date of the First Amendment. The interest rate on these loans was lowered by the First Amendment from the LIBOR Borrowing Rate plus 2.75% or 3.0% to LIBOR Borrowing Rate plus 2.0%. As of September 30, 2016, $30.0 million was outstanding under the revolving line of credit. As of September 30, 2016, $9.8 million was outstanding under the term loan.

The Company also has a term loan with East West Bank of $5.0 million with monthly payments of principal and interest that matures on July 31, 2019. As of September 30, 2016, the outstanding balance was $3.2 million.

On June 24, 2016, the Company executed a Change in Terms Agreement, Notice of Final Agreement and Modification of the Construction Loan Agreement ("Modification Agreement") to its Construction Loan Agreement with East West Bank for up to $22.0 million dollars to finance the construction of the Company's campus expansion plan in Sugar Land, Texas, originally dated January 26, 2015. Upon signing the original Construction Loan Agreement, the Company deposited $11.0 million into a restricted bank account for owner's contribution of construction costs. The Modification Agreement has a fifteen month draw down period with monthly interest payments commencing on February 26, 2015 and ending on July 31, 2016. Thereafter, the entire outstanding principal balance shall be converted to a sixty-six month term loan with principal and interest payments due monthly amortized over three hundred months. The first principal and interest payment commenced on August 26, 2016, and continue the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. The Company may pay without penalty all or a portion of the amount owed earlier than due. Under the Construction Loan Agreement, the loan bears interest at an annual rate based on the one-month LIBOR Borrowing Rate plus 2.75%, and the interest rate is reduced to LIBOR Borrowing Rate plus 2.0% under the Modification Agreement. As of September 30, 2016, there was $21.8 million outstanding under this loan agreement and there was $0.8 million in the restricted bank account.

On September 27, 2016, the Company executed a Change in Terms Agreement, Notice of Final Agreement and Second Modification to the Construction Loan Agreement ("Second Modifications") to its Construction Loan Agreement with East West Bank. The Second Modifications amends and restates in part the Company's Promissory Note and Construction

Loan Agreement which was originally executed on January 26, 2015, and the Modification Agreement. The draw down period end date, under the Second Modifications, is amended from July 31, 2016 to September 30, 2016. And thereafter, the entire outstanding principal balance shall be converted to a sixty-four (64) month term loan, amended from a sixty (66) month term loan, with principal and interest payments due monthly amortized over three hundred (300) months. The first principal and interest payment is due on October 26, 2016 and will continue on the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. Except as expressly changed by the Second Modifications, the terms of the original obligation and Modification Agreement remain unchanged.

The loan and security agreements with East West Bank and Comerica Bank require the Company to maintain certain financial covenants, including a minimum cash balance, a current ratio, a maximum leverage ratio and a minimum fixed charge coverage ratio. As of September 30, 2016, the Company was in compliance with all covenants contained in these agreements.

On February 19, 2016, the Company's Taiwan branch renewed and increased its credit facility originally dated January 6, 2015 with CTBC Bank Co. Ltd. in Taipei, Taiwan for 320 million New Taiwan dollars, or approximately $10.3 million, one year revolving credit facility. The obligations under the credit facility are unsecured up to $6.3 million; the remaining $4.0 million is available provided that the Company purchases the same amount of secured certificates of deposit with the bank. Borrowings under the credit facility bear interest at a rate based on the bank's corporate interest rate index plus 1.5% for the unsecured portion of the credit facility and bank's corporate interest rate index plus 0.93% for the secured portion of the credit facility, adjusted monthly. As of the execution of the credit facility, the bank's corporate interest rate index is 0.71%. As of September 30, 2016, no balance was outstanding for the secured loan and $6.3 million was outstanding under this unsecured credit facility.

On April 8, 2016, the Company's Taiwan branch renewed its 90 million New Taiwan dollars, or approximately $2.6 million, and 120 million New Taiwan dollars, or approximately $4.0 million, one year revolving credit facilities, originally dated March 9, 2015, with E. Sun Commercial Bank Co., Ltd. in Taipei, Taiwan. Borrowings under the 90 million New Taiwan dollars credit facility will bear interest at a rate equal to the LIBOR plus 1.7% divided by 0.946. Borrowings under the 120 million New Taiwan dollars credit facility will bear interest at a rate equal to the bank's personal monthly time deposit interest rate plus 0.480%. Any future borrowings under the 120 million New Taiwan dollars credit facility are available provided that the Company purchases certificates of deposit in amounts equal to the borrowing from the bank. As of September 30, 2016, no balance was outstanding under the 120 million New Taiwan dollars credit facility and $2.2 million was outstanding under the 90 million New Taiwan dollars credit facility.

14

On December 22, 2015, the Company’s Taiwan branch renewed its $4.0 million credit facility, originally dated December 20, 2013, and entered into a $2.0 million, one year revolving credit facility agreement with Mega International Commercial Bank (“Mega Bank”). Obligations under the $4.0 million credit facility are available provided that the Company purchases certificates of deposit in amounts equal to the borrowing from Mega Bank. Borrowings under the $4.0 million credit facility bear interest at a rate not less than the LIBOR borrowing rate plus 1.0%, divided by 0.946 for U.S. and other currency borrowings; New Taiwan dollars borrowings bear interest at a rate equal to the bank’s base lending rate plus 0.76%. Borrowings under the $2.0 million credit facility bear interest at a rate not less than the LIBOR borrowing rate plus 1.2%, divided by 0.946 for U.S. dollar borrowings; New Taiwan dollars borrowings bear interest at a rate equal to the bank’s base lending rate plus 0.76% but shall not be less than 1.90%; and other currency borrowings shall bear interest at a rate at the bank’s based lending rate plus 1.0%, divided by 0.946. As of September 30, 2016, $2.0 million was outstanding under the unsecured credit facility and no balance was outstanding under the $4.0 million credit facility.

On April 22, 2016, the Company’s Taiwan branch entered into a Comprehensive Credit Line Agreement originally dated April 1, 2015, with the Taipei branch of China Construction Bank, providing a revolving credit line of $10 million, maturing on March 15, 2017. Borrowings under the Comprehensive Credit Line Agreement are secured by a standby letter of credit issued by the China branch of the bank under existing agreements between the bank and the Company’s China subsidiary. Borrowings under the Comprehensive Credit Line Agreement reduce the amounts available under the existing credit line between the bank and the Company’s China subsidiary and cannot exceed 97% of the amount of the standby letter of credit issued by the China branch of the bank. Borrowings under the Comprehensive Credit Line Agreement bear interest at a rate negotiated separately for each drawing depending on the nature of the borrowings. As of September 30, 2016, $6.9 million was outstanding under this credit facility with interest rates at approximately 2.67%.

On June 30, 2015, the Company’s Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease Finance Co, Ltd. (“Chailease”) in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the sale contract, the Company's Taiwan branch sold certain equipment to Chailease for a purchase price of 115,240,903 New Taiwan dollars, approximately $3.7 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The monthly lease payments range from 2,088,804 New Taiwan dollars, approximately $0.1 million, to 2,364,650 New Taiwan dollars, approximately $0.1 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 40,240,903 New Taiwan dollars, approximately $1.3 million. The Finance Lease Agreement has a three year term, with monthly payments, maturing on May 27 and June 30, 2018 respectively. The title to the equipment will be transferred to the Company’s Taiwan branch upon the expiration of the Finance Lease Agreement. As of September 30, 2016, $3.5 million was outstanding under this Finance Lease Agreement.

On March 31, 2016, the Company's Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the Purchase and Sale Contract, the Company's Taiwan branch sold certain equipment to Chailease for a purchase price of 312,927,180 New Taiwan dollars, approximately $10.1 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The Finance Lease Agreement has a three year term with monthly lease payments range from 6,772,500 New Taiwan dollars, approximately $0.2 million, to 7,788,333 New Taiwan dollars, approximately $0.3 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 62,927,180 New Taiwan dollars, approximately $2.0 million. Based on the payments made under the Finance Lease Agreement, the annual interest rate is calculated to be 4.0%. The title to the equipment will be transferred to the Company's Taiwan branch upon the expiration of the Finance Lease Agreement. As of September 30, 2016, $6.6 million was outstanding under this Finance Lease Agreement.

As of September 30, 2016, the Company's Chinese subsidiary had credit facilities with China Construction Bank totaling $13.3 million, which can be drawn in U.S. currency, RMB currency, issuing bank acceptance notes to vendors with different interest rates or issuing standby letters of credit. As of September 30, 2016, the Company's Chinese subsidiary used $7.0 million of its credit facility and issued standby letters of credit as collateral for the Company's Taiwan branch line of credit with China Construction Bank. As of September 30, 2016, the Company had no outstanding balance for the U.S. currency based loan. The outstanding balances of bank acceptance notes issued to vendors were $3.2 million with zero interest rate as of September 30, 2016.

As of September 30, 2016, the Company had $24.1 million of unused borrowing capacity.

As of September 30, 2016, there was $4.9 million of restricted cash, investments or security deposit associated mainly with the loan facilities.

Note 9. Accrued Liabilities

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

	September 30, 2016	December 31, 2015
Accrued payroll	$ 6,139	$ 6,757
Accrued rent	939	792
Accrued employee benefits	1,526	1,379
Accrued state and local taxes	451	372
Accrued income taxes	177	–
Advance payments	386	1,258
Accrued product warranty	486	412
Accrued commission expenses	162	126
Accrued professional fees	221	81
Accrued other	829	329
	$ 11,316	$ 11,506

Note 10. Other Income and Expense

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

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Unrealized foreign exchange gain (loss)	$3,318	$(3,160)	$3,686	$(2,270)
Realized foreign exchange gain (loss)	(3,387)	393	(4,300)	552
Government subsidy income	125	3	145	202
Other non-operating gain	14	20	26	29
Loss on disposal of assets	(4)	(3)	(89)	(13)
	$66	$(2,747)	$(532)	$(1,500)

During the three and nine months ended September 30, 2016, $3.0 million of realized exchange loss was recognized when the company transferred assets and liabilities of its Taiwan branch office to Prime World International Holding Company, its wholly-owned subsidiary.

Note 11. Share-Based Compensation

Equity Plans

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

- the 1998 Share Incentive Plan
- the 2000 Share Incentive Plan
- the 2004 Share Incentive Plan
- the 2006 Share Incentive Plan
- the 2013 Equity Incentive Plan ("2013 Plan")

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

Stock Options

Options have been granted to the Company’s employees under the five incentive plans and generally become exercisable as to 25% of the shares on the first anniversary date following the date of grant and 12.5% on a semi-annual basis thereafter. All options expire ten years after the date of grant.

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

	Number of shares	Weighted Average Exercise Price	Weighted Average Share Price on Date of Exercise	Weighted Average Fair Value	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at January 1, 2016	1,310	$ 9.07		$ 4.59	–	$ 10,598
Exercised	(81)	6.79	$ 14.96	2.18	–	659
Forfeited	(9)	8.26		3.70	–	81
Outstanding at September 30, 2016	1,220	$ 9.23		$ 4.76	6.559	$ 15,839
Exercisable at September 30, 2016	965	$ 8.99		$ 4.60	6.460	$ 12,762
Vested and expected to vest	1,207	$ 9.22		$ 4.75	6.555	$ 15,686

As of September 30, 2016, there was approximately $1.2 million of unrecognized stock option expense, net of estimated forfeitures, which is expected to be recognized over 1 year.

Restricted Stock Units/Awards

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

	Number of	Weighted Average	Weighted Average	Aggregate Intrinsic

	shares	Share Price on Date of Release	Fair Value	Value
Outstanding at January 1, 2016	152		$ 11.20	$ 2,611
Granted	496		15.72	7,798
Released	(119)	$ 13.34	13.95	1,587
Cancelled/Forfeited	(6)		15.30	101
Outstanding at September 30, 2016	523		$ 14.81	$ 11,620
Exercisable at September 30, 2016	14		$ 11.41	$ 311
Vested and expected to vest	504		$ 14.80	$ 11,199

As of September 30, 2016, there was $6.9 million of unrecognized compensation expense related to these RSUs and RSAs. This expense is expected to be recognized over 3.12 years.

Share-Based Compensation

Employee share-based compensation expenses recognized for the periods indicated (in thousands):

	Three months ended September 30, 2016	Three months ended September 30, 2015	Nine months ended September 30, 2016	Nine months ended September 30, 2015
Share-Based compensation - by expense type				
Cost of sales	$53	$17	$140	$52
Research and development	165	55	437	165
Sales and marketing	97	58	264	162
General and administrative	732	387	1,989	1,188
	$1,047	$517	$2,830	$1,567

	Three months ended September 30, 2016	**Three months ended September 30,** 2015	**Nine months ended September 30,** 2016	**Nine months ended September 30,** 2015
Share-Based compensation - by award type				
Employee stock options	$374	$388	$1,111	$1,152
Restricted stock units/awards	673	129	1,719	415
	$1,047	$517	$2,830	$1,567

Note 12. Stockholders' Equity

Common Stock

The Company has authorized the issuance of up to 45,000,000 shares of common stock, all of which have been designated voting common stock, under its Amended and Restated Certificate of Incorporation.

Convertible Preferred Stock

The Company has authorized the issuance of up to 5,000,000 shares of preferred stock under the Company's Amended and Restated Certificate of Incorporation.

Public Offerings of Common Stock

On June 3, 2015, the Company filed a Securities Registration Statement on Form S-3 (the "Form S-3") with the Securities and Exchange Commission effective June 23, 2015, providing for the public offer and sale of certain securities of the Company from time to time, at its discretion, up to an aggregate amount of $140 million. In connection with the Company's Form S-3, the Company entered into an Equity Distribution Agreement with Raymond James & Associates, Inc. (the "sales agent") pursuant to which the Company may issue and sell shares of the Company's stock having an aggregate offering price of up to $40 million (the "ATM Offering") from time to time through the sales agent. The Company completed its ATM Offering in August 2015 and sold 1.9 million shares at a weighted average price of $21.54 per share, providing proceeds of $38.6 million, net of expenses and underwriting discounts and commissions.

Note 13. Geographic Information

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Revenues:				
United States	$7,277	$5,218	$15,314	$13,295
Taiwan	44,723	43,220	126,991	97,802
China	18,137	8,647	33,508	25,854
	$70,137	$57,085	$175,813	$136,951

	As of the period ended	
	September 30, 2016	**December 31,** 2015
Long-lived assets:		
United States	$61,891	$44,280
Taiwan	51,629	45,420
China	31,814	24,753
	$145,334	$114,453

Note 14. Subsequent Events

On October 17, 2016, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission, effective November 1, 2016, providing for the public offer and sale of certain securities of the Company from time to time, at its discretion, up to an aggregate amount of $250 million.

19

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q for the period ended September 30, 2016 and the audited consolidated financial statements and notes thereto and management's discussion and analysis of financial condition and results of operations for the fiscal year ended December 31, 2015 included in our Annual Report on Form 10-K. References to "Applied Optoelectronics" "we," "our" and "us" are to Applied Optoelectronics, Inc. and its subsidiaries unless otherwise specified or the context otherwise requires.

This Quarterly Report on Form 10-Q contains "forward-looking statements" that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Terminology such as "believe," "may," "estimate," "continue," "anticipate," "intend," "should," "could," "would," "target," "seek," "aim," "believe," "predicts," "think," "objectives," "optimistic," "new," "goal," "strategy," "potential," "is likely," "will," "expect," "plan" "project," "permit" or by other similar expressions that convey uncertainty of future events or outcomes are intended to identify forward-looking statements.

We have based these forward-looking statements largely on our current expectations and projections about future events and industry and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified in "Part II —Item 1A. Risk Factors" provided below, and those discussed in other documents we file with the SEC. Furthermore, such forward-looking statements speak only as of the date of this Quarterly Report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of this Quarterly Report.

Overview

We are a leading, vertically integrated provider of fiber-optic networking products, primarily for four networking end-markets: internet data center, cable television, or CATV, fiber-to-the-home, or FTTH, and telecommunication, or telecom. We design and manufacture a range of optical communications products at varying levels of integration, from components, subassemblies and modules to complete turn-key equipment. In designing products for our customers, we begin with the fundamental building blocks of lasers and laser components. From these foundational products, we design and manufacture a wide range of products to meet our customers' needs and specifications, and such products differ from each other by their end market, intended use and level of integration. We are primarily focused on the higher-performance segments within all four of our target markets, which increasingly demand faster connectivity and innovation.

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

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

We have three manufacturing sites: Sugar Land, Texas, Ningbo, China and Taipei, Taiwan. Our research and development functions are partnered with our manufacturing locations and we have an additional research and development center in Lawrenceville, Georgia. In our Sugar Land facility, we manufacture laser chips (utilizing our MBE process), subassemblies and components. The subassemblies are used in the manufacture of components by our other manufacturing facilities or sold to third parties as modules. We manufacture our laser chips only within our Sugar Land facility, where our laser design team is located. In our Taiwan location, we manufacture optical components, such as our butterfly lasers, which incorporate laser chips, subassemblies and components manufactured within our U.S. facility. In addition, in our Taiwan location, we manufacture transceivers for the internet data center, FTTH, telecom, and other markets. In our China facility, we take advantage of lower labor costs and manufacture certain more labor intensive components and optical equipment systems, such as optical subassemblies for the internet data center market, CATV transmitters (at the headend) and CATV outdoor equipment (at the node). Each manufacturing facility conducts testing on the components, modules or subsystems it manufactures and each such facility is certified to ISO 9001:2008. Our facilities in Ningbo, China, Taipei, Taiwan, and Sugar Land, TX are all certified to ISO 14001:2004.

Our sales model focuses on direct engagement and close coordination with our customers to determine product design, qualifications, and performance through coordination of our sales, product engineering and manufacturing teams. Our strategy is to use our direct sales force to sell to key accounts within our markets, increasing product penetration within those customers while also growing our overall customer base in certain international and domestic markets. We have direct sales personnel in each of our U.S., Taiwan and China locations focusing on a direct and local interaction with our CATV, FTTH, telecom and internet data center customers. Throughout our sales cycle, we work closely with our customers to achieve design wins that we believe provide long-lasting relationships and promote higher customer retention.

Our principal executive offices are located at 13139 Jess Pirtle Blvd., Sugar Land, TX 77478, and our telephone number is (281) 295-1800.

Results of Operations

The following table set forth our consolidated results of operations for the periods presented and as a percentage of our revenue for those periods (in thousands):

	Three months ended September 30, 2016		Three months ended September 30, 2015		Nine months ended September 30, 2016		Nine months ended September 30, 2015	
Revenue, net	$70,137	100.0%	$57,085	100.0%	$175,813	100.0%	$ 136,951	100.0%
Cost of goods sold	46,976	67.0%	39,032	68.4%	121,097	68.9%	92,116	67.3%
Gross profit	23,161	33.0%	18,053	31.6%	54,716	31.1%	44,835	32.7%
Operating expenses								
Research and development	8,362	11.9%	5,386	9.4%	24,572	13.9%	14,892	10.9%
Sales and marketing	1,594	2.3%	1,582	2.8%	4,884	2.8%	4,748	3.5%
General and administrative	6,445	9.2%	4,963	8.7%	18,084	10.3%	14,500	10.5%
Total operating expenses	16,401	23.4%	11,931	20.9%	47,540	26.9%	34,140	24.9%
Income from operations	6,760	9.6%	6,122	10.7%	7,176	4.2%	10,695	7.8%
Other income (expense)								
Interest income	40	0.1%	82	0.1%	206	0.1%	236	0.2%
Interest expense	(462)	-0.7%	(351)	-0.6%	(1,313)	-0.7%	(776)	-0.6%
Other income (expense), net	66	0.1%	(2,747)	-4.8%	(532)	-0.3%	(1,500)	-1.1%
Total other expense	(356)	-0.5%	(3,016)	-5.3%	(1,639)	-0.9%	(2,040)	-1.5%
Income before income taxes	6,404	9.1%	3,106	5.4%	5,537	3.3%	8,655	6.3%
Income tax (expense) benefit	11,332	16.2%	(406)	-0.7%	11,472	6.5%	(541)	-0.4%
Net income	$17,736	25.3%	$2,700	4.7%	$17,009	9.8%	$ 8,114	5.9%

21

Comparison of Financial Results

Revenue

We generate revenue through the sale of our products to equipment providers and network operators for the internet data center, CATV, FTTH and telecom markets. We derive a significant portion of our revenue from our top ten customers, and we anticipate that we will continue to do so for the foreseeable future. The following charts provide the revenue contribution from each of the markets we served for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
CATV	18.4%	24.9%	17.1%	31.2%
Data Center	75.5%	67.6%	75.8%	61.7%
FTTH	0.7%	1.7%	0.8%	1.7%
Telecom	4.9%	5.4%	5.7%	5.0%
Other	0.5%	0.4%	0.6%	0.4%
	100.0%	100.0%	100.0%	100.0%

	Three months ended September 30,		Change		Nine months ended September 30,		Change	
	2016	2015	Amount	%	2016	2015	Amount	%
CATV	$12,891	$14,233	$(1,342)	(9.4%)	$30,143	$42,675	$(12,532)	(29.4%)
Data Center	52,949	38,591	14,358	37.2%	133,209	84,517	48,692	57.6%
FTTH	476	962	(486)	(50.5%)	1,333	2,371	(1,038)	(43.8%)
Telecom	3,441	3,078	363	11.8%	10,082	6,867	3,215	46.8%
Other	380	221	159	71.9%	1,046	521	525	100.8%
Total Revenue	$70,137	$57,085	$13,052	22.9%	$175,813	$136,951	$38,862	28.4%

Growth in the three months ended September 30, 2016 was driven primarily by increasing revenue from our internet data center customers, and we also anticipate that our revenue derived from this market will continue to increase as a percentage of our revenue as we further penetrate and extend our products into this market.

During the third quarter of 2016 and nine months ended September 30, 2016, revenues in the internet data center market were driven primarily by increasing demand for our 40 gigabits per second and 100 Gbps transceivers as our customers continued to upgrade their technology infrastructure, partially offset by a decrease in demand for our older 10G products. The decrease in revenue in our FTTH market is due to a decline in demand for certain older legacy products. Demand for these legacy products is expected to continue to fluctuate. The decrease in revenues in the CATV market for the year was a result of lower demand from certain customers who resold our product into foreign markets where currencies had weakened. The increase in revenue in our telecom market is due to increased sales of products that were introduced within the last 12-18 months. These products are used in a variety of interconnect applications within telecom networks.

For the three and nine months ended September 30, 2016 and 2015, our top ten customers represented 95.5% and 95.2% of our revenue, respectively.

22

Cost of goods sold and gross margin

	Three months ended September 30,					
	2016		2015		Change	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
	(in thousands, except percentages)					
Cost of goods sold	$46,976	67.0%	$39,032	68.4%	$7,944	20.4%
Gross margin	23,161	33.0%	18,053	31.6%	5,108	28.3%

	Nine months ended September 30,					
	2016		2015		**Change**	
	Amount	**% of Revenue**	**Amount**	**% of Revenue**	**Amount**	**%**
	(in thousands, except percentages)					
Cost of goods sold	$121,097	68.9%	$92,116	67.3%	$28,981	31.5%
Gross margin	54,716	31.1%	44,835	32.7%	9,881	22.0%

Cost of goods sold increased by $7.9 million, or 20.4%, for the three months ended September 30, 2016, as compared to the three months ended September 30, 2015, primarily due to a 22.9% increase in sales over the prior year. The increase in gross margin for the three months ended September 30, 2016 compared to the same period ended September 30, 2015 was primarily the result of lower production costs associated with certain 40G and 100G products, along with increased revenue from our CATV products.

Operating expenses

	Three months ended September 30,					
	2016		2015		Change	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
	(in thousands, except percentages)					
Research and development	$8,362	11.9%	$5,386	9.4%	$2,976	55.3%
Sales and marketing	1,594	2.3%	1,582	2.8%	12	0.8%
General and administrative	6,445	9.2%	4,963	8.7%	1,482	29.9%
Total operating expenses	$16,401	23.4%	$11,931	20.9%	$4,470	37.5%

Nine months ended September 30,

	2016		2015		Change	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
	(in thousands, except percentages)					
Research and development	$24,572	14.0%	$14,892	10.9%	$9,680	65.0%
Sales and marketing	4,884	2.8%	4,748	3.5%	136	2.9%
General and administrative	18,084	10.3%	14,500	10.5%	3,584	24.7%
Total operating expenses	$47,540	27.0%	$34,140	24.9%	$13,400	39.3%

23

Research and development expense

Research and development expense increased by $3.0 million, or 55.3%, for the three months ended September 30, 2016 as compared to the three months ended September 30, 2015. For the nine months ended September 30, 2016, research and development expense increased $9.7 million, or 65.0% as compared to the nine months ended September 30, 2015. This increase was primarily due to increases in personnel costs, R&D work orders, R&D material usage and other project costs related to 40G and 100G data center products, DOCSIS 3.1-capable CATV products, including remote-PHY products, and other new product development, and an increase in depreciation expense resulting from additional R&D equipment investments, and additional depreciation expenses related to our new building in Sugar Land.

Sales and marketing expense

Sales and marketing expense remained unchanged for the three months ended September 30, 2016 as compared to the three months ended September 30, 2015. For the nine months ended September 30, 2016, sales and marketing expense increased $0.1 million as compared to the nine months ended September 30, 2015. This increase was due to an increase in personnel costs offset by a decrease in commissions paid to sales personnel.

General and administrative expense

General and administrative expense increased by $1.5 million, or 29.9%, for the three months ended September 30, 2016 compared to the three months ended September 30, 2015. For the nine months ended September 30, 2016, general and administrative expense increased by $3.6 million, or 24.7% as compared to the nine months ended September 30, 2015. This was primarily due to an increase in personnel costs, professional fees, share-based compensation, and overhead costs associated with our new building in Sugar Land.

Other income (expense), net

Three months ended September 30,		
2016	2015	Change

	Amount	% of Revenue	Amount	% of Revenue	Amount	%
	(in thousands, except percentages)					
Interest income	$40	0.1%	$82	0.1%	(42)	(51.2%)
Interest expense	(462)	(0.7%)	(351)	(0.6%)	(111)	31.6%
Other income (expense), net	66	0.1%	(2,747)	(4.8%)	2,813	102.4%
Total Other expense, net	$(356)	(0.5%)	$(3,016)	(5.3%)	$2,660	88.2%

	Nine months ended September 30,					
	2016		2015		Change	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
	(in thousands, except percentages)					
Interest income	$206	0.1%	$236	0.2%	$(30)	(12.7%)
Interest expense	(1,313)	(0.7%)	(776)	(0.6%)	(537)	69.2%
Other income (expense), net	(532)	(0.3%)	(1,500)	(1.1%)	968	64.5%
Total Other expense, net	$(1,639)	(0.9%)	$(2,040)	(1.5%)	$401	19.7%

24

Interest income decreased 51.2% for the three months ended September 30, 2016 as compared to the three months ended September 30, 2015 and decreased 12.7% for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015 due to lower cash balances during the period.

Interest expense increased 31.6% for the three months ended September 30, 2016 as compared to the three months ended September 30, 2015 and increased 69.2% for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015. This was due to borrowing activities to fund the expansion projects, including the expansion of our Sugar Land facility.

Other income (expense) increased by $2.8 million for the three months ended September 30, 2016 compared to the same period of the prior year due to unrealized exchange gains resulting from the favorable fluctuation of certain Asian currencies against the U.S. dollar. Other income (expense) increased by $1.0 million for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015 due to a $5.9 million increase in unrealized gain resulting from the favorable fluctuation of certain Asian currencies against the U.S. dollar, offset by a $4.9 million increase in realized exchange loss arising from foreign currency transactions. $3.0 million of realized exchange loss was recognized when the company transferred assets and liabilities of its Taiwan branch office to Prime World International Holding Company, its wholly-owned subsidiary. We qualify as a high-tech enterprise in China, as determined by the Chinese government, and are paid subsidies from time to time by the Chinese government to foster local high-tech manufacturing. We received $0.1 million of subsidies in each of the three and nine months ended September 30, 2016 compared to $0.0 and $0.2 million for the same periods in 2015.

Provision for income taxes

	Three months ended September 30,			
	2016	2015	Change	
	(in thousands, except percentages)			
Benefit (provision) for income taxes	$11,332	$(406)	$(11,738)	(2891.1%)

	Nine months ended September 30,			
	2016	2015	Change	
	(in thousands, except percentages)			
Benefit (provision) for income taxes	$11,472	$(541)	$(12,013)	(2220.5%)

We recorded an income tax benefit of $11.3 million and $11.5 million for the three and nine months ended September 30, 2016, respectively, as compared to a tax provision of $0.4 million and $0.5 million for the three and nine months ended September, 2015, respectively. The income tax benefit recorded in the three and nine months ended September 30, 2016 was related to the release of the valuation allowance previously recorded against deferred tax assets.

Liquidity and Capital Resources

From inception until our initial public offering in September 2013, we financed our operations through private sales of equity securities, cash generated from operations and from various lending arrangements. As of September 30, 2016, we had $24.1 million of unused borrowing capacity from all of our loan agreements. As of September 30, 2016, our cash, cash equivalents, restricted cash and short-term investments totaled $60.2 million. Cash and cash equivalents are held for working capital purposes and are invested primarily in money market or time deposit funds. We do not enter into investments for trading or speculative purposes. On October 17, 2016, we filed a Registration Statement on Form S-3 with the Securities and Exchange Commission, which was declared effective on November 1, 2016, providing for the public offer and sale of certain securities of the Company from time to time, at our discretion, up to an aggregate amount of $250 million.

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

	Nine months ended September 30,	
	2016	2015
Net cash provided by (used in) operating activities	$28,368	$(17,738)
Net cash used in investing activities	(31,906)	(35,657)
Net cash provided by financing activities	26,554	59,047
Effect of exchange rates on cash and cash equivalents	4,817	(235)
Net increase in cash and cash equivalents	$27,833	$5,417

Operating activities

For the nine months ended September 30, 2016, net cash provided by operating activities was $28.4 million. During the nine months ended September 30, 2016, we recorded net income of $17.0 million. The net income included non-cash charges, including depreciation and amortization of $9.9 million, share-based compensation expense of $2.8 million, non-cash increases to our inventory reserve account of $2.8 million, deferred income tax benefit of $11.9 million from the release of our valuation allowance and an unrealized exchange gain of $3.5 million. Cash provided by operating activities primarily related to a $9.4 million decrease in inventory related to sales orders and cash provided by the increase of accounts payable to our vendors of $3.9 million. These increases were offset by an increase in our accounts receivable of $5.4 million from the sale of our products in excess of collection of trade receivables.

For the nine months ended September 30, 2015, net cash used in operating activities was $17.7 million. During the nine months ended September 30, 2015, we recorded net income of $8.1 million. The net income included non-cash charges, including depreciation and amortization of $6.7 million, share-based compensation expense of $1.6 million and non-cash increases to our inventory reserve account of $2.2 million. Cash used in operating activities was primarily related to a $30.6 million increase in inventory related to sales orders, an increase of $9.8 million in our accounts receivable from the sale of our products, a decrease of $4.1 million in other current assets, offset by $1.7 million of cash provided by an increase in accounts payable to our vendors.

Investing activities

For the nine months ended September 30, 2016, net cash used in investing activities was $31.9 million mainly for the purchase of additional machinery and equipment and investment in construction of our U.S. plant of $40.3 million, offset by the maturity of short term investments of $7.7 million.

For the nine months ended September 30, 2015, net cash used in investing activities was $35.7 million, $31.9 million for the purchase of additional machinery and equipment and investment in construction of our U.S. plant and $2.4 million used to increase deposits and deferred charges.

Financing activities

For the nine months ended September 30, 2016, our financing activities provided $26.6 million in cash. We received $28.9 million in net long-term borrowings associated with our bank loans, offset by $4.0 million of principal payment. In addition, we received net $1.3 million cash from our line of credit facility and $0.3 million of net cash receipt from acceptances payable.

For the nine months ended September 30, 2015, our financing activities provided $59.0 million in cash. We received $21.8 million in net borrowings associated with our bank loans, $2.0 million in net proceeds from acceptances payable, offset by increased restricted cash of $3.1 million related to our bank loan requirements. We also received $38.7 million in net proceeds from our ATM Offering which was completed in August, 2015.

Loans and commitments

We have lending arrangements with several financial institutions, including a revolving line of credit and a term loan with East West Bank and Comerica Bank in the U.S., lines of credit and financing agreements for our Taiwan branch and several lines of credit arrangements for our China subsidiary. As of September 30, 2016, we had $24.1 million of unused borrowing capacity.

On June 24, 2016, we entered into a First Amendment to our Credit Agreement with East West Bank and Comerica Bank ("First Amendment"), a second lien deed of trust, multiple security agreements and promissory notes evidencing two credit facilities and a term loan originally entered into on June 30, 2015. The First Amendment increased our revolving lines of credit from $25 million to $40 million, which mature on June 30, 2018, and retains a $10.0 million term loan maturing on June 30, 2020. The First Amendment also provides for an additional $10.0 million equipment term loan with a one year drawdown period commencing on April 1, 2016 and maturing five years from the closing date of the First Amendment. The interest rate on these loans was lowered by the First Amendment from the LIBOR Borrowing Rate plus 2.75% or 3.0% to LIBOR Borrowing Rate plus 2.0%. As of September 30, 2016, $30.0 million was outstanding under the revolving line of credit. As of September 30, 2016, $9.8 million was outstanding under the term loan.

We also have a term loan with East West Bank of $5.0 million with monthly payments of principal and interest that matures on July 31, 2019. As of September 30, 2016, the outstanding balance was $3.2 million.

On June 24, 2016, we executed a Change in Terms Agreement, Notice of Final Agreement and Modification of the Construction Loan Agreement ("Modification Agreement") to our Construction Loan Agreement with East West Bank for up to $22.0 million dollars to finance the construction of the Company's campus expansion plan in Sugar Land, Texas, originally dated January 26, 2015. Upon signing the original Construction Loan Agreement, the Company deposited $11.0 million into a restricted bank account for owner's contribution of construction costs. The Modification Agreement has a fifteen month draw down period with monthly interest payments commencing on February 26, 2015 and ending on July 31, 2016. Thereafter, the entire outstanding principal balance shall be converted to a sixty-six month term loan with principal and interest payments due monthly amortized over three hundred months. The first principal and interest payment commenced on August 26, 2016, and continue the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. We may pay without penalty all or a portion of the amount owed earlier than due. Under the Construction Loan Agreement, the loan bears interest at an annual rate based on the one-month LIBOR Borrowing Rate plus 2.75%, and the interest rate is reduced to LIBOR Borrowing Rate plus 2.0% under the Modification Agreement. As of September 30, 2016, there was $21.8 million outstanding under this loan agreement and there was $0.8 million in the restricted bank account.

On September 27, 2016, we executed a Change in Terms Agreement, Notice of Final Agreement and Second Modification to the Construction Loan Agreement ("Second Modifications") to its Construction Loan Agreement with East West Bank. The Second Modifications amends and restates in part the Company's Promissory Note and Construction

Loan Agreement which was originally executed on January 26, 2015, and the Modification Agreement. The draw down period end date, under the Second Modifications, is amended from July 31, 2016 to September 30, 2016. And thereafter, the entire outstanding principal balance shall be converted to a sixty-four (64) month term loan, amended from a sixty (66) month term loan, with principal and interest payments due monthly amortized over three hundred (300) months. The first principal and interest payment is due on October 26, 2016 and will continue on the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. Except as expressly changed by the Second Modifications, the terms of the original obligation and the Modification Agreement remain unchanged.

The loan and security agreements with East West Bank and Comerica Bank require us to maintain certain financial covenants, including a minimum cash balance, a current ratio, a maximum leverage ratio and a minimum fixed charge coverage ratio. As of September 30, 2016, we were in compliance with all covenants contained in these agreements.

On February 19, 2016, our Taiwan branch renewed and increased its credit facility originally dated January 6, 2015 with CTBC Bank Co. Ltd. in Taipei, Taiwan for 320 million New Taiwan dollars, or approximately $10.3 million, one year revolving credit facility. The obligations under the credit facility are unsecured up to $6.3 million; the remaining $4.0 million is available provided that we purchase the same amount of secured certificates of deposit with the bank. Borrowings under the credit facility bear interest at a rate based on the bank’s corporate interest rate index plus 1.5% for the unsecured portion of the credit facility and bank’s corporate interest rate index plus 0.93% for the secured portion of the credit facility, adjusted monthly. As of the execution of the credit facility, the bank’s corporate interest rate index is 0.71%. As of September 30, 2016, no balance was outstanding for the secured loan and $6.3 million was outstanding under this unsecured credit facility.

On April 8, 2016, our Taiwan branch renewed its 90 million New Taiwan dollars, or approximately $2.6 million, and 120 million New Taiwan dollars, or approximately $4.0 million, one year revolving credit facilities, originally dated March 9, 2015, with E. Sun Commercial Bank Co., Ltd. in Taipei, Taiwan. Borrowings under the 90 million New Taiwan dollars credit facility will bear interest at a rate equal to the LIBOR plus 1.7% divided by 0.946. Borrowings under the 120 million New Taiwan dollars credit facility will bear interest at a rate equal to the bank’s personal monthly time deposit interest rate plus 0.480%. Any future borrowings under the 120 million New Taiwan dollars credit facility are available provided that we purchase certificates of deposit in amounts equal to the borrowing from the bank. As of September 30, 2016, we have no balance outstanding under the 120 million New Taiwan dollars credit facility and we have $2.2 million outstanding under the 90 million New Taiwan dollars credit facility.

27

On December 22, 2015, our Taiwan branch renewed its $4.0 million credit facility, originally dated December 20, 2013, and entered into a $2.0 million, one year revolving credit facility agreement with Mega International Commercial Bank ("Mega Bank"). Obligations under the $4.0 million credit facility are available provided that we purchase certificates of deposit in amounts equal to the borrowing from Mega Bank. Borrowings under the $4.0 million credit facility bear interest at a rate not less than the LIBOR borrowing rate plus 1.0%, divided by 0.946 for U.S. and other currency borrowings; New Taiwan dollars borrowings bear interest at a rate equal to the bank's base lending rate plus 0.76%. Borrowings under the $2.0 million credit facility bear interest at a rate not less than the LIBOR borrowing rate plus 1.2%, divided by 0.946 for U.S. dollar borrowings; New Taiwan dollars borrowings bear interest at a rate equal to the bank's base lending rate plus 0.76% but shall not be less than 1.90%; and other currency borrowings shall bear interest at a rate at the bank's based lending rate plus 1.0%, divided by 0.946. As of September 30, 2016, $2.0 million was outstanding under the unsecured credit facility and no balance was outstanding under the $4.0 million credit facility.

On April 22, 2016, our Taiwan branch entered into a Comprehensive Credit Line Agreement originally dated April 1, 2015, with the Taipei branch of China Construction Bank, providing a revolving credit line of $10 million, maturing on March 15, 2017. Borrowings under the Comprehensive Credit Line Agreement are secured by a standby letter of credit issued by the China branch of the bank under existing agreements between the bank and our China subsidiary. Borrowings under the Comprehensive Credit Line Agreement reduce the amounts available under the existing credit line between the bank and our China subsidiary and cannot exceed 97% of the amount of the standby letter of credit issued by the China branch of the bank. Borrowings under the Comprehensive Credit Line Agreement bear interest at a rate negotiated separately for each drawing depending on the nature of the borrowings. As of September 30, 2016, $6.9 million was outstanding under this credit facility with interest rates at approximately 2.67%..

On June 30, 2015, our Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease Finance Co, Ltd. ("Chailease") in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the sale contract, our Taiwan branch sold certain equipment to Chailease for a purchase price of 115,240,903 New Taiwan dollars, approximately $3.7 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The monthly lease payments range from 2,088,804 New Taiwan dollars, approximately $0.1 million, to 2,364,650 New Taiwan dollars, approximately $0.1 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 40,240,903 New Taiwan dollars, approximately $1.3 million. The Finance Lease Agreement has a three year term, with monthly payments, maturing on May 27 and June 30, 2018 respectively. The title to the equipment will be transferred to our Taiwan branch upon the expiration of the Finance Lease Agreement. As of September 30, 2016, $3.5 million was outstanding under this Finance Lease Agreement.

On March 31, 2016, our Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the Purchase and Sale Contract, our Taiwan branch sold certain equipment to Chailease for a purchase price of 312,927,180 New Taiwan dollars, approximately $10.1 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The Finance Lease Agreement has a three year term with monthly lease payments range from 6,772,500 New Taiwan dollars, approximately $0.2 million, to 7,788,333 New Taiwan dollars, approximately $0.3 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 62,927,180 New Taiwan dollars, approximately $2.0 million. Based on the payments made under the Finance Lease Agreement, the annual interest rate is calculated to be 4.0%. The title to the equipment will be transferred to our Taiwan branch upon the expiration of the Finance Lease Agreement. As of September 30, 2016, $6.6 million was outstanding under this Finance Lease Agreement.

As of September 30, 2016, our Chinese subsidiary had credit facilities with China Construction Bank totaling $13.3 million, which can be drawn in U.S. currency, RMB currency, issuing bank acceptance notes to vendors with different interest rates or issuing standby letters of credit. As of September 30, 2016, our Chinese subsidiary used $7.0 million of its credit facility and issued standby letters of credit as collateral for our Taiwan branch line of credit with China Construction Bank. As of September 30, 2016, we had no outstanding balance for the U.S. currency based loan. The outstanding balances of bank acceptance notes issued to vendors were $3.2 million with zero interest rate as of September 30, 2016.

As of September 30, 2016, there was $4.9 million of restricted cash, investments or security deposit associated mainly with the loan facilities.

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

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

28

Future liquidity needs

We believe that our existing cash and cash equivalents, and cash flows from our operating activities and borrowings from our lenders, will be sufficient to meet our anticipated cash needs for the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending to support our research and development efforts, the expansion of our sales and marketing activities, the introduction of new and enhanced products, the expansion of our manufacturing capacity and the continuing market acceptance of our products. In the event that additional liquidity is required to meet our long-term investments, we may need to explore additional sources of liquidity by additional bank credit facilities or raising capital through additional equity or debt financing including our equity financing under our Registration Statement filed with the SEC in October 2016. The sale of additional equity or debt security could result in additional dilution to our stockholders, and its terms and prices may not be acceptable to us. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

Contractual Obligations and Commitments

The following summarizes our contractual obligations as of September 30, 2016 (in thousands):

	Payments due by period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Bank acceptance payable and long-term debt(1)	$95,524	$28,323	$44,319	$4,381	$18,501
Operating leases(2)	13,039	913	2,893	5,187	4,046
Total commitments	$108,563	$29,236	$47,212	$9,568	$22,547

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

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

Inflation

We believe that the relatively low rate of inflation in the U.S. over the past few years has not had a significant impact on our sales or operating results or on the prices of raw materials. However, an increase in the rate of inflation in the future may have an adverse effect on our levels of gross profit if material prices rise and if sales prices for our products do not proportionately increase. Changes in the proportion of our operations in China or Taiwan may result in the rate of inflation having a more significant impact on our operating results in the future.

Off-Balance Sheet Arrangements

For the three and nine months ended September 30, 2016, we did not, and we do not currently, have any off-balance sheet arrangements.

Critical Accounting Policies and Estimates

In our annual report on Form 10-K for the year ended December 31, 2015 and in the Notes to the Financial Statements herein, we identify our most critical accounting policies. In preparing the financial statements, we make assumptions, estimates and judgments that affect the amounts reported. We periodically evaluate our estimates and judgments that are most critical in nature which are related to revenue recognition under long-term construction contracts; allowance for doubtful accounts; inventory reserves; impairment of long-lived assets (excluding goodwill and other indefinite-lived intangible assets); goodwill and other indefinite-lived intangible assets; purchase price allocation of acquisitions; service and product warranties; and income taxes. Our estimates are based on historical experience and on our future expectations that we believe are reasonable. The combination of these factors forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results are likely to differ from our current estimates and those differences may be material.

JOBS Act

The Jumpstart Our Business Startups Act of 2012, or JOBS Act, contains provisions that, among other things, reduce certain reporting requirements for qualifying public companies. As defined in the JOBS Act, a public company whose initial public offering of common equity securities occurred after December 8, 2011 and whose annual gross revenues are less than $1.0 billion will, in general, qualify as an "emerging growth company" until the earliest of:

- the last day of its fiscal year following the fifth anniversary of the date of its initial public offering of common equity securities;
- the last day of its fiscal year in which it has annual gross revenue of $1.0 billion or more;
- the date on which it has, during the previous three-year period, issued more than $1.0 billion in non-convertible debt; and
- the date on which it is deemed to be a "large accelerated filer," which will occur at such time as the company (a) has an aggregate worldwide market value of common equity securities held by non-affiliates of $700 million or more as of the last business day of its most recently completed second fiscal quarter, (b) has been required to file annual and quarterly reports under the Exchange Act for a period of at least 12 months and (c) has filed at least one annual report pursuant to the Securities Act of 1934, as amended.

Under this definition, we are an "emerging growth company" and could remain one until as late as December 31, 2018.

As an "emerging growth company" we have chosen to rely on such exemptions and are therefore not required to, among other things, (i) provide an auditor's attestation report on our system of internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, (ii) provide all of the compensation disclosure that may be required of non-emerging growth public companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act, (iii) comply with any requirement that may be adopted by the Public Company Accounting Oversight Board, or PCAOB, regarding mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements (auditor discussion and analysis) and (iv) disclose certain executive compensation-related items such as the correlation between executive compensation and performance and comparisons of the Chief Executive Officer's compensation to median employee compensation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

For quantitative and qualitative disclosures about market risk affecting the Company, see Item 7A – Quantitative and Qualitative Disclosures about Market Risk in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. We do not believe the Company's exposure to market risk has changed materially since December 31, 2015.

Item 4. Controls and Procedures

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2016. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three month period covered by this Quarterly Report on Form 10-Q, which were identified in connection with management's evaluation required by the Rules 13a-15(d) and 15d-15(d) under the Exchange Act that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

30

Part II. Other Information

Item 1. Legal Proceedings

As of September 30, 2016, we were not involved in any material pending legal proceedings.

Item 1A. Risk Factors

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

Risks Inherent in Our Business

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

We generate much of our revenue from a limited number of customers. In 2015, 2014 and 2013 and the three and nine months ended September 30, 2016, our top ten customers represented 88.7%, 87.2%, 76.9%, 95.5% and 95.2% of our revenue, respectively. In 2015, Amazon represented 52.5% of our revenue, Microsoft represented 11.6% of our revenue, and Cisco represented 10.4% of our revenue. As a result, the loss of, or a significant reduction in orders from any of our key customers would materially and adversely affect our revenue and results of operations. We typically do not have long-term contracts with our customers and instead rely on recurring purchase orders. If our key customers do not continue to purchase our existing products or fail to purchase additional products from us, our revenue would decline and our results of operations would be adversely affected.

Adverse events affecting our key customers could also negatively affect our ability to retain their business and obtain new purchase orders, which could adversely affect our revenue and results of operations. For example, in recent years, there has been consolidation among various network equipment manufacturers and this trend is expected to continue. For example, in January 2016, Arris Group Inc. (“Arris”) completed its purchase of Pace Plc (“Pace”). Pace and Arris have historically been our customers, and if we fail to achieve historical levels of sales of our products to the new entity, the loss or reduction in sales could have an adverse effect on our business, financial condition, results of operations, and cash flows. We are unable to predict the impact that industry consolidation would have on our existing or potential customers. We may not be able to offset any potential decline in revenue arising from the consolidation of our existing customers with revenue from new customers or additional revenue from the merged company.

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

We make planning and spending decisions, including determining the levels of business that we will seek and accept, production schedules, component procurement commitments, personnel needs and other resource requirements, based on our estimates of product demand and customer requirements. Our products are typically purchased pursuant to individual purchase orders. While our customers may provide us with their demand forecasts, they are typically not contractually committed to buy any quantity of products beyond firm purchase orders. Furthermore, many of our customers may increase, decrease, cancel or delay purchase orders already in place without significant penalty. The short-term nature of commitments by our customers and the possibility of unexpected changes in demand for their products reduce our ability to accurately estimate future customer requirements. On occasion, customers may require rapid increases in production, which can strain our resources, cause our manufacturing to be negatively impacted by materials shortages, necessitate more onerous procurement commitments and reduce our gross margin. We may not have sufficient capacity at any given time to meet the volume demands of our customers, or one or more of our suppliers may not have sufficient capacity at any given time to meet our volume demands. If any of our major customers decrease, stop or delay purchasing our products for any reason, we will likely have excess manufacturing capacity or inventory and our business and results of operations would be harmed.

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

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

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

Our ability to successfully qualify and scale capacity for new technologies and products is important to our ability to grow our business and market presence, and we may invest a significant amount to scale our capacity to meet potential demand from customers for our new technologies and products. If we are unable to qualify and sell any of our new products in volume, on time, or at all, our results of operations may be adversely affected.

We face intense competition which could negatively impact our results of operations and market share.

The markets into which we sell our products are highly competitive. Our competitors range from large, international companies offering a wide range of products to smaller companies specializing in niche markets. Current and potential competitors may have substantially greater name recognition, financial, marketing, research and manufacturing resources than we do, and there can be no assurance that our current and future competitors will not be more successful than us in specific product lines or markets. Some of our competitors may also have better-established relationships with our current or potential customers. Some of our competitors have more resources to develop or acquire new products and technologies and create market awareness for their products and technologies. In addition, some of our competitors have the financial resources to offer competitive products at below-market pricing levels that could prevent us from competing effectively and result in a loss of sales or market share or cause us to lower prices for our products. In recent years, there has been consolidation in our industry and we expect such consolidation to continue. Consolidation involving our competitors could result in even more intense competition. Network equipment manufacturers, who are our customers, and network service providers may decide to manufacture the optical subsystems incorporated into their network systems in-house instead of outsourcing such products to companies such as us. We also encounter potential customers that, because of existing relationships with our competitors, are committed to the products offered by our competitors.

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

The markets for our products are characterized by frequent new product introductions, changes in customer requirements and evolving industry standards, all with an underlying pressure to reduce cost and meet stringent reliability and qualification requirements. Our future performance will depend on our successful development, introduction and market acceptance of new and enhanced products that address these challenges. If we are unable to make our new or enhanced products commercially available on a timely basis, we may lose existing and potential customers and our financial results would suffer.

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

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

32

Product development delays may result from numerous factors, including:

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

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

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

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

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

In each of our target markets, including the CATV market, our sales depend on the aggregate capital expenditures of service providers as they build out and upgrade their network infrastructure. These markets are highly cyclical and characterized by constant and rapid technological change, price erosion, evolving standards and wide fluctuations in product supply and demand. In the past, these markets have experienced significant downturns, often connected with, or in anticipation of, the maturation of product cycles. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. Our historical results of operations have been subject to these cyclical fluctuations, and we may experience substantial period-to-period fluctuations in our future results of operations. Any future downturn in any of the markets in which we compete could significantly reduce the demand for our products and therefore may result in a significant reduction in our revenue. Our revenue and results of operations may be materially and adversely affected in the future due to changes in demand from individual customers or cyclical changes in any of the markets utilizing our products. We may not be able to accurately predict these cyclical fluctuations and the impact of these fluctuations may have on our revenue and operating results.

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

Historically, we have generated much of our revenue from the CATV market. In 2015, 2014 and 2013, the CATV market represented 28.3%, 36.3% and 60.4% of our revenue, respectively. In the CATV market, we are relying on expected increasing demand for bandwidth-intensive services and applications such as on-demand television programs, high-definition television channels, or HDTV, social media, peer-to-peer file sharing and online video creation and viewing from network service providers. Without network and bandwidth growth, the need for our products will not increase and may decline, adversely affecting our financial condition and results of operations. Although demand for broadband access is increasing, network and bandwidth growth may be limited by several factors, including an uncertain regulatory environment, high infrastructure costs to purchase and install equipment and uncertainty as to which competing content delivery solution, such as telecommunications, wireless or satellite, will gain the most widespread acceptance. If the trend of outsourcing for the design and manufacture of CATV equipment does not continue, or continues at a slower pace than currently expected, our customers' demand for our design and manufacturing services may not grow as quickly as expected. If expectations for the growth of the CATV market are not realized, our financial condition or results of operations will be adversely affected. In addition, if the CATV market is adversely impacted, whether due to competitive pressure from telecommunication service providers, regulatory changes, or otherwise, our business would be adversely affected. We may not be able to offset any potential decline in revenue from the CATV market with revenue from new customers in other markets.

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

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

We expanded to new facilities in our Sugar Land, TX location. These facilities will add significant additional costs and if we fail to adequately utilize the additional production

capacity, our results of operations will suffer.

In 2015, we began construction of two new buildings located immediately adjacent to our existing headquarters building in Sugar Land, TX. The construction of these two new buildings was completed in May, 2016. The estimated cost of construction for these new facilities is approximately $33 million, and we expect to invest significant additional resources to add production equipment to the new facilities. Much of this equipment must be ordered far in advance of its delivery date, and accordingly we must make the decision to purchase equipment long before we see additional orders for our products. While we endeavor to order equipment that is flexible in utilization, if we over-estimate aggregate demand for our products, or if we fail to accurately predict the types of products that customers will demand in the future, we may be forced to under-utilize this equipment, which could result in asset impairment charges, additional costs to reconfigure equipment to be used in other production, or other charges that would negatively affect our results of operations. Any delay to our start-up schedule for this new equipment could cause us to have insufficient production capacity to meet customer orders.

We have limited operating history in the FTTH market, and our business could be harmed if this market does not develop as we expect.

For 2015 and 2014, respectively, we generated 1.3%, and 10.4% of our revenue from the FTTH market. We have only recently begun offering products to the FTTH market, and our WDM-PON products designed for this market have not yet, and may never, gain widespread acceptance by large internet service providers. Our business in this market is dependent on the deployment of our optical components, modules and subassemblies. We are relying on increasing demand for bandwidth-intensive services and telecommunications service providers' acceptance and deployment of WDM-PON as a technology supporting 1 gigabit per second service to the home. Without network and bandwidth growth and adoption of our solutions by operators in these markets, we will not be able to sell our products in these markets in high volume or at our targeted margins, which would adversely affect our financial condition and results of operations. For example, WDM-PON technology may not be adopted by equipment and service providers in the FTTH market as rapidly as we expect or in the volumes we need to achieve acceptable margins. Network and bandwidth growth may be limited by several factors, including an uncertain regulatory environment, high infrastructure costs to purchase and install equipment and uncertainty as to which competing content delivery solution, such as CATV, will gain the most widespread acceptance. In addition, as we enter new markets or expand our product offerings in existing markets, our margins may be adversely affected due to competition in those markets and commoditization of competing products. If our expectations for the growth of these markets are not realized, our financial condition or results of operations will be adversely affected.

34

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

We may experience delays, disruptions or quality control problems in our manufacturing operations. These and other factors may cause less than acceptable yields at our wafer fabrication facility. Manufacturing yields depend on a number of factors, including the quality of available raw materials, the degradation or change in equipment calibration and the rate and timing of the introduction of new products. Changes in manufacturing processes required as a result of changes in product specifications, changing customer needs and the introduction of new product lines may significantly reduce our manufacturing yields, resulting in low or negative margins on those products. In addition, we use our Molecular Beam Epitaxy, or MBE, fabrication process to make our lasers, in addition to Metal Organic Chemical Vapor Deposition, or MOCVD, the technique most commonly used in optical manufacturing by communications optics vendors, and our MBE fabrication process relies on custom-manufactured equipment. If our MBE or MOCVD fabrication facility in Sugar Land, Texas were to be damaged or destroyed for any reason, our manufacturing process would be severely disrupted. Any such manufacturing problems would likely delay product shipments to our customers, which would negatively affect our sales, competitive position and reputation. We may also experience delays in production, typically in February, during the Chinese New Year holiday when our facilities in China and Taiwan are closed.

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

We have a high fixed cost base due to our vertically integrated business model, including the fact that 1,960 of our employees as of December 31, 2015 were employed in manufacturing and research and development operations. We may not be able to adjust these fixed costs quickly to adapt to rapidly changing market conditions. Our gross profit and gross margin are greatly affected by our sales volume and volatility on a quarterly basis and the corresponding absorption of fixed manufacturing overhead expenses. In addition, because we are a vertically integrated manufacturer, insufficient demand for our products may subject us to the risk of high inventory carrying costs and increased inventory obsolescence. Given our vertical integration, the rate at which we turn inventory has historically been low when compared to our cost of sales. We do not expect this to change significantly in the future and believe that we will have to maintain a relatively high level of inventory compared to our cost of sales. As a result, we continue to expect to have a significant amount of working capital invested in inventory. We may be required to write down inventory costs in the future and our high inventory costs may have an adverse effect on our gross profits and our results of operations.

We have a history of losses and have a substantial accumulated deficit.

We have a history of losses and have a substantial accumulated deficit. In the years ended December 31, 2013 and 2012, we experienced net losses of $1.4 million and $0.9 million, respectively. In 2014 and 2015, we experienced profit of $4.3 million and $10.8 million, respectively. As of December 31, 2015 and 2014, our accumulated deficit was $68.2 million and $79.0 million, respectively. Our losses in past years were due to expenditures made to expand our business, including expenditures for hiring additional research and development, and sales and marketing personnel, and expenditures to expand and maintain our manufacturing facilities and research and development operations. We expect to continue to make significant expenditures related to our business, including expenditures for hiring additional research and development, and sales and marketing personnel, and expenditures to maintain and expand our manufacturing facilities and research and development operations. In addition, we have incurred significant additional time demands and legal, accounting and other expenses since we became a public company in September 2013. Our management and other personnel devote a substantial amount of time to complying with the applicable rules and requirements of being a public company.

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

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

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

- changes in accounting rules;
- the evolving and unpredictable nature of the markets for products incorporating our solutions; and
- general economic conditions and changes in such conditions specific to our target markets.

36

The foregoing factors are difficult to forecast, and these, as well as other factors, could materially adversely affect our quarterly and annual operating results. In addition, a significant amount of our operating expenses is relatively fixed in nature due to our internal manufacturing, research and development, sales and general administrative efforts. Any failure to adjust spending quickly enough to compensate for a revenue shortfall could magnify the adverse impact of such revenue shortfall on our results of operations. For these reasons, you should not rely on quarter-to-quarter comparisons of our results of operations as an indicator of future performance. Moreover, our operating results may not meet our announced guidance or the expectations of research analysts or investors, in which case the price of our common stock could decrease significantly. There can be no assurance that we will be able to successfully address these risks.

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

The continued services of our executive officers and other key engineering, sales, marketing, manufacturing and support personnel is essential to our success. For example, our ability to achieve new design wins depends upon the experience and expertise of our engineers. Any of our key employees, including our Chief Executive Officer, Chief Financial Officer, Senior Vice President of Network Equipment Module Business Unit, Senior Vice President of Optical Module Division and Asia General Manager, may resign at any time. We do not have key person life insurance policies covering any of our employees. To implement our business plan, we also intend to hire additional employees, particularly in the areas of engineering, manufacturing and sales. Our ability to continue to attract and retain highly skilled employees is a critical factor in our success. Competition for highly skilled personnel is intense. We may not be successful in attracting, assimilating or retaining qualified personnel to satisfy our current or future needs. Our ability to develop, manufacture and sell our products, and thus our financial condition and results of operations, would be adversely affected if we are unable to retain existing personnel or hire additional qualified personnel.

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

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

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

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

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

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

Our products are complex and undergo quality testing as well as formal qualification by our customers. Our customers' testing procedures are limited to evaluating our products under likely and foreseeable failure scenarios and over varying amounts of time. For various reasons, such as the occurrence of performance problems that are unforeseeable in testing or that are detected only when products age or are operated under peak stress conditions, our products may fail to perform as expected long after customer acceptance. Failures could result from faulty components or design, problems in manufacturing or other unforeseen reasons. As a result, we could incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. Our products are typically embedded in, or deployed in conjunction with, our customers' products, which incorporate a variety of components, modules and subsystems and may be expected to interoperate with modules produced by third parties. As a result, not all defects are immediately detectable and when problems occur, it may be difficult to identify the source of the problem. While we have not experienced material failures in the past, we will continue to face this risk going forward because our products are widely deployed in many demanding environments and applications worldwide. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty to maintain customer relationships. Any significant product failure could result in litigation, damages, repair costs and lost future sales of the affected product and other products, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems, all of which would harm our business. Although we carry product liability insurance, this insurance may not adequately cover our costs arising from defects in our products or otherwise.

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

We currently derive, and expect to continue to derive, a significant portion of our revenue from sales to international customers. In 2015, 2014 and 2013, 19.0%, 29.5% and 41.0% of our revenue was derived from sales that occurred outside of North America, respectively. In addition, a significant portion of our manufacturing operations is based in Ningbo, China and Taipei, Taiwan. Our international revenue and operations are subject to a number of material risks, including:

- difficulties in staffing, managing and supporting operations in more than one country;
- difficulties in enforcing agreements and collecting receivables through foreign legal systems;

- fewer legal protections for intellectual property in foreign jurisdictions;
- foreign and U.S. taxation issues and international trade barriers;
- difficulties in obtaining any necessary governmental authorizations for the export of our products to certain foreign jurisdictions;
- fluctuations in foreign economies;
- fluctuations in the value of foreign currencies and interest rates;
- trade and travel restrictions;
- domestic and international economic or political changes, hostilities and other disruptions in regions where we currently operate or may operate in the future;
- difficulties and increased expenses in complying with a variety of U.S. and foreign laws, regulations and trade standards, including the Foreign Corrupt Practices Act; and
- different and changing legal and regulatory requirements in the jurisdictions in which we currently operate or may operate in the future.

Negative developments in any of these factors in China or Taiwan or other countries could result in a reduction in demand for our products, the cancellation or delay of orders already placed, difficulties in producing and delivering our products, threats to our intellectual property, difficulty in collecting receivables, and a higher cost of doing business. Although we maintain certain compliance programs throughout the company, violations of U.S. and foreign laws and regulations may result in criminal or civil sanctions, including material monetary fines, penalties and other costs against us or our employees, and may have a material adverse effect on our business.

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

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

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

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

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

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

We have lending arrangements with several financial institutions, including loan agreements with East West Bank and Comerica Bank in the U.S., and our Taiwan location and China subsidiary have several lines of credit arrangements. Our loan agreements governing our long-term debt obligations in the U.S. contain certain financial and operating covenants that limit our management’s discretion with respect to certain business matters. Among other things, these covenants require us to maintain certain financial ratios and restrict our ability to incur additional debt, create liens or other encumbrances, change the nature of our business, pay dividends, sell or otherwise dispose of assets and merge or consolidate with other entities. These restrictions may limit our flexibility in responding to business opportunities, competitive developments and adverse economic or industry conditions. Any failure by us or our subsidiaries to comply with these agreements could harm our business, financial condition and operating results. In addition, our obligations under our loan agreements with East West Bank and Comerica Bank are secured by substantially all of our U.S. assets. A breach of any of covenants under our loan agreements, or a failure to pay interest or indebtedness when due under any of our credit facilities, could result in a variety of adverse consequences, including the acceleration of our indebtedness.

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

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

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

If we raise additional funds through the issuance of our common stock or convertible securities, the ownership interests of our stockholders could be significantly diluted. These newly issued securities may have rights, preferences or privileges senior to those of existing stockholders. Additional financing may not, however, be available on terms favorable to us, or at all, if and when needed, and our ability to fund our operations, take advantage of unanticipated opportunities, develop or enhance our infrastructure or respond to competitive pressures could be significantly limited. If we cannot raise required capital when needed, including under our Registration Statement filed with the SEC in October 2016, we may be unable to meet the demands of existing and prospective customers, adversely affecting our sales and market opportunities and consequently our business, financial condition and results of operations.

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

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

- difficulties integrating the acquired business;
-

unanticipated costs, capital expenditures or liabilities or changes related to research in progress and product development;
- diversion of financial and management resources from our existing business;
- difficulties integrating the business relationships with suppliers and customers of the acquired business with our existing business relationships;
- risks associated with entering markets in which we have little or no prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

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

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

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

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

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

40

Foreign currency fluctuations may adversely affect our revenue and our costs and expenses, and hence our results of operations. The value of the NT dollar or the RMB against the U.S. dollar and other currencies may fluctuate and be affected by, among other things, changes in political and economic conditions. The RMB currency is no longer being pegged solely to the value of the U.S. dollar. In the long term, the RMB may appreciate or depreciate significantly in value against the U.S. dollar, depending upon the fluctuation of the basket of currencies against which it is currently valued, or it may be permitted to enter into a full float, which may also result in a significant appreciation or depreciation of the RMB against the U.S. dollar. In addition, our currency exchange variations may be magnified by Chinese exchange control regulations that restrict our ability to convert RMB into foreign currency.

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

To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedging transactions may be limited and we may not be able to successfully hedge our exposure.

Natural disasters or other catastrophic events could harm our operations.

Our operations in the U.S., China and Taiwan could be subject to significant risk of natural disasters, including earthquakes, hurricanes, typhoons, flooding and tornadoes, as well as other catastrophic events, such as epidemics, terrorist attacks or wars. For example, our corporate headquarters and wafer fabrication facility in Sugar Land, Texas, is located near the Gulf of Mexico, an area that is susceptible to hurricanes. We use a proprietary MBE laser manufacturing process that requires customized equipment, and this process is currently conducted and located solely at our wafer fabrication facility in Sugar Land, Texas, such that a natural disaster, terrorist attack or other catastrophic event that affects that facility would materially harm our operations. In addition, our manufacturing facility in Taipei, Taiwan, is susceptible to typhoons and earthquakes, and our manufacturing facility in Ningbo, China, has from time to time, suffered electrical outages. Any disruption in our manufacturing facilities arising from these and other natural disasters or other catastrophic events could cause significant delays in the production or shipment of our products until we are able to shift production to different facilities or arrange for third parties to manufacture our products. We may not be able to obtain alternate capacity on favorable terms or at all. Our property insurance coverage with respect to natural disaster is limited and is subject to deductible and coverage limits. Such coverage may not be adequate or continue to be available at commercially reasonable rates and terms. The occurrence of any of these circumstances may adversely affect our financial condition and results of operation.

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

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

Policing unauthorized use of our technology is difficult and we cannot be certain that the steps we have taken will prevent the misappropriation, unauthorized use or other infringement of our intellectual property rights. Further, we may not be able to effectively protect our intellectual property rights from misappropriation or other infringement in foreign countries where we have not applied for patent protections, and where effective patent, trademark, trade secret and other intellectual property laws may be unavailable, or may not protect our proprietary rights as fully as U.S. law. We may seek to secure comparable intellectual property protections in other countries. However, the level of protection afforded by patent and other laws in other countries may not be comparable to that afforded in the U.S.

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

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

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

Participants in the markets in which we sell our products have experienced frequent litigation regarding patent and other intellectual property rights. While we have a policy in place that is designed to reduce the risk of infringement of intellectual property rights of others and we have conducted a limited review of other companies' relevant patents, there can be no assurance that third parties will not assert infringement claims against us. We cannot be certain that our products would not be found infringing on the intellectual property rights of others. Regardless of their merit, responding to such claims can be time consuming, divert management's attention and resources and may cause us to incur significant expenses. Intellectual property claims against us could force us to do one or more of the following:

·

obtain from a third party claiming infringement a license to the relevant technology, which may not be available on reasonable terms, or at all;
- stop manufacturing, selling, incorporating or using our products that use the challenged intellectual property;
- pay substantial monetary damages; or
- expend significant resources to redesign the products that use the technology and to develop non-infringing technology.

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

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

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

From time to time we may choose to or be required to license technology or intellectual property from third parties in connection with the development of our products. We cannot assure you that third party licenses will be available to us on commercially reasonable terms, if at all. Generally, a license, if granted, would include payments of up-front fees, ongoing royalties or both. These payments or other terms could have a significant adverse impact on our results of operations. Our inability to obtain a necessary third party license required for our product offerings or to develop new products and product enhancements could require us to substitute technology of lower quality or performance standards, or of greater cost, either of which could adversely affect our business. If we are not able to obtain licenses from third parties, if necessary, then we may also be subject to litigation to defend against infringement claims from these third parties. Our competitors may be able to obtain licenses or cross-license their technology on better terms than we can, which could put us at a competitive disadvantage.

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

Preparing our consolidated financial statements involves a number of complex manual and automated processes, which are dependent upon individual data input or review and require significant management judgment. One or more of these elements may result in errors that may not be detected and could result in a material misstatement of our consolidated financial statements. The Sarbanes-Oxley Act requires, among other things, that as a publicly-traded company we disclose whether our internal control over financial reporting and disclosure controls and procedures are effective. In addition, for so long as we qualify as an "emerging growth company" under the JOBS Act, which may be up to five years following our initial public offering in September 2013, we will not have to provide an auditor's attestation report on our internal controls in future annual reports on Form 10-K as otherwise required by Section 404(b) of the Sarbanes-Oxley Act. During the course of any evaluation, documentation or attestation, we or our independent registered public accounting firm may identify weaknesses and deficiencies that we may not otherwise identify in a timely manner or at all as a result of the deferred implementation of this additional level of review.

We have implemented internal controls that we believe provide reasonable assurance that we will be able to avoid accounting errors or material weaknesses in future periods. However, our internal controls cannot guarantee that no accounting errors exist or that all accounting errors, no matter how immaterial, will be detected because a control system, no matter how well designed and operated, can provide only reasonable, but not absolute assurance that the control system's objectives will be met. If we are unable to implement and maintain effective internal control over financial reporting, our ability to accurately and timely report our financial results could be adversely impacted. This could result in late filings of our annual and quarterly reports under the Securities Exchange Act of 1934, or the Exchange Act, restatements of our consolidated financial statements, a decline in our stock price, suspension or delisting of our common stock by NASDAQ, or other material adverse effects on our business, reputation, results of operations or financial condition.

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

As of December 31, 2015, we had U.S. accumulated net operating losses, or NOLs, of approximately $50.3 million for U.S. federal income tax purposes. Under Section 382 of the Internal Revenue Code of 1986, as amended, if a corporation undergoes an "ownership change," the corporation's ability to use its pre-change NOLs, R&D credits and other pre-change tax attributes to offset its post-change income may be limited. An ownership change is generally defined as a greater than 50% change in equity ownership by value over a 3-year period.

Based upon an analysis of our equity ownership, we believe that we have experienced ownership changes and therefore our annual utilization of our NOLs is limited. In addition, should we experience additional ownership changes, our NOL carry forwards may be further limited.

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

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

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

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

43

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

Following the lead of the European Union, or EU, various governmental agencies have either already put into place or are planning to introduce regulations that regulate the permissible levels of hazardous substances in products sold in various regions of the world. For example, the RoHS directive for EU took effect on July 1, 2006. The labeling provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU have required their suppliers to be compliant with the new directive. Many of our customers have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort in planning and executing our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such events, we could experience the following consequences: loss of revenue, damages reputation, diversion of resources, monetary penalties, and legal action.

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

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

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

We are subject to export and import control laws, trade regulations and other trade requirements that limit which products we sell and where and to whom we sell our products. Specifically, the Bureau of Industry and Security of the U.S. Department of Commerce is responsible for regulating the export of most commercial items that are so called dual-use goods that may have both commercial and military applications. A limited number of our products are exported by license under the Export Control Classification Number, or ECCN, of 5A991. Export Control Classification requirements are dependent upon an item's technical characteristics, the destination, the end-use, and the end-user, and other activities of the end-user. Should the regulations applicable to our products change, or the restrictions applicable to countries to which we ship our products change, then the export of our products to such countries could be restricted. As a result, our ability to export or sell our products to certain countries could be restricted, which could adversely affect our business, financial condition and results of operations. Changes in our products or any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in delayed or decreased sales of our products to existing or potential customers. In such event, our business and results of operations could be adversely affected.

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

We design our products to conform to regulations established by governments and to standards set by industry standards bodies worldwide, such as the American National Standards Institute, the European Telecommunications Standards Institute, the International Telecommunications Union and the Institute of Electrical and Electronics Engineers, Inc. Various industry organizations are currently considering whether and to what extent to create standards applicable to our products. Because certain of our products are designed to conform to current specific industry standards, if competing or new standards emerge that are preferred by our customers, we would have to make significant expenditures to develop new products. If our customers adopt new or competing industry standards with which our products are not compatible, or the industry groups adopt standards or governments issue regulations with which our products are not compatible, our existing products would become less desirable to our customers and our revenue and results of operations would suffer.

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

Public companies are required to disclose the use of tin, tantalum, tungsten and gold (collectively, "conflict minerals") mined from the Democratic Republic of the Congo and adjoining countries (the "covered countries") if a conflict mineral(s) is necessary to the functionality of a product manufactured, or contracted to be manufactured, by the company. We filed our initial conflict minerals report on Form SD on May 31, 2016. We may determine, as part of our compliance efforts, that certain products or components we obtain from our suppliers contain conflict minerals. If we are unable to conclude that all our products are free from conflict minerals originating from covered countries, this could have a negative impact on our business, reputation and/or results of operations. We may also encounter challenges to satisfy customers who require that our products be certified as conflict free, which could place us at a competitive disadvantage if we are unable to substantiate such a claim. Compliance with these rules could also affect the sourcing and availability of some of the minerals used in the manufacture of products or components we obtain from our suppliers, including our ability to obtain products or components in sufficient quantities and/or at competitive prices. Certain of our customers are requiring additional information from us regarding the origin of our raw materials, and complying with these customer requirements may cause us to incur additional costs, such as costs related to determining the origin of any minerals used in our products. Our supply chain is complex and we may be unable to verify the origins for all metals used in our products. We may also encounter challenges with our customers and stockholders if we are unable to certify that our products are conflict free.

Risks Related to Our Operations in China

Our business operations conducted in China are critical to our success. A total of $20.6 million, $22.0 million and $31.9 million or 11.0% 16.9% and 40.6%, of our revenue in the years ended December 31, 2015, 2014 and 2013 was attributable to our product manufacturing plants in China, respectively. Additionally, a substantial portion of our property, plant and equipment, 22% and 26% as of December 31, 2015 and 2014, was located in China, respectively. We expect to make further investments in China in the foreseeable future. Therefore, our business, financial condition, results of operations and prospects are to a significant degree subject to economic, political, legal, and social events and developments in China.

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

The Chinese economy differs from the economies of most developed countries in many respects, including the level of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. The Chinese economy has been transitioning from a planned economy to a more market-oriented economy. Despite reforms, the government continues to exercise significant control over China's economic growth by way of the allocation of resources, control over foreign currency-denominated obligations and monetary policy and provision of preferential treatment to particular industries or companies.

In addition, the laws, regulations and legal requirements in China, including the laws that apply to foreign-invested enterprises, or FIEs, are subject to frequent changes. The interpretation and enforcement of such laws is uncertain. Protections of intellectual property rights and confidentiality in China may not be as effective as in the U.S. or other countries or regions with more developed legal systems. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention. Any adverse changes to these laws, regulations and legal requirements or their interpretation or enforcement could have a material adverse effect on our business.

Furthermore, while China's economy has experienced rapid growth in the past 20 years, growth has been uneven across different regions, among various economic sectors and over time. China has also in the past and may in the future experience economic downturns due to, for example, government austerity measures, changes in government policies relating to capital spending, limitations placed on the ability of commercial banks to make loans, reduced levels of exports and international trade, inflation, lack of financial liquidity, stock market volatility and global economic conditions. Any of these developments could contribute to a decline in business and consumer spending in addition to other adverse market conditions, which could adversely affect our business.

The termination and expiration or unavailability of our preferential tax treatments in China may have a material adverse effect on our operating results.

Prior to January 1, 2008, entities established in China were generally subject to a 30% state and 3% local enterprise income tax rate. In accordance with the China Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, effective through December 31, 2007, our China subsidiary enjoyed preferential income tax rates. Effective January 1, 2008, the China Enterprise Income Tax Law, or the EIT law, imposes a single uniform income tax rate of 25% on all Chinese enterprises, including FIEs, and eliminates or modifies most of the tax exemptions, reductions and preferential treatment available under the previous tax laws and regulations. As a result, our China subsidiary may be subject to the uniform income tax rate of 25% unless we are able to qualify for preferential status. Currently, we have qualified for a preferential 15% tax rate that is available for state-encouraged new high technology enterprises. The preferential rate has applied to calendar years 2015, 2014, 2013 and 2012. We have not yet realized any benefit from the 10% reduction in income tax rate due to losses incurred by our China subsidiary; however, if we fail to continue to qualify for this preferential rate in the future, we may incur higher tax rates on our income in China. In order to retain the preferential tax rate, we must meet certain operating conditions, satisfy certain product requirements, meet certain headcount requirements and maintain certain levels of research expenditures. We applied for an additional three years of preferential status with the Chinese government in 2014 and received approval as a high-technology enterprise through September 2017. Any future increase in the enterprise income tax rate applicable to us or the expiration or other limitation of preferential tax rates available to us could increase our tax liabilities and reduce our net income.

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

Any loans that we wish to make to our China subsidiary are subject to China regulations and approvals. For example, any loans to our China subsidiary to finance their activities cannot exceed statutory limits, must be registered with State Administration of Foreign Exchange, or SAFE, or its local counterpart, and must be approved by the relevant government authorities. Any capital contributions to our China subsidiary must be approved by the Ministry of Commerce or its local counterpart. In addition, under Circular 142, our China subsidiary, as a FIE, may not be able to convert our capital contributions to them into RMB for equity investments or acquisitions in China.

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

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

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

The turnover of direct labor in manufacturing industries in China is high, which could adversely affect our production, shipments and results of operations.

Employee turnover of direct labor in the manufacturing sector in China is high and retention of such personnel is a challenge to companies located in or with operations in China. Although direct labor costs do not represent a high proportion of our overall manufacturing costs, direct labor is required for the manufacture of our products. If our direct labor turnover rates are higher than we expect, or we otherwise fail to adequately manage our direct labor turnover rates, then our results of operations could be adversely affected.

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

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

46

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

Businesses in China have historically not adopted a western style of management and financial reporting concepts and practices, which includes strong corporate governance, internal controls and computer, financial and other control systems. Moreover, familiarity with U.S. GAAP principles and reporting procedures is less common in China. As a consequence, we may have difficulty finding accounting personnel experienced with U.S. GAAP, and we may have difficulty training and integrating our China-based accounting staff with our U.S.-based finance organization. As a result of these factors, we may experience difficulty in establishing management and financial controls over our China operations. These difficulties include collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet U.S. public-company reporting requirements. We may, in turn, experience difficulties in implementing and maintaining adequate internal controls as required under Section 404 of the Sarbanes-Oxley Act.

Risks Related to Our Common Stock

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

The market price of our common stock has been and is likely to be subject to wide fluctuations in response to, among other things, the risk factors described in this section of this Quarterly Report on Form 10-Q, and other factors beyond our control, such as fluctuations in the valuation of companies perceived by investors to be comparable to us.

Furthermore, the stock markets have experienced price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political and market conditions, such as recessions, interest rate changes or international currency fluctuations, may negatively affect the market price of our common stock.

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may become the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

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

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

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

We currently do not plan to declare or pay dividends on shares of our common stock in the foreseeable future. In addition, the terms of our loan and security agreement with East West Bank and Comerica Bank restrict our ability to pay dividends. Consequently, your only opportunity to achieve a return on any shares of our common stock that you may acquire will be if the market price of our common stock appreciates and you sell your shares at a profit. There is no guarantee that the price of our common stock in the market will ever exceed the price that you pay.

47

Our charter documents, stock incentive plans and Delaware law could prevent a takeover that stockholders consider favorable and could also reduce the market price of our stock.

Our amended and restated certificate of incorporation and our amended and restated bylaws and our stock incentive plans contain provisions that could delay or prevent a change in control of our company. These provisions could also make it more difficult for stockholders to elect directors and take other corporate actions. These provisions include:

- providing for a classified board of directors with staggered, three-year terms;
- not providing for cumulative voting in the election of directors;
- authorizing our board of directors to issue, without stockholder approval, preferred stock rights senior to those of common stock;
- prohibiting stockholder action by written consent;
- limiting the persons who may call special meetings of stockholders;
- requiring advance notification of stockholder nominations and proposals; and
- change of control provisions in our stock incentive plans, and the individual stock option agreements, which provide that a change of control may accelerate the vesting of the stock options issued under such plans.

In addition, we are governed by the provisions of Section 203 of the Delaware General Corporate Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding common stock, from engaging in certain business combinations without the approval of substantially all of our stockholders for a certain period of time.

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

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

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

If research analysts do not publish research about our business or if they issue unfavorable commentary or downgrade our common stock, our stock price and trading volume could decline.

The trading market for our common stock depends on the research and reports that research analysts publish about us and our business. The price of our common stock could decline if one or more research analysts downgrade our common stock or if those analysts issue other unfavorable commentary or cease publishing reports about us or our business. If one or more of the research analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price or trading volume to decline.

As an "emerging growth company" within the meaning of the Securities Act, we utilize certain modified disclosure requirements, and we cannot be certain if these reduced requirements will make our common stock less attractive to investors.

We are an emerging growth company within the meaning of the rules under the Securities Act. We have in this Quarterly Report on Form 10-Q utilized, and we plan in future filings with the SEC to continue to utilize, the modified disclosure requirements available to emerging growth companies, including reduced disclosure about our executive compensation and omission of compensation discussion and analysis, and an exemption from the requirement of holding a nonbinding advisory vote on executive compensation and an exemption from the requirement that outside auditors attest as to our internal control over financial reporting. As a result, our stockholders may not have access to certain information they may deem important.

In addition, Section 107 of the JOBS Act also provides that an emerging growth company can utilize the extended transition period provided in Section 7(a)(2)(B) of the Securities Act for complying with new or revised accounting standards. Thus, an emerging growth company can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We have elected to utilize this extended transition period. Our financial statements may therefore not be comparable to those of companies that comply with such new or revised accounting standards as they become applicable to public companies.

We cannot predict if investors will find our common stock less attractive because we will rely on these exemptions. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be more volatile. We could remain an "emerging growth company" for up to five years, or until the earliest of (i) the last day of the first fiscal year in which our annual gross revenue exceed $1 billion, (ii) the date that we become a "large accelerated filer" as defined in Rule 12b-2 under the Exchange Act, which would occur if the market value of our common stock that is held by non-affiliates exceeds $700 million as of the last business day of our most recently completed second fiscal quarter or (iii) the date on which we have issued more than $1 billion in non-convertible debt during the preceding three-year period.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index.

SIGNATURES

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.

		APPLIED OPTOELECTRONICS, INC.
Date: November 8, 2016	By:	/s/ Stefan J. Murry Stefan J. Murry Chief Financial Officer *(principal financial officer and principal accounting officer)*

EXHIBIT INDEX

Number	Description
3.1*	Amended and Restated Certificate of Incorporation, as currently in effect (filed as Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2013).
3.2*	Amended and Restated Bylaws, as currently in effect (filed as Exhibit 3.2 to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2013).
4.1*	Common Stock Specimen (filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 15, 2015).
10.1*	Change in Terms Agreement, dated October 5, 2016, between Applied Optoelectronics, Inc. and East West Bank (filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2016).
10.2*	Notice of Final Agreement, dated October 5, 2016, between Applied Optoelectronics, Inc. and East West Bank (filed as Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2016).
10.3*	Second Modification to the Construction Loan Agreement, dated October 5, 2016, between Applied Optoelectronics, Inc. and East West Bank (filed as Exhibit 10.3 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2016).
31.1**	Certification of Chief Executive Officer pursuant to Exchange Act Rule, 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2**	Certification of Chief Financial Officer pursuant to Exchange Act Rule, 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certification pursuant to 18 U.S.C. 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Executive Officer and Chief Financial Officer
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.

---

* Incorporated herein by reference to the indicated filing.

** Filed herewith.

51