

AXT INC
Form 10-Q
August 07, 2018
Table of Contents

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended June 30, 2018

Or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the transition period from to

Commission File Number 000-24085

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AXT, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	94-3031310
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)

4281 Technology Drive, Fremont, California 94538

(Address of principal executive offices) (Zip code)

(510) 438-4700

(Registrant's telephone number, including area code)

Indicate by check-mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check-mark whether the registrant has submitted electronically and posted on its 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). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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(Do not check if a smaller reporting company) ☐ Emerging growth company

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at August 1, 2018
Common Stock, \$0.001 par value	39,510,924

Table of Contents

AXT, INC.

FORM 10-Q

TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (unaudited)</u>	
<u>Condensed Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017</u>	3
<u>Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2018 and 2017</u>	4
<u>Condensed Consolidated Statements of Comprehensive (Loss) Income for the three and six months ended June 30, 2018 and 2017</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2018 and 2017</u>	6
<u>Notes To Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	44
<u>Item 4. Controls and Procedures</u>	46
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	47
<u>Item 1A. Risk Factors</u>	47
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	67
<u>Item 3. Defaults upon Senior Securities</u>	67
<u>Item 4. Mine Safety Disclosures</u>	67
<u>Item 5. Other Information</u>	68
<u>Item 6. Exhibits</u>	69
<u>Signatures</u>	71

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

AXT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share data)

	June 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 29,698	\$ 44,352
Short-term investments	18,802	20,032
Accounts receivable, net of allowances of \$358 and \$527 as of June 30, 2018 and December 31, 2017	22,516	22,778
Inventories	57,038	45,840
Prepaid expenses and other current assets	9,416	7,519
Total current assets	137,470	140,521
Long-term investments	5,714	12,576
Property, plant and equipment, net	65,174	46,530
Other assets	11,323	11,573
Total assets	\$ 219,681	\$ 211,200
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 14,059	\$ 11,445
Accrued liabilities	11,793	11,149
Total current liabilities	25,852	22,594
Other long-term liabilities	296	289
Total liabilities	26,148	22,883
Commitments and contingencies (Note 12)		
Stockholders' equity:		
Preferred stock Series A, \$0.001 par value; 2,000 shares authorized; 883 shares issued and outstanding as of June 30, 2018 and December 31, 2017 (Liquidation preference of \$6,904 and \$6,819 as of June 30, 2018 and December 31, 2017)	3,532	3,532
Common stock, \$0.001 par value; 70,000 shares authorized; 39,511 and 39,413 shares issued and outstanding as of June 30, 2018 and December 31, 2017	39	39
Additional paid-in capital	232,984	231,679
Accumulated deficit	(48,061)	(54,837)

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Accumulated other comprehensive income	1,172	3,407
Total AXT, Inc. stockholders' equity	189,666	183,820
Noncontrolling interests	3,867	4,497
Total stockholders' equity	193,533	188,317
Total liabilities and stockholders' equity	\$ 219,681	\$ 211,200

See accompanying notes to condensed consolidated financial statements.

Table of Contents

AXT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenue	\$ 27,120	\$ 23,557	\$ 51,539	\$ 44,173
Cost of revenue	16,110	16,301	30,956	30,629
Gross profit	11,010	7,256	20,583	13,544
Operating expenses:				
Selling, general and administrative	4,987	3,942	9,209	7,735
Research and development	1,500	1,019	2,920	2,143
Total operating expenses	6,487	4,961	12,129	9,878
Income from operations	4,523	2,295	8,454	3,666
Interest income, net	139	114	281	212
Equity in earnings (loss) of unconsolidated joint ventures	307	(188)	(27)	(1,121)
Other expense, net	(51)	(102)	(266)	(54)
Income before provision for income taxes	4,918	2,119	8,442	2,703
Provision for income taxes	367	321	701	480
Net income	4,551	1,798	7,741	2,223
Less: Net (income) loss attributable to noncontrolling interests	(650)	132	(965)	372
Net income attributable to AXT, Inc.	\$ 3,901	\$ 1,930	\$ 6,776	\$ 2,595
Net income attributable to AXT, Inc. per common share:				
Basic	\$ 0.10	\$ 0.05	\$ 0.17	\$ 0.07
Diluted	\$ 0.10	\$ 0.05	\$ 0.17	\$ 0.07
Weighted-average number of common shares outstanding:				
Basic	39,001	38,306	38,970	36,238
Diluted	40,216	39,706	40,289	37,645

See accompanying notes to condensed consolidated financial statements.

Table of Contents

AXT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(Unaudited, in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net income	\$ 4,551	\$ 1,798	\$ 7,741	\$ 2,223
Other comprehensive (loss) income, net of tax:				
Change in foreign currency translation (loss) gain, net of tax	(5,018)	847	(2,202)	1,322
Change in unrealized gain (loss) on available-for-sale investments, net of tax	40	(2)	(77)	(125)
Total other comprehensive (loss) income, net of tax	(4,978)	845	(2,279)	1,197
Comprehensive (loss) income	(427)	2,643	5,462	3,420
Less: Comprehensive (income) loss attributable to noncontrolling interests	(346)	30	(921)	215
Comprehensive (loss) income attributable to AXT, Inc.	\$ (773)	\$ 2,673	\$ 4,541	\$ 3,635

See accompanying notes to condensed consolidated financial statements.

Table of Contents

AXT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	Six Months Ended June 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 7,741	\$ 2,223
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	2,207	2,250
Amortization of marketable securities premium	81	75
Impairment charge on equity investee	—	313
Stock-based compensation	931	622
Realized gain on sale of available-for-sale securities	—	(77)
Gain on disposal of equipment	(13)	(1)
Loss from equity method investments, net	27	808
Changes in operating assets and liabilities:		
Accounts receivable	61	(3,683)
Inventories	(11,923)	(119)
Prepaid expenses and other current assets	(2,075)	(264)
Other assets	59	(28)
Accounts payable	2,833	1,368
Accrued liabilities	(414) *	21 *
Other long-term liabilities, including royalties	24	(302)
Net cash (used in) provided by operating activities	(461)	3,206
Cash flows from investing activities:		
Purchases of property, plant and equipment	(21,920)	(1,831)
Proceeds from sale of equipment	11	—
Purchases of available-for-sale securities	(9,936)	(23,763)
Proceeds from sales and maturities of available-for-sale securities	17,870	10,170
Repayment of related party notes receivable	—	53
Net cash used in investing activities	(13,975)	(15,371)
Cash flows from financing activities:		
Proceeds from issuance of common stock and options exercised, net of issuance costs	178	32,746
Considerations paid in cash to repurchase subsidiary shares from noncontrolling interests	(163)	—
Dividends paid by joint ventures to their minority shareholders	—	(465)
Net cash provided by financing activities	15	32,281
Effect of exchange rate changes on cash and cash equivalents	(233)	215

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Net increase (decrease) in cash and cash equivalents	(14,654)	20,331
Cash and cash equivalents at the beginning of the period	44,352	36,152
Cash and cash equivalents at the end of the period	\$ 29,698	\$ 56,483
Supplemental disclosure of non-cash flow information:		
Consideration payable to repurchase subsidiary shares from noncontrolling interests, included in accrued liabilities	\$ 1,192	—
Reduction of noncontrolling interests in excess of total consideration paid and payable in connection with the repurchase of subsidiaries shares from noncontrolling interests	\$ 196	—

* Dividend accrued but not paid by one of our consolidated subsidiaries of \$524 and \$512 was included in accrued liabilities as of June 30, 2018 and 2017, respectively.

See accompanying notes to condensed consolidated financial statements.

Table of Contents

AXT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

The accompanying condensed consolidated financial statements of AXT, Inc. (“AXT,” the “Company,” “we,” “us,” and “our” refer to AXT, Inc. and all of its consolidated subsidiaries) are unaudited, and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, this interim quarterly financial report does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of our management, the unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, considered necessary to present fairly the financial position, results of operations and cash flows of AXT and our consolidated subsidiaries for all periods presented.

Certain reclassifications have been made to prior periods’ financial statements to conform to the current period presentation. These reclassifications did not result in any change in previously reported net income or total assets.

Our management has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ materially from those estimates.

The results of operations for the three and six months ended June 30, 2018 are not necessarily indicative of the results to be expected in the future or for the full fiscal year. It is recommended that these condensed consolidated financial statements be read in conjunction with our consolidated financial statements and the notes thereto included in our 2017 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the “SEC”) on March 9, 2018 and our Quarterly Report on Form 10-Q for the three months ended March 31, 2018 filed with the SEC on May 4, 2018.

The condensed consolidated financial statements include the accounts of AXT, our wholly-owned subsidiaries, Beijing Tongmei Xtal Technology Co., Ltd., Baoding Tongmei Xtal Technology Co., Ltd. and Chaoyang Tongmei Xtal Technology Co., and our majority-owned, or significantly controlled subsidiaries, Beijing JiYa Semiconductor Material Co., Ltd., Nanjing JinMei Gallium Co., Ltd. and Beijing BoYu Semiconductor Vessel Craftwork Technology Co., Ltd. All significant inter company accounts and transactions have been eliminated. Investments in business entities in which we do not have controlling interests, but have the ability to exercise significant influence over operating and financial policies (generally 20-50% ownership), are accounted for by the equity method. We have seven companies accounted for by the equity method. For subsidiaries that we consolidate, we reflect the portion we do not own as noncontrolling interests on our condensed consolidated balance sheets in stockholders' equity and in our condensed consolidated statements of operations.

Table of Contents

Note 2. Investments and Fair Value Measurements

Our cash and cash equivalents consist of cash and instruments with original maturities of less than three months. Our investments consist of instruments with original maturities of more than three months. As of June 30, 2018 and December 31, 2017, our cash, cash equivalents and investments are classified as follows (in thousands):

	June 30, 2018				December 31, 2017			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized (Loss)	Fair Value	Amortized Cost	Gross Unrealized Gain	Gross Unrealized (Loss)	Fair Value
Classified as:								
Cash	\$ 29,698	\$ —	\$ —	\$ 29,698	\$ 43,610	\$ —	\$ —	\$ 43,610
Cash equivalents:								
Certificates of deposit 1	—	—	—	—	742	—	—	742
Total cash and cash equivalents	29,698	—	—	29,698	44,352	—	—	44,352
Investments (available-for-sale):								
Certificates of deposit 2	6,189	—	(43)	6,146	7,099	—	(24)	7,075
Corporate bonds	18,497	—	(127)	18,370	25,602	—	(69)	25,533
Total investments	24,686	—	(170)	24,516	32,701	—	(93)	32,608
Total cash, cash equivalents and investments	\$ 54,384	\$ —	\$ (170)	\$ 54,214	\$ 77,053	\$ —	\$ (93)	\$ 76,960
Contractual maturities on investments:								
Due within 1 year 3	\$ 18,912			\$ 18,802	\$ 20,056			\$ 20,032
Due after 1 through 5 years 4	5,774			5,714	12,645			12,576
	\$ 24,686			\$ 24,516	\$ 32,701			\$ 32,608

1. Certificates of deposit with original maturities of less than three months.
2. Certificates of deposit with original maturities of more than three months.
3. Classified as “Short-term investments” in our condensed consolidated balance sheets.
4. Classified as “Long-term investments” in our condensed consolidated balance sheets.

We manage our investments as a single portfolio of highly marketable securities that is intended to be available to meet our current cash requirements. Certificates of deposit and corporate bonds are typically held until maturity. Corporate equity securities have no maturity and may be sold at any time.

We previously held corporate equity securities consisting of common stock of GCS Holdings, Inc. (“GHI”) (previously Global Communication Semiconductors, Inc.), a Taiwan publicly-traded company. We began classifying GHI as an available-for-sale security in the second quarter of 2015 when we determined that there was sufficient trading volume in the exchange for the stock to be deemed readily marketable. During the three months ended March 31, 2017, we sold the remainder of our GHI stock; therefore, there were no GHI transactions in the three months ended June 30, 2017. During the six months ended June 30, 2017, our cash proceeds from sales of GHI stock were \$125,000. Our cost was \$48,000 and our gross realized gain from sales of GHI stock was \$77,000. There were no GHI transactions in the three and six months ended June 30, 2018.

The gross unrealized losses related to our portfolio of available-for-sale securities were primarily due to changes in interest rates and market and credit conditions of the underlying securities. We have determined that the gross unrealized losses on our available-for-sale securities as of June 30, 2018 are temporary in nature. We periodically review our investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.

Table of Contents

A portion of our investments would generate a loss if we sold them on June 30, 2018. The following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of June 30, 2018 (in thousands):

	In Loss Position < 12 months		In Loss Position > 12 months		Total In Loss Position	
	Fair Value	Gross Unrealized (Losses)	Fair Value	Gross Unrealized (Losses)	Fair Value	Gross Unrealized (Losses)
As of June 30, 2018						
Investments:						
Certificates of deposit	\$ 4,931	\$ (39)	\$ 1,196	\$ (4)	\$ 6,127	\$ (43)
Corporate bonds	11,133	(82)	7,237	(45)	18,370	(127)
Total in loss position	\$ 16,064	\$ (121)	\$ 8,433	\$ (49)	\$ 24,497	\$ (170)

The following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2017 (in thousands):

	In Loss Position < 12 months		In Loss Position > 12 months		Total In Loss Position	
	Fair Value	Gross Unrealized (Loss)	Fair Value	Gross Unrealized (Loss)	Fair Value	Gross Unrealized (Loss)
As of December 31, 2017						
Investments:						
Certificates of deposit	\$ 3,994	\$ (16)	\$ 2,342	\$ (8)	\$ 6,336	\$ (24)
Corporate bonds	25,533	(69)	—	—	25,533	(69)
Total in loss position	\$ 29,527	\$ (85)	\$ 2,342	\$ (8)	\$ 31,869	\$ (93)

Investments in Privately-held Companies

We have made strategic investments in private companies located in China in order to gain access at a competitive cost to raw materials that are critical to our substrate business (see Note 7). The investment balances for all of these companies, including minority investments indirectly in privately-held companies made by our consolidated subsidiaries, are accounted for under the equity method and included in “Other assets” in the condensed consolidated balance sheets and totaled \$9.7 million and \$9.8 million as of June 30, 2018 and December 31, 2017, respectively. As of June 30, 2018, there were seven companies accounted for under the equity method. There were no impairment charges in the three and six months ended June 30, 2018. There were no impairment charges in the three months ended June 30, 2017. The six months ended June 30, 2017 include an impairment charge of \$313,000 for one of the

gallium companies. During the first quarter of 2017, management determined that it was unlikely that this company would recover from the difficult pricing environment and we had written the investment down to zero.

Fair Value Measurements

We invest primarily in money market accounts, certificates of deposits, corporate bonds and notes, and government securities. Accounting Standards Codification (“ASC”) Topic 820, Fair Value Measurements and Disclosures (“ASC 820”), establishes three levels of inputs that may be used to measure fair value. Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets of the asset or identical assets. Level 2 instrument valuations are obtained from readily-available, observable pricing sources for comparable instruments. Level 3 instrument valuations are obtained from unobservable inputs in which there is little or no market data, which require us to develop our own assumptions. On a recurring basis, we measure certain financial assets and liabilities at fair value, primarily consisting of our short-term and long-term investments.

The type of instrument valued based on quoted market prices in active markets include our money market funds, which are generally classified within Level 1 of the fair value hierarchy. Other than corporate equity securities which are based on quoted market prices and classified as Level 1, we classify our available-for-sale securities including

Table of Contents

certificates of deposit and corporate bonds as having Level 2 inputs. The valuation techniques used to measure the fair value of these financial instruments having Level 2 inputs were derived from bank statements, quoted market prices, broker or dealer statements or quotations, or alternative pricing sources with reasonable levels of price transparency.

We place short-term foreign currency hedges that are intended to offset the potential cash exposure related to fluctuations in the exchange rate between the United States dollar and Japanese Yen. We measure the fair value of these foreign currency hedges at each month end and quarter end using current exchange rates and in accordance with generally accepted accounting principles. At quarter end any foreign currency hedges not settled are netted in “Accrued liabilities” on the condensed consolidated balance sheet and classified as Level 3 assets and liabilities. As of June 30, 2018, the net change in fair value from the placement of the hedge to settlement at each month end during the quarter had a de minimis impact to the consolidated results.

There were no changes in valuation techniques or related inputs in the three and six months ended June 30, 2018. There have been no transfers between fair value measurements levels during the three and six months ended June 30, 2018.

The following table summarizes our financial assets and liabilities measured at fair value on a recurring basis in accordance with ASC 820 as of June 30, 2018 (in thousands):

	Balance as of June 30, 2018	Quoted Prices in Active Markets of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents and investments:				
Certificates of deposit	\$ 6,146	\$ —	\$ 6,146	\$ —
Corporate bonds	18,370	—	18,370	—
Total	\$ 24,516	\$ —	\$ 24,516	\$ —

The following table summarizes our financial assets and liabilities measured at fair value on a recurring basis in accordance with ASC 820 as of December 31, 2017 (in thousands):

	Balance as of December 31, 2017	Quoted Prices in Active Markets of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
--	------------------------------------	--	---	--

Assets:

Cash equivalents and
investments:

Certificates of deposit	\$ 7,817	\$ —	\$ 7,817	\$ —
Corporate bonds	25,533	—	25,533	—
Total	\$ 33,350	\$ —	\$ 33,350	\$ —

Items Measured at Fair Value on a Nonrecurring Basis

Certain assets that are subject to nonrecurring fair value measurements are not included in the table above. These assets include investments in privately-held companies accounted for by the equity or cost method (See Note 7). There were no impairment charges in the three and six months ended June 30, 2018. There were no impairment charges in the three months ended June 30, 2017. The six months ended June 30, 2017 include an impairment charge of \$313,000 for one of the gallium companies. During the first quarter of 2017, management determined that it was unlikely that this company would recover from the difficult pricing environment and we had written the investment down to zero.

Except as mentioned, we did not record other-than-temporary impairment charges for the remainder of these investments during the three and six months ended June 30, 2018 and 2017.

Table of Contents

Note 3. Inventories

The components of inventories are summarized below (in thousands):

	June 30, 2018	December 31, 2017
Inventories:		
Raw materials	\$ 29,379	\$ 23,554
Work in process	25,281	20,135
Finished goods	2,378	2,151
	\$ 57,038	\$ 45,840

As of June 30, 2018 and December 31, 2017, carrying values of inventories were net of inventory reserves of \$13.7 million and \$13.3 million, respectively, for excess and obsolete inventory and \$26,000 and \$291,000, respectively, for lower of cost or net realizable value reserves.

Note 4. Property, Plant and Equipment, Net

The components of our property, plant and equipment are summarized below (in thousands):

	June 30, 2018	December 31, 2017
Property, plant and equipment:		
Machinery and equipment, at cost	\$ 47,536	\$ 44,549
Less: accumulated depreciation and amortization	(41,419)	(40,845)
Building, at cost	32,058	32,461
Less: accumulated depreciation and amortization	(11,908)	(11,501)
Leasehold improvements, at cost	5,488	5,539
Less: accumulated depreciation and amortization	(4,447)	(4,288)
Construction in progress	37,866	20,615
	\$ 65,174	\$ 46,530

As of June 30, 2018, the balance of construction in progress was \$37.9 million of which \$26.8 million was related to our buildings in our new Dingxing and Chaoyang locations, \$4.1 million was for manufacturing equipment purchases and \$7.0 million was from our construction in progress for our other consolidated subsidiaries. As of December 31,

2017, the balance of construction in progress was \$20.6 million, of which, \$14.8 million was for our buildings in our new Dingxing location, \$3.6 million was for manufacturing equipment purchases not yet placed in service, and \$2.2 million was for our construction in progress at our other consolidated subsidiaries.

Table of Contents

Note 5. Accrued Liabilities

The components of accrued liabilities are summarized below (in thousands):

	June 30, 2018	December 31, 2017
Preferred stock dividends payable	\$ 2,901	\$ 2,901
Accrued compensation and related charges	2,580	3,205
Payable in connection with purchase of subsidiary shares from noncontrolling interests	1,192	—
Advances from customers	927	924
Dividends payable by consolidated joint ventures	524	533
Accrued professional services	409	570
Accrued income taxes	341	270
Current portion of royalty payments	288	575
Other personnel related costs	221	230
Accrued product warranty	178	133
Other tax payable	85	395
Accrual for sales refund liabilities	82	—
Other accrued liabilities	2,065	1,413
	\$ 11,793	\$ 11,149

Note 6. Related Party Transactions

In August 2011, our consolidated joint venture, Beijing JiYa Semiconductor Material Co., Ltd. (“JiYa”), entered into a non-interest bearing note agreement in the amount of \$1.6 million for a loan to one of its equity investment entities. The original term of the loan was for two years and ten months with three periodic principal payments required. After various amendments to the terms of the note, in December 2013, the parties agreed to delay all principal repayment until December 2017. In December 2016, we determined that this receivable was in substance an investment and began re-classifying this long term loan from “Related party notes receivable – long-term” to “Other assets” in our consolidated balance sheets. As of June 30, 2018 and December 31, 2017, we included \$1.1 million and \$1.2 million in “Other assets” in our condensed consolidated balance sheets, respectively.

JiYa also purchases raw materials from one of its equity investment entities for production in the ordinary course of business. The general manager of JiYa has a family member who has a 10% ownership position in this equity investment entity. As of June 30, 2018 and December 31, 2017, amounts payable of \$2.0 million and \$2.1 million were included in “Accounts payable” in our condensed consolidated balance sheets, respectively.

JiYa also sells raw materials to one of its equity investment entities for production in the ordinary course of business. As of June 30, 2018 and December 31, 2017, amounts receivable of \$328,000 and \$334,000, respectively, were included in “Accounts receivable” in our condensed consolidated balance sheets. During the three months ended December 31, 2016, we deemed the collection of the outstanding amount to be improbable and established an allowance in full. There have since been no additional sales made on credit to the customer and, as of June 30, 2018, the existing outstanding amount continues to be fully reserved.

Beginning in 2012, our consolidated joint venture, Nanjing JinMei Gallium Co., Ltd. (“JinMei”), is contractually obligated under an agency sales agreement to sell raw material on behalf of its equity investment entity. JinMei bills the customers and remits the receipts, net of its portions of sales commission, to this equity investment entity. For the three months ended June 30, 2018 and 2017, JinMei has recorded \$1,000 and \$0 income from agency sales, respectively. For each of the six months ended June 30, 2018 and 2017, JinMei has recorded \$1,000 income from agency sales which were included in “Other (expense) income, net” in the condensed consolidated statements of operations.

Table of Contents

In March 2012, our wholly-owned subsidiary, Beijing Tongmei Xtal Technology Co., Ltd. (“Tongmei”), entered into an operating lease for the land it owns with our consolidated joint venture, Beijing BoYu Semiconductor Vessel Craftwork Technology Co., Ltd. (“BoYu”). The lease agreement for the land of approximately 22,081 square feet commenced on January 1, 2012 for a term of 10 years with annual lease payments of \$24,000 subject to a 5% increase at each third year anniversary. The annual lease payment is due by January 31st of each year.

Tongmei has paid certain amounts on behalf of Donghai County Dongfang High Purity Electronic Materials Co., Ltd. (“Dongfang”), its equity investment entity, to purchase materials. The original agreement was signed between Tongmei and Dongfang in 2014 and the date of repayment was set as December 31, 2015. In 2015, both parties agreed to delay the date of repayment to December 31, 2017. During 2017, the repayment of the full amount of principal and interest totaling \$114,000 was received by our wholly owned subsidiary.

In April 2014, Tongmei loaned an additional \$46,000 to Dongfang. The loan bears interest at 6.15% per annum and was due on December 31, 2017. During 2017, the repayment of the full amount of principal and interest totaling \$55,000 was received by our wholly owned subsidiary.

Tongmei also purchases raw materials from Dongfang for production in the ordinary course of business. As of June 30, 2018 and December 31, 2017, amounts payable of \$295,000 and \$0, respectively, were included in “Accounts payable” in our condensed consolidated balance sheets.

Tongmei also purchases raw materials from one of our equity investment entities, Emei Shan Jiamei Materials Co. Ltd. (“Jiamei”), for production in the ordinary course of business. As of June 30, 2018 and December 31, 2017, amounts payable of \$123,000 and \$370,000, respectively, were included in “Accounts payable” in our condensed consolidated balance sheets.

Tongmei also purchases raw materials from one of our equity investment entities, Xilingol Tongli Germanium Refine Co. Ltd. (“Tongli”), for production in the ordinary course of business. As of June 30, 2018 and December 31, 2017, amounts payable of \$238,000 and \$219,000, respectively, were included in “Accounts payable” in our condensed consolidated balance sheets.

In July 2017, Tongmei, provided an inter-company loan to JinMei in the amount of \$768,000 in preparation for the acquisition of the land use rights and the construction of a new building. The inter-company loan carries an interest rate of 4.9% per annum and is due in three installments between December 2021 and December 2023. JinMei is in the process of relocating its headquarters and manufacturing operations to an alternative location. Currently, JinMei has identified a site as a possible candidate and the estimated costs for the land use rights acquisition and facility construction are expected to be in the range of \$2 million to \$4 million.

In April 2016, our consolidated joint venture, BoYu, provided a personal loan of \$177,000 to one of its executive employees. This loan is secured by the officer's shares in BoYu. The loan bears interest at 2.75% per annum. Principal and accrued interest are due on March 31, 2019. During the three months ended June 30, 2017, the repayment of the principal and interest totaling \$180,000 was received by our consolidated joint venture. In November 2017, BoYu provided another personal loan of \$318,000 to the same executive employee. The loan bears interest at 2.75% per annum. Principal and accrued interest are due on November 30, 2020. As of June 30, 2018 and December 31, 2017, the balances, including both principal and accrued interest, were \$308,000 and \$307,000, respectively, and included in "Other assets" in our condensed consolidated balance sheets.

On November 2, 2017, our consolidated joint venture, BoYu, raised additional capital in the amount of \$2 million in cash from a third-party investor through the issuance of shares equivalent to 10% ownership of BoYu. This third-party investor is an immediate family member of the owner of one of BoYu's customers. For the three months ended June 30, 2018 and 2017, BoYu has recorded \$530,000 and \$51,000, respectively, in revenue from this customer. For the six months ended June 30, 2018 and 2017, BoYu has recorded \$1.3 million and \$388,000, respectively, in revenue from this customer. As of June 30, 2018 and December 31, 2017, amounts receivable of \$550,000 and \$635,000, respectively, were included in "Accounts receivable" in our condensed consolidated balance sheets.

Table of Contents

Our Related Party Transactions Policy seeks to prohibit all conflicts of interest in transactions between related parties and us, unless they have been approved by our Board of Directors. This policy applies to all of our employees, directors, and our consolidated subsidiaries. Our executive officers retain board seats on the board of directors of the companies in which we have invested in our China joint ventures. See Note 7 for further details.

Note 7. Investments in Privately-Held Companies

We have made strategic investments in private companies located in China in order to gain access at a competitive cost to raw materials that are critical to our substrate business. We have six direct investments. Our consolidated subsidiaries have also made investments in private companies. We have four indirect investments. These companies form part of our overall supply chain.

The six direct investments are summarized below (in thousands):

Company	Investment Balance as of		Accounting Method	Ownership Percentage	
	June 30, 2018	December 31, 2017			
Beijing JiYa Semiconductor Material Co., Ltd.	\$ 3,331	\$ 3,331	Consolidated	46	%
Nanjing JinMei Gallium Co., Ltd.	592	592	Consolidated	95	%
Beijing BoYu Semiconductor Vessel Craftwork Technology Co., Ltd.	1,346	1,346	Consolidated	63	%
	\$ 5,269	\$ 5,269			
Donghai County Dongfang High Purity Electronic Materials Co., Ltd.	\$ 1,515	\$ 1,473	Equity	46	%
Xilingol Tongli Germanium Co. Ltd.	2,955	3,190	Equity	25	%
Emeishan JiaMei High Purity Metals Co., Ltd.	903	915	Equity	25	%
	\$ 5,373	\$ 5,578			

Our ownership of JiYa is 46%. We continue to consolidate JiYa as we are the founding and largest shareholder, appoint the general manager and controller and have the ability to exercise control in substance over the long-term strategic decisions made. Our Chief Executive Officer is chairman of the JiYa board and we have appointed one other representative, Davis Zhang, to serve on the board. Mr. Zhang was an executive officer of AXT for 27 years. Further, our Chief Financial Officer, Gary Fischer, is on the board of supervisors of JiYa.

Our ownership of JinMei is 95%. Before June 15, 2018, our ownership of JinMei was 83%. On June 15, 2018, we purchased a 12% ownership interest from one of the minority owners for \$1.4 million. The \$1.4 million is scheduled

to be paid in two installments. On June 15, 2018, we paid the first installment of \$163,000. The second installment of \$1.2 million is scheduled to be paid after the completion of the relocation of JinMei's headquarters and manufacturing operations and was included in "Accrued liabilities" in our condensed consolidated balance sheets. As a result, our ownership of JinMei increased from 83% to 95%. We continue to consolidate JinMei as we have a controlling financial interest and have majority control of the board. Our Chief Executive Officer is chairman of the JinMei board and we have appointed two other representatives to serve on the board.

Our ownership of BoYu is 63%. On November 2, 2017, BoYu raised additional capital in the amount of \$2 million in cash from a third-party investor through the issuance of shares equivalent to 10% ownership of BoYu. As a result, our ownership of BoYu was diluted from 70% to 63%. We continue to consolidate BoYu as we have a controlling financial interest and have majority control of the board and, accordingly, no gain was recognized as a result of this equity transaction. Our Chief Executive Officer is chairman of the BoYu board and we have appointed two other representatives to serve on the board.

Although we have representation on the board of directors of each of these companies, the daily operations of each of these companies are managed by local management and not by us. Decisions concerning their respective short-term strategy and operations, ordinary course of business capital expenditures and sales of finished products, are made by local management with regular guidance and input from us.

Table of Contents

During the three months ended June 30, 2018 and 2017, the three consolidated joint ventures, before eliminating inter-company transactions, generated income of \$2.1 million and \$208,000, respectively, of which a gain of \$650,000 and a loss of \$132,000, respectively, were allocated to noncontrolling interests, resulting in an income of \$1.5 million and \$340,000 respectively, to our net income. During the six months ended June 30, 2018 and 2017, the three consolidated joint ventures generated income of \$3.5 million and \$196,000, respectively, of which a gain of \$965,000 and a loss of \$372,000 respectively, were allocated to noncontrolling interests, resulting in an income of \$2.5 million and an income of \$568,000, respectively, to our net income.

For AXT's three direct minority investment entities that are not consolidated, the investment balances are included in "Other assets" in our condensed consolidated balance sheets and totaled \$5.4 million and \$5.6 million as of June 30, 2018 and December 31, 2017, respectively. We own 46% of the ownership interests in one of these companies and 25% in each of the other two companies. These three companies are not considered variable interest entities because:

- all three companies have sustainable businesses of their own;
- our voting power is proportionate to our ownership interests;
- we only recognize our respective share of the losses and/or residual returns generated by the companies if they occur; and
- we do not have controlling financial interest in, do not maintain operational or management control of, do not control the board of directors of, and are not required to provide additional investment or financial support to any of these companies.

We also maintain four minority investments indirectly in privately-held companies through our consolidated joint ventures. JiYa holds three investments and JinMei holds one investment. These minority investments are accounted for under the equity method in the books of our consolidated joint ventures. As of June 30, 2018 and December 31, 2017, our consolidated joint ventures included these minority investments in "Other assets" in our condensed consolidated balance sheets with a carrying value of \$4.3 million and \$4.3 million, respectively.

There were no impairment charges in the three and six months ended June 30, 2018. There were no impairment charges in the three months ended June 30, 2017. The six months ended June 30, 2017 include an impairment charge of \$313,000 for one of the gallium companies. During the first quarter of 2017, management determined that it is unlikely that this company will recover from the difficult pricing environment and we had written the investment down to zero.

AXT's three direct minority investment entities and the three minority investments of JiYa and the one minority investment of JinMei are not consolidated and are accounted for under the equity method. Excluding one fully impaired entity, the equity entities had the following summarized income information (in thousands) for the three and six months ended June 30, 2018 and 2017.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net revenue	\$ 8,993	\$ 5,908	\$ 16,349	\$ 11,363
Gross profit	\$ 1,702	\$ 4,277	\$ 1,737	\$ 7,999
Operating income (loss)	\$ 1,871	\$ (794)	\$ 708	\$ (1,631)
Net income (loss)	\$ 694	\$ (818)	\$ (737)	\$ (2,523)

Our portion, including impairment charges, from these seven minority investment entities that are not consolidated and are accounted for under the equity method was income of \$307,000 and a loss of \$188,000 for the three months ended June 30, 2018 and 2017, respectively. Our portion, including impairment charges, from these seven minority investment entities that are not consolidated and are accounted for under the equity method were a loss of \$27,000 and a loss of \$1.1 million for the six months ended June 30, 2018 and 2017, respectively.

Table of Contents

Note 8. Stockholders' Equity

Condensed Consolidated Statement of Changes in Stockholders' Equity

(in thousands)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	AXT, Inc Stockholders' Equity	Noncontrolling Interests	Total Stockholders' Equity
Balance as of December 31, 2017	\$ 3,532	\$ 39	\$ 231,679	\$ (54,837)	\$ 3,407	\$ 183,820	\$ 4,497	\$ 188,317
Common stock options exercised	—	—	178	—	—	178	—	178
Purchase of subsidiary shares from noncontrolling interest			196			196	(1,551)	(1,355)
Stock-based compensation	—	—	931	—	—	931	—	931
Net income	—	—	—	6,776	—	6,776	965	7,741
Other comprehensive loss	—	—	—	—	(2,235)	(2,235)	(44)	(2,279)
Balance as of June 30, 2018	\$ 3,532	\$ 39	\$ 232,984	\$ (48,061)	\$ 1,172	\$ 189,666	\$ 3,867	\$ 193,533

There were no reclassification adjustments from accumulated other comprehensive income for the three and six months ended June 30, 2018 and 2017.

Stock Repurchase Program

On October 27, 2014, our Board of Directors approved a stock repurchase program pursuant to which we may repurchase up to \$5.0 million of our outstanding common stock. These repurchases can be made from time to time in the open market and are funded from our existing cash balances and cash generated from operations. During 2015, we repurchased approximately 908,000 shares at an average price of \$2.52 per share for a total purchase price of approximately \$2.3 million under the stock repurchase program. No shares were repurchased during 2016 and 2017. During the three and six months ended June 30, 2018, we did not repurchase any shares under the approved stock repurchase program. As of June 30, 2018, approximately \$2.7 million remained available for future repurchases

under this program. Currently, we do not plan to repurchase additional shares.

Note 9. Stock-Based Compensation

We account for stock-based compensation in accordance with the provisions of ASC Topic 718, Compensation-Stock Compensation (“ASC 718”), which established accounting for stock-based awards exchanged for employee services. Stock-based compensation cost is measured at each grant date, based on the fair value of the award, and is recognized as expense over the employee’s requisite service period of the award. All of our stock compensation is accounted for as an equity instrument.

The following table summarizes compensation costs related to our stock-based awards (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Cost of revenue	\$ 21	\$ 7	\$ 42	\$ 15
Selling, general and administrative	368	252	737	508
Research and development	75	51	152	99
Total stock-based compensation	464	310	931	622
Tax effect on stock-based compensation	—	—	—	—
Net effect on net income	\$ 464	\$ 310	\$ 931	\$ 622

Table of Contents

As of June 30, 2018, the unamortized compensation costs related to unvested stock options granted to employees under our stock option plan was approximately \$1.3 million, net of estimated forfeitures of \$158,000. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 2.0 years and will be adjusted for subsequent changes in estimated forfeitures. We did not capitalize any stock-based compensation to inventory as of June 30, 2018 and December 31, 2017 due to the immateriality of the amount.

We estimate the fair value of stock options using the Black-Scholes valuation model, consistent with the provisions of ASC 718. There were no options granted in the three and six months ended June 30, 2018. There were no options granted in the three months ended June 30, 2017. There were 60,000 options with a weighted-average grant date fair values of \$2.76 per share granted in the six months ended June 30, 2017. The fair values of our stock options granted to employees for six months ended June 30, 2018 and 2017 were estimated using the following weighted-average assumptions:

	Six Months Ended June 30, 2018		Six Months Ended June 30, 2017	
Expected term (in years)	—		5.9	
Volatility	—	%	46.71	%
Expected dividend	—	%	—	%
Risk-free interest rate	—	%	2.08	%

The following table summarizes the stock option transactions during the three months ended June 30, 2018 (in thousands, except per share data):

Stock Options	Number of Options Outstanding	Weighted- average Exercise Price	Weighted average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Balance as of January 1, 2018	2,666	\$ 3.81	6.87	\$ 13,149
Granted	—	—		
Exercised	(66)	2.68		
Canceled and expired	(2)	5.21		
Balance as of June 30, 2018	2,598	\$ 3.83	6.44	\$ 8,715
Options vested as of June 30, 2018 and unvested options expected to vest, net of forfeitures	2,576	\$ 3.81	6.42	\$ 8,678
Options exercisable as of June 30, 2018	1,771	\$ 3.42	5.71	\$ 6,452

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing price of \$7.05 on June 30, 2018, which would have been received by the option holder had all option holders exercised their options on that date.

Table of Contents

Restricted stock awards

A summary of activity related to restricted stock awards for the six months ended June 30, 2018 is presented below (in thousands, except per share data):

Stock Awards	Shares	Weighted-Average Grant Date Fair Value
Non-vested as of January 1, 2018	480	\$ 7.13
Granted	35	\$ 7.49
Vested	(49)	\$ 6.19
Forfeited	(3)	\$ 9.50
Non-vested as of June 30, 2018	463	\$ 7.24

As of June 30, 2018, the unamortized compensation costs related to unvested restricted stock awards was approximately \$2.8 million, which is to be amortized on a straight-line basis over a weighted-average period of approximately 1.6 years.

Note 10. Net Income Per Share

Basic net income per share is computed using the weighted-average number of common shares outstanding during the periods less shares of common stock subject to repurchase and non-vested stock awards. Diluted net income per share is computed using the weighted-average number of common shares outstanding and potentially dilutive common shares outstanding during the periods. The dilutive effect of outstanding stock options and restricted stock awards is reflected in diluted earnings per share by application of the treasury stock method. Potentially dilutive common shares consist of common shares issuable upon the exercise of stock options and vesting of restricted stock awards. Potentially dilutive common shares are excluded from the computation of weighted-average number of common shares outstanding in net loss years, as their effect would be anti-dilutive to the computation.

A reconciliation of the numerators and denominators of the basic and diluted net income per share calculations is as follows (in thousands, except per share data):

Three Months Ended June 30,	Six Months Ended June 30,
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	2018	2017	2018	2017
Numerator:				
Net income attributable to AXT, Inc.	\$ 3,901	\$ 1,930	\$ 6,776	\$ 2,595
Less: Preferred stock dividends	(44)	(44)	(88)	(88)
Net income available to common stockholders	\$ 3,857	\$ 1,886	\$ 6,688	\$ 2,507
Denominator:				
Denominator for basic net income per share - weighted-average common shares	39,001	38,306	38,970	36,238
Effect of dilutive securities:				
Common stock options	1,094	1,212	1,191	1,216
Restricted stock awards	121	188	128	191
Denominator for dilutive net income per common shares	40,216	39,706	40,289	37,645
Net income attributable to AXT, Inc. per common share:				
Basic	\$ 0.10	\$ 0.05	\$ 0.17	\$ 0.07
Diluted	\$ 0.10	\$ 0.05	\$ 0.17	\$ 0.07
Options excluded from diluted net income per share as the impact is anti-dilutive	228	622	186	617
Restricted stock excluded from diluted net income per share as the impact is anti-dilutive	249	—	240	5

Table of Contents

The 883,000 shares of \$0.001 par value Series A preferred stock issued and outstanding as of June 30, 2018 and December 31, 2017, valued at \$3,532,000, are non-voting and non-convertible preferred stock with a 5.0% cumulative annual dividend rate payable when declared by the board of directors and a \$4 per share liquidation preference over common stock, which must be paid before any distribution is made to common stockholders. These preferred shares were issued to Lyte Optronics, Inc. stockholders in connection with the completion of our acquisition of Lyte Optronics, Inc. on May 28, 1999.

Note 11. Segment Information and Foreign Operations

Segment Information

We operate in one segment for the design, development, manufacture and distribution of high-performance compound and single element semiconductor substrates and sale of raw materials integral to these substrates. In accordance with ASC Topic 280, Segment Reporting, our chief operating decision-maker has been identified as our Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the Company. Since we operate in one segment, all financial segment and product line information can be found in the condensed consolidated financial statements.

Product Information

The following table represents revenue amounts (in thousands) by product type:

	Three Months Ended		Six Months Ended	
	June 30, 2018	2017	June 30, 2018	2017
Product Type:				
Substrates	\$ 21,603	\$ 19,109	\$ 40,967	\$ 35,718
Raw Materials and Others	5,517	4,448	10,572	8,455
Total	\$ 27,120	\$ 23,557	\$ 51,539	\$ 44,173

Geographical Information

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The following table represents revenue amounts (in thousands) reported for products shipped to customers in the corresponding geographic region:

Geographical region:	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
China	\$ 8,820	\$ 6,324	\$ 16,003	\$ 10,746
Europe (primarily Germany)	6,685	5,848	13,078	11,446
Taiwan	4,280	4,195	9,329	7,513
Asia Pacific (excluding China, Taiwan and Japan)	2,571	2,645	4,065	4,716
Japan	2,524	2,862	4,979	6,002
North America (primarily the United States)	2,240	1,683	4,085	3,750
Total	\$ 27,120	\$ 23,557	\$ 51,539	\$ 44,173

Table of Contents

Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Long-lived assets, net of depreciation, by geographic region were as follows (in thousands):

	As of June 30, 2018	December 31, 2017
Long-lived assets by geographic region, net of depreciation:		
North America	\$ 853	\$ 1,410
China	64,321	45,120
	\$ 65,174	\$ 46,530

Significant Customers

No customer represented more than 10% of our revenue for the three months ended June 30, 2018 while two customers, Osram Opto and Landmark, represented 12% and 11% respectively, of our revenue for the three months ended June 30, 2017. Our top five customers, although not the same five customers for each period, represented 33% and 37% of our revenue for the three months ended June 30, 2018 and 2017, respectively.

Two customers, Osram Opto and Landmark, represented 11% and 10%, respectively, of our revenue for the six months ended June 30, 2018 while two customers, Osram Opto and Landmark, represented 11% and 10%, respectively, of our revenue for the six months ended June 30, 2017. Our top five customers, although not the same five customers for each period, represented 35% and 36% of our revenue for the six months ended June 30, 2018 and 2017, respectively.

We perform ongoing credit evaluations of our customers' financial condition, and limit the amount of credit extended when deemed necessary, but generally do not require collateral. One customer accounted for 11% of our accounts receivable balance as of June 30, 2018, and the same customer accounted for 12% of our accounts receivable balance as of December 31, 2017.

Note 12. Commitments and Contingencies

Indemnification Agreements

We have entered into indemnification agreements with our directors and officers that require us to indemnify our directors and officers against liabilities that may arise by reason of their status or service as directors or officers, other than liabilities arising from willful misconduct of a culpable nature; to advance their expenses incurred as a result of any proceeding against them as to which they could be indemnified; and to obtain directors' and officers' insurance if available on reasonable terms, which we currently have in place.

Table of Contents

Product Warranty

We provide warranties for our products for a specific period of time, generally twelve months, against material defects. We provide for the estimated future costs of warranty obligations in cost of sales when the related revenue is recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that we expect to incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. On a quarterly basis, we review the accrued balances and update the historical warranty cost trends. The following table reflects the change in our warranty accrual which is included in “Accrued liabilities” on the condensed consolidated balance sheets, during the three and six months ended June 30, 2018 and 2017 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Beginning accrued product warranty	\$ 117	\$ 133	\$ 133	\$ 251
Accruals for warranties issued	74	37	133	70
Adjustments related to pre-existing warranties including expirations and changes in estimates	23	(27)	(23)	(132)
Cost of warranty repair	(36)	(13)	(65)	(59)
Ending accrued product warranty	\$ 178	\$ 130	\$ 178	\$ 130

Contractual Obligations

We lease certain office space, warehouse facilities and equipment under long-term operating leases expiring at various dates through April 2023. The majority of our lease obligations relate to our lease agreement for the facility in Fremont, California with approximately 19,467 square feet. The term of the original lease for this facility would have expired in 2017. According to the lease agreement, we had an option to extend the term of the lease for an additional three years. In May 2017, we exercised this option and the lease was extended for an additional three year term. All terms of this lease otherwise remain the same and the term of this lease will expire in 2020.

We entered into a royalty agreement with a competitor effective December 3, 2010 with a term of eight years, terminating December 31, 2018. We and our related companies are granted a worldwide, nonexclusive, royalty bearing, irrevocable license to certain patents for the term of the agreement. We shall pay up to \$7.0 million of royalty payments over eight years that began in 2011 based on future royalty bearing sales. This royalty agreement contains a clause that allows us to claim a credit, starting in 2013, in the event that the royalty bearing sales for the year are lower than a pre-determined amount set forth in this agreement.

The following table summarizes our contractual obligations as of June 30, 2018 (in thousands):

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Operating leases	\$ 493	\$ 217	\$ 252	\$ 24	\$ —
Royalty agreement	288	288	—	—	—
Total	\$ 781	\$ 505	\$ 252	\$ 24	\$ —

Land Purchase and Investment Agreement

We are in the process of relocating our gallium arsenide production line to Dingxing, China. In addition to a land rights and building purchase agreement that we entered into with a private real estate development company to acquire our new manufacturing facility, we also entered into a cooperation agreement with the Dingxing local government. In addition to pledging its full support and cooperation, the Dingxing local government will issue certain credits or rebates to us as we achieve certain milestones. We, in turn, agreed to hire local workers over time, pay taxes when due and eventually demonstrate a total investment of approximately \$90 million in value, assets and capital. The investment will include cash paid for the land and buildings, cash on deposit in our name at local banks, the gross value of new and used equipment

Table of Contents

(including future equipment that might be used for indium phosphide and germanium substrates production), the deemed value for our customer list or the end user of our substrates (for example, the end users of 3-D sensing VCSELs (vertical cavity surface emitting lasers)), a deemed value for employment of local citizens, a deemed value for our proprietary process technology, other intellectual property, other intangibles and additional items of value. There is no timeline or deadline by which this must be accomplished, rather it is a good faith covenant entered into between AXT and the Dingxing local government. Further, there is no specific penalty contemplated if either party breaches the agreement. However, the agreement does state that each party has a right to seek from the other party compensation for losses. Under certain conditions, the Dingxing local government may purchase the land and building at the appraised value. We believe that such cooperation agreements are normal, customary and usual in China and that the future valuation is flexible. We have a similar agreement with the city of Kazuo, China, although on a smaller scale. The total investment targeted by AXT in Kazuo is approximately \$15 million in value, assets and capital. In addition, BoYu has a similar agreement with the city of Kazuo. The total investment targeted by BoYu in Kazuo is approximately \$8 million in value, assets and capital.

Purchase Obligations with Penalties for Cancellation

In the normal course of business, we issue purchase orders to various suppliers. In certain cases, we may incur a penalty if we cancel the purchase order. As of June 30, 2018, we do not have any outstanding purchase orders that will incur a penalty if cancelled by the Company.

Legal Proceedings

From time to time we may be involved in judicial or administrative proceedings concerning matters arising in the ordinary course of business. We do not expect that any of these matters, individually or in the aggregate, will have a material adverse effect on our business, financial condition, cash flows or results of operations.

Note 13. Foreign Exchange Transaction Gains/Losses

We incurred a foreign currency transaction exchange loss of \$116,000 and \$90,000 for the three months ended June 30, 2018 and 2017, respectively. We incurred a foreign currency transaction exchange loss of \$340,000 and a loss of \$75,000 for the six months ended June 30, 2018 and 2017, respectively. These amounts are included in “Other (expense) income, net” on our condensed consolidated statements of operations.

Note 14. Income Taxes

We account for income taxes in accordance with ASC Topic 740, Income Taxes (“ASC 740”), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. ASC 740 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. Our deferred tax assets have been reduced to zero by a valuation allowance.

We provide for income taxes based upon the geographic composition of worldwide earnings and tax regulations governing each region, particularly China. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws, particularly in foreign countries such as China.

We recognize interest and penalties related to uncertain tax positions in income tax expense. Income tax expense for the three and six months ended June 30, 2018 includes no interest and penalties. As of June 30, 2018, we have no accrued interest and penalties related to uncertain tax positions. We file income tax returns in the U.S. federal, various states and foreign jurisdictions. We have substantially concluded all U.S. federal and state income tax matters through 2002 and 2013, respectively.

Provision for income taxes for the three and six months ended June 30, 2018 was mostly related to our wholly owned China subsidiaries and our three partially owned subsidiaries in China. Besides the state tax liabilities, no income taxes or benefits have been provided for U.S. operations for the three and six months ended June 30, 2018 due to the loss

Table of Contents

in the U.S. and the uncertainty of generating future profit in the U.S., which has resulted in our deferred tax asset being fully reserved.

On December 22, 2017, the Tax Cuts & Jobs Act (“TCJA”) was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business, such as imposing a one-time transition tax on deemed repatriation of deferred foreign income, reducing the U.S. federal statutory tax rate, and adopting a territorial tax system. The TCJA includes a provision to tax global intangible low-taxed income (“GILTI”) of foreign subsidiaries and a base erosion anti-abuse tax (“BEAT”) measure that taxes certain payments between a U.S. corporation and its subsidiaries. The GILTI and BEAT provisions of the TCJA is effective for us beginning January 1, 2018. We have included an estimate of the current GILTI impact in our June 30, 2018 tax provision. We are not subject to BEAT provision.

Note 15. Revenue

Revenue Recognition

We manufacture and sell high-performance compound semiconductor substrates including indium phosphide, gallium arsenide and germanium wafers, and our three consolidated subsidiaries sell certain raw materials, including 99.99% pure gallium (4N Ga), high purity gallium (7N Ga), pyrolytic boron nitride (pBN) crucibles and boron oxide (B₂O₃). After we ship our products, there are no remaining obligations or customer acceptance requirements that would preclude revenue recognition. Our products are typically sold pursuant to purchase orders placed by our customers, and our terms and conditions of sale do not require customer acceptance. We account for a contract with a customer when there is a legally enforceable contract, which could be the customer’s purchase order, the rights of the parties are identified, the contract has commercial terms, and collectibility of the contract consideration is probable. The majority of our contracts have a single performance obligation to transfer products and are short term in nature, usually less than one year. Our revenue is measured based on the consideration specified in the contract with each customer in exchange for transferring products that is generally based upon a negotiated, formula, list or fixed price. Revenue is recognized when control of the promised goods is transferred to our customer, which is either upon shipment from our dock, receipt at the customer’s dock, or removal from consignment inventory at the customer’s location, in an amount that reflects the consideration we expect to be entitled to receive in exchange for those goods.

We have elected to account for shipping and handling as activities to fulfill the promise to transfer the goods. As such, shipping and handling fees billed to customers in a sales transaction are recorded in revenue and shipping and handling costs incurred are recorded in cost of revenue. Sales taxes and value added taxes in foreign jurisdictions that are collected from customers and remitted to governmental authorities are accounted for on a net basis and, therefore, are excluded from net sales.

We do not provide training, installation or commissioning services. We provide for future returns based on historical data, prior experience, current economic trends and changes in customer demand at the time revenue is recognized. We do not recognize any asset associated with the incremental cost of obtaining revenue generating customer contracts. As such, sales commissions are expensed as incurred, given that the expected period of benefit is less than one year.

On January 1, 2018, we adopted ASC Topic 606, Revenue from Contracts with Customers (“ASC 606”), and its related amendments, using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. The adoption of ASC 606, using the modified retrospective approach, had no significant impact to our accumulated deficit as of January 1, 2018 and no significant impact to the total net cash from or used in operating, investing, or financing activities within the condensed consolidated statements of cash flows. In connection with this adoption on January 1, 2018, we reclassified our refund liabilities relating to sales with a right of return in the amount of \$169,000 to present it separately from “Accounts receivables” and included it in “Accrued liabilities” on the condensed consolidated balance sheets.

Table of Contents

Contract Balances

We receive payments from customers based on a billing schedule as established in our contracts. Contract assets are recorded when we have a conditional right to consideration for our completed performance under the contracts. Accounts receivables are recorded when the right to this consideration becomes unconditional. We do not have any material contract assets as of June 30, 2018.

Contract liabilities primarily relate to advances or deposits received from our customers before revenue is recognized under the contract. Contract liabilities are recognized as revenue as, or when, we perform under the contract. These amounts are recorded in “Accrued liabilities” on the condensed consolidated balance sheets.

	June 30, 2018	March 31 2018	December 31, 2017
Contract liabilities	\$ (927)	\$ (1,061)	\$ (924)
Revenue recognized in the six and three months period ended as of June 30, 2018 from:			
Amounts included in contract liabilities at the beginning of the period	\$ 600	\$ 382	Not Applicable

Disaggregated Revenue

In general, revenue disaggregated by product types and geography (See Note 11) is aligned according to the nature and economic characteristics of our business and provides meaningful disaggregation of our results of operations. Since we operate in one segment, all financial segment and product line information can be found in the condensed consolidated financial statements.

Practical Expedients and Exemptions

As part of our adoption of ASC 606, we elected to use the following practical expedients: (i) not to adjust the promised amount of consideration for the effects of a significant financing component when we expect, at contract inception, that the period between our transfer of a promised product or service to a customer and when the customer pays for that product or service will be one year or less; (ii) to expense costs as incurred for costs to obtain a contract when the amortization period would have been one year or less; (iii) not to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer.

In addition, we do not disclose the value of unsatisfied performance obligations for contracts with an original expected length of one year or less.

Note 16. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued new guidance related to revenue recognition, which outlines a comprehensive revenue recognition model and supersedes most current revenue recognition guidance. The new guidance requires a company to recognize revenue as control of goods or services transfers to a customer at an amount that reflects the expected consideration to be received in exchange for those goods or services. In August 2015, the FASB issued an amendment to defer the effective date of the guidance. The guidance became effective in the first quarter of our fiscal year 2018. The new standard creates a single source of revenue guidance under accounting principles generally accepted in the United States, eliminating industry-specific guidance.

The underlying principle of the standard is to recognize revenue when a customer obtains control of promised goods or services at an amount that reflects the consideration that is expected to be received in exchange for those goods or services. An entity should apply a five-step approach for recognizing revenue as follows (1) identify the contract with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when, or as, the entity satisfies a performance obligation. The standard also requires increased disclosures including the nature, amount, timing, and uncertainty of revenues and cash flows related to contracts with customers. The standard allows two methods of

Table of Contents

adoption: (1) retrospectively to each prior period presented ("full retrospective method"), or (2) retrospectively with the cumulative effect recognized in retained earnings as of the date of adoption ("modified retrospective method").

With regard to Accounting Standards Update ("ASU") 2014-09 Revenue from Contracts with Customers, we established a crossfunctional team to assess the potential impact of the new standard and reviewed current accounting policies and practices to identify potential differences that would result from applying the requirements of the new standard to revenue contracts and identifying appropriate changes to the business processes, systems and controls to support revenue recognition and disclosure requirements under the new standard. We completed our evaluation of the potential impact on business processes, systems, controls and condensed consolidated financial statements of the new revenue standard and have concluded there are no significant changes to our condensed consolidated statement of operations. In connection with this adoption on January 1, 2018, we reclassified our refund liabilities relating to sales with a right of return in the amount of \$169,000 to present it separately from "Accounts receivables" and included it in "Accrued liabilities" on the condensed consolidated balance sheets. We adopted this standard on January 1, 2018 using the modified retrospective method (See Note 15).

In January 2016, the FASB issued ASU 2016-01, which made changes to the accounting for financial instruments that primarily affect equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The amendments in this update supersede the guidance to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale) and require equity securities to be measured at fair value with changes in the fair value recognized through net income. The standard amends financial reporting by providing relevant information about an entity's equity investments and reducing the number of items that are recognized in other comprehensive income. This update became effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. We adopted this guidance effective January 1, 2018 and it did not have a significant impact on our condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, which replaces the existing guidance for leases. The new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than twelve months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years and requires retrospective application. We will adopt this standard in fiscal 2019 and are currently evaluating the impact of the guidance on our condensed consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, which reduces diversity in practice where the FASB was either unclear or did not provide specific guidance for classifying cash payments and receipts in the statement of cash flows for eight specific transactions. The guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years and requires retrospective application with early application permitted. We adopted this guidance effective January 1, 2018 and it did not have a significant impact on our condensed consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, which clarifies the accounting for the current and deferred income taxes for an intra-entity transfer of an asset other than inventory. The guidance is effective for fiscal years

beginning after December 15, 2017, including periods within those fiscal years and requires retrospective application with early application permitted. We adopted this guidance effective January 1, 2018 and it did not have a significant impact on our condensed consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, which clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The definition of a business affects many areas of accounting including acquisitions, disposals, goodwill, and consolidation. The guidance is effective for fiscal years beginning after December 15, 2017, including periods within those fiscal years and requires retrospective application with early application permitted. We adopted this guidance effective January 1, 2018 and it did not have a significant impact on our condensed consolidated financial statements.

Table of Contents

In May 2017, the FASB issued ASU No. 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. The guidance provides clarity and reduces diversity in practice and cost and complexity when accounting for a change to the terms or conditions of a share-based payment award. The guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance effective January 1, 2018 and it did not have a significant impact on our condensed consolidated financial statements.

Table of Contents

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

This quarterly report on Form 10-Q contains 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. Statements relating to our expectations regarding results of operations, customer demand, customer qualifications of our products, our ability to expand our markets or increase sales, the development of new products, applications, enhancements or technologies, the life cycles of our products and applications, gross margins, expense levels, the impact of the adoption of certain accounting pronouncements, our investments in capital projects, our ability to relocate our gallium arsenide production line in a timely and orderly manner, our estimated construction and relocation costs with respect to the relocation of our gallium arsenide production line, our ability to have customers re-qualify substrates from our new manufacturing location in Dingxing, China and our belief that we have adequate cash and investments to meet our needs over the next 12 months are forward-looking statements. Words such as “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “goals,” “should,” “continues,” “would,” “could” and similar expressions or variations of such are intended to identify forward looking statements, but are not the exclusive means of identifying forward looking statements in this quarterly report. Additionally, statements concerning future matters such as our strategy, plans, industry trends and the impact of trends and economic cycles on our business are forward-looking statements. All forward-looking statements are based upon management’s views as of the date of this quarterly report and are subject to risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated in such forward-looking statements. Such risks and uncertainties include those set forth under the section entitled “Risk Factors” in Item 1A below, as well as those discussed elsewhere in this quarterly report, and identify important factors that could disrupt or injure our business or cause actual results to differ materially from those predicted in any such forward-looking statements.

These forward-looking statements are not guarantees of future performance. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Readers are urged to carefully review and consider the various disclosures made in this report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations and prospects. We undertake no obligation to revise or update any forward looking statements in order to reflect any development, event or circumstance that may arise after the date of this report. This discussion should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2017 and the condensed consolidated financial statements included elsewhere in this report.

Table of Contents

Overview

AXT, Inc. (“AXT”, “the company”, “we,” “us,” and “our” refer to AXT, Inc. and its consolidated subsidiaries) is a worldwide materials science company that develops and produces high-performance compound and single element semiconductor substrates, also known as wafers. Our consolidated subsidiaries produce and sell certain raw materials some of which are used in our substrate manufacturing process and some of which are sold to other companies.

Our substrate wafers are used when a typical silicon substrate wafer cannot meet the performance requirements of a semiconductor or optoelectronic device. The dominant substrates used in producing semiconductor chips and other electronic circuits are made from silicon. However, certain chips may become too hot or perform their function too slowly if silicon is used as the base material. In addition, optoelectronic applications, such as LED lighting and chip-based lasers, do not use silicon substrates because they require a wave form frequency that cannot be achieved using silicon. Alternative or specialty materials are used to replace silicon as the preferred base in these situations. Our wafers provide such alternative or specialty materials. We do not design or manufacture the chips. We add value by researching, developing and producing the specialty material wafers. We have two product lines: specialty material substrates and raw materials integral to these substrates. Our compound substrates combine indium with phosphorous (indium phosphide: InP) or gallium with arsenic (gallium arsenide: GaAs). Our single element substrates are made from germanium (Ge).

Semi-insulating GaAs is used to create various high speed microwave components, including power amplifier chips used in cell phones, satellite communications and broadcast television applications. Semi-conducting GaAs substrates are used to create opto-electronic products, including high brightness light emitting diodes (HBLEDs) that are often used to backlight wireless handsets and liquid crystal display (LCD) TVs and also used for automotive panels, signage, display and lighting applications. A possible new application for semi-conducting GaAs is 3-D sensing chips using VCSELs (vertical cavity surface emitting lasers) as an array of lasers on a single chip that could be used in cell phones and other devices. InP is a high performance semiconductor substrate used in broadband and fiber optic applications and data center connectivity. In recent years, InP demand has increased. Ge substrates are used in applications such as solar cells for space and terrestrial photovoltaic applications.

Our raw materials include both raw gallium and purified gallium. We use purified gallium in producing our GaAs substrates and sell both raw gallium and purified gallium in the open market to other companies for use in magnetic materials, high temperature thermometers, single crystal ingots including gallium arsenide, gallium nitride, gallium antimonide, gallium phosphide, and other materials and alloys. We also produce pyrolytic boron nitride (pBN) crucibles used in the high temperature (typically in the range 500 C to 1,500 C) growth process of single crystal ingots and epitaxial layer growth in MBE (Molecular Beam Epitaxy) reactors. We use these pBN crucibles in our own ingot growth processes and also sell them in the open market to other companies. Our substrate product group generated 80%, 81% and 75% of our revenue and our raw materials product group generated 20%, 19% and 25% for 2017, 2016 and 2015, respectively.

Table of Contents

The following chart shows our substrate products and their materials, diameters and illustrative applications and shows our raw materials group primary products and their illustrative uses and applications.

Products	Wafer Diameter	Sample of Applications
Substrate Group		
Indium Phosphide (InP)	2", 3", 4"	<ul style="list-style-type: none"> • Fiber optic lasers and detectors • Passive Optical Networks (PONs) • Data center connectivity using light/lasers • Silicon photonics • Photonic Integrated circuits (PICs) • High efficiency terrestrial solar cells (CPV) • RF amplifier and switching (military wireless and potential 5G) • Infrared light-emitting diode (LEDs) motion control • Infrared thermal imaging
Gallium Arsenide (GaAs - semi-insulating)	1", 2", 3", 4", 5", 6"	<ul style="list-style-type: none"> • Power amplifiers for wireless devices • Direct broadcast television • High-performance transistors • Satellite communications • High efficiency solar cells for drones and automobiles
Gallium Arsenide (GaAs - semi-conducting)	1", 2", 3", 4", 5", 6"	<ul style="list-style-type: none"> • 3-D sensing using VCSELs • Data center communication using VCSELs • High brightness LEDs • Lasers • Near-infrared sensors • Printer head lasers and LEDs • Laser machining, cutting and drilling • Optical couplers • High efficiency solar cells for drones and automobiles • Night vision goggles
Germanium (Ge)	2", 4", 6"	<ul style="list-style-type: none"> • Satellite solar cells • Optical sensors and detectors • Terrestrial concentrated photo voltaic (CPV) cells • Multi-junction solar cells for satellites • Infrared detectors
Raw Materials Group		
4N raw gallium		<ul style="list-style-type: none"> • Magnetic materials • High temperature thermometers • Low melting point alloys • Optical glass • Infrared detectors
6N+ purified gallium		<ul style="list-style-type: none"> • Key material in single crystal ingots such as: <ul style="list-style-type: none"> - Gallium Arsenide (GaAs) - Gallium Nitride (GaN) - Gallium Antimonide (GaSb) - Gallium Phosphide (GaP)
Boron trioxide (B2O3)		

Gallium-Magnesium alloy	<ul style="list-style-type: none">• Encapsulant in the ingot growth of III-V compound semiconductors
pyrolytic boron nitride (pBN) crucibles	<ul style="list-style-type: none">• Used for the synthesis of organo-gallium compounds in epitaxial growth on semiconductor wafers• Used when growing single-crystal compound semiconductor ingots
pBN insulating parts	<ul style="list-style-type: none">• Used when growing epitaxial layers in MBE reactors• Metal-Organic Chemical Vapour Deposition (MOCVD) reactors and organic light-emitting diode (OLED) rings

Table of Contents

We manufacture all of our products in the People's Republic of China (PRC or China), which generally has favorable costs for facilities and labor compared with comparable facilities in the United States, Europe or Japan. Our supply chain includes partial ownership of 10 companies in China (subsidiaries/joint ventures). We believe this supply chain arrangement provides us with pricing advantages, reliable supply, market trend visibility and better sourcing lead-times for key raw materials central to manufacturing our substrates. Our subsidiaries and joint venture companies produce materials, including raw gallium (4N Ga), high purity gallium (6N Ga), arsenic, germanium, germanium dioxide, pyrolytic boron nitride (pBN) crucibles and boron oxide (B₂O₃). Our ownership and the ownership held by our consolidated subsidiaries in these companies range from 95% to 20%. We have board representation in all 10 of these companies. We consolidate the companies in which we have either a controlling financial interest, or majority financial interest combined with the ability to exercise substantive control over the operation or financial decisions made by such companies. We use the equity method to account for companies in which we have smaller financial interest and have the ability to exercise significant influence, but not control, over such companies. We purchase portions of the materials produced by these companies for our own use and they sell the remainder of their production to third parties.

The Beijing city government is expanding its offices into the area where our manufacturing facility is currently located and is in the process of moving thousands of government employees into this area. The Beijing city government desires to upgrade this area and has applied pressure on manufacturing companies to relocate, including us. We are cooperating with the government and, in accordance with our relocation plan, are relocating our gallium arsenide production line. On September 12, 2017, we announced that we completed the purchase of a new manufacturing site in the city of Dingxing, China. Dingxing, located in the province of Hebei and under the jurisdiction of the prefecture-level city of Baoding, is approximately a 90 minute drive south of our current Beijing location. The Dingxing site is approximately 18.75 acres and currently has three existing buildings, which comprise approximately 140,000 sq. feet of production space and 50,000 sq. feet designated for offices and dormitories. We are developing plans to construct a fourth building at this site. We have also acquired property in the city of Kazuo, China, located in the province of Liaoning near the Inner Mongolia Autonomous Region and under the jurisdiction of the prefecture-level city of Chaoyang. Initially, the Kazuo site will be used to perform the first step in producing gallium arsenide, which is the blending or synthesis of gallium and arsenic ("poly synthesis"). We also intend to use the Kazuo site for ingot growth. The Dingxing site will focus on wafer processing and the ingots will be shipped from our Kazuo site to our Dingxing site. Although our current focus is on relocating our gallium arsenide production line, we are also relocating our germanium production line and will consider moving our indium phosphide production line in the future. Additional environmental permits, regulatory approvals and zoning conformance applications are in process.

To mitigate our risks and maintain our production schedule, we are moving our gallium arsenide equipment in stages so that we will continue to produce our gallium arsenide products at our Beijing site and then subsequently transfer increasing volume to the new sites. This approach will also minimize any disruption to our customers. We intend to complete this relocation by the end of 2018 or the first half of 2019. The relocation of our gallium arsenide production line requires us to accurately execute our relocation plan. Our major customers will want to examine and qualify the wafer substrates produced from the new manufacturing line before placing volume purchase orders for such products. We have made available to certain customers initial gallium arsenide qualification wafers produced from the new manufacturing line. A failure to properly execute our relocation plan could result in disruption to our production and have a material adverse impact on our revenue and our results of operations and financial condition. If we fail to meet the product qualification requirements of a customer, we may lose sales to that customer. Our reputation may also be damaged. Any loss of sales could have a material adverse effect on our revenue and our results

of operations and financial condition.

Critical Accounting Policies and Estimates

We prepare our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Accordingly, we make estimates, assumptions and judgments that affect the amounts reported on our condensed consolidated financial statements. These estimates, assumptions and judgments about future events and their effects on our results cannot be determined with certainty, and are made based upon our historical experience and on other assumptions that are believed to be reasonable under the circumstances. These estimates may change as new events occur or additional information is obtained, and we may periodically be faced with uncertainties, the outcomes of which are not within our control and may not be known for a prolonged period of time.

30

Table of Contents

We have identified the policies below as critical to our business operations and understanding of our financial condition and results of operations. Critical accounting policies are material to the presentation of our condensed consolidated financial statements and require us to make difficult, subjective or complex judgments that could have a material effect on our financial reports and results of operations. They may require us to make assumptions about matters that are highly uncertain at the time of the estimate. Different estimates that we could have used, or changes in the estimate that are reasonably likely to occur, may have a material impact on our financial condition or results of operations.

Revenue Recognition

We manufacture and sell high-performance compound semiconductor substrates including indium phosphide, gallium arsenide and germanium wafers, and our three consolidated subsidiaries sell certain raw materials, including 99.99% pure gallium (4N Ga), high purity gallium (7N Ga), pyrolytic boron nitride (pBN) crucibles and boron oxide (B₂O₃). After we ship our products, there are no remaining obligations or customer acceptance requirements that would preclude revenue recognition. Our products are typically sold pursuant to purchase orders placed by our customers, and our terms and conditions of sale do not require customer acceptance. We account for a contract with a customer when there is a legally enforceable contract, which could be the customer's purchase order, the rights of the parties are identified, the contract has commercial terms, and collectibility of the contract consideration is probable. The majority of our contracts have a single performance obligation to transfer products and are short term in nature, usually less than one year.

Our revenue is measured based on the consideration specified in the contract with each customer in exchange for transferring products that is generally based upon a negotiated, formula, list or fixed price. Revenue is recognized when control of the promised goods is transferred to our customer, which is either upon shipment from our dock, receipt at the customer's dock, or removal from consignment inventory at the customer's location, in an amount that reflects the consideration we expect to be entitled to receive in exchange for those goods.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are recorded at the invoiced amount and are not interest bearing. We periodically review the likelihood of collection on our accounts receivable balances and provide an allowance for doubtful accounts receivable primarily based upon the age of these accounts. We evaluate receivables from U.S. customers with an emphasis on balances in excess of 90 days and for receivables from customers located outside the U.S. with an emphasis on balances in excess of 120 days and establish a reserve allowance on the receivable balances if needed. The reason for the difference in the evaluation of receivables between foreign and U.S. customers is that U.S. customers have historically made payments in a shorter period of time than foreign customers. Foreign business practices generally require us to allow customer payment terms that are longer than those accepted in the United

States. We assess the probability of collection based on a number of factors, including the length of time a receivable balance has been outstanding, our past history with the customer and their credit-worthiness.

We exercise judgment when determining the adequacy of our reserves as we evaluate historical bad debt trends, general economic conditions in the United States and internationally, and changes in customer financial conditions. Uncollectible receivables are recorded as bad debt expense when all efforts to collect have been exhausted and recoveries are recognized when they are received. As of June 30, 2018 and December 31, 2017, our accounts receivable, net balance was \$22.5 million and \$22.8 million, respectively, which was net of an allowance for doubtful accounts of \$358,000 and \$358,000, respectively. If actual uncollectible accounts differ substantially from our estimates, revisions to the estimated allowance for doubtful accounts would be required, which could have a material impact on our financial results for the future periods.

Historically, our allowance for sales returns reserve was deducted from gross accounts receivable. Upon adoption of the new revenue recognition guidance we reclassified our sales returns reserve to accrued liabilities. As of June 30, 2018 and December 31, 2017, the balance was \$82,000 and \$169,000, respectively.

Table of Contents

Product Warranty

We maintain a product warranty based upon our claims experience during the prior twelve months and any pending claims and returns of which we are aware. Warranty costs are accrued at the time revenue is recognized. As of June 30, 2018 and December 31, 2017, accrued product warranties totaled \$178,000 and \$133,000, respectively.

The increase in accrued product warranties is primarily attributable to increased claims for quality issues experienced by customers. If actual warranty costs or pending new claims differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material impact on our financial condition and results of operations for future periods.

Inventory Valuation

Inventories are stated at the lower of cost (approximated by standard cost) or net realizable value. Cost is determined using the weighted-average cost method. Our inventory consists of raw materials as well as finished goods and work in process that include material, labor and manufacturing overhead costs. We routinely evaluate the levels of our inventory in light of current market conditions in order to identify excess and obsolete inventory, and we provide a valuation allowance for certain inventories based upon the age and quality of the product and the projections for sale of the completed products. As of June 30, 2018 and December 31, 2017, we had an inventory reserve of \$13.7 million and \$13.3 million, respectively, for excess and obsolete inventory and \$26,000 and \$291,000, respectively, for lower of cost or net realizable value reserves. If actual demand for our products were to be substantially lower than estimated, additional inventory adjustments for excess or obsolete inventory might be required, which could have a material impact on our business, financial condition and results of operations.

Impairment of Investments

We classify marketable investments in debt and equity securities as available-for-sale securities in accordance with Accounting Standards Codification (“ASC”) Topic 320, Investments - Debt and Equity Securities (“ASC 320”). All available-for-sale securities with a quoted market value below cost (or adjusted cost) are reviewed in order to determine whether the decline is other-than-temporary. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.

We also invest in equity instruments of privately-held companies in China for business and strategic purposes. Investments in our unconsolidated joint venture companies are classified as other assets and accounted for under either the equity or cost method, depending on whether we have the ability to exercise significant influence over their operations or financial decisions. We monitor our investments for impairment and record reductions in carrying value when events or changes in circumstances indicate that the carrying value may not be recoverable. Determination of impairment is highly subjective and is based on a number of factors, including an assessment of the strength of each company's management, the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the company, fundamental changes to the business prospects of the company, share prices of subsequent offerings, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in our carrying value.

There were no impairment charges in the three and six months ended June 30, 2018. The six months ended June 30, 2017 include an impairment charge of \$313,000 for one of the gallium companies. During the first quarter of 2017, management determined it unlikely that this company will recover from the difficult pricing environment and we had written the investment down to zero.

Table of Contents

Fair Value of Investments

ASC 820, Fair Value Measurements and Disclosures (“ASC 820”) establishes three levels of inputs that may be used to measure fair value.

Level 1 instruments represent quoted prices in active markets. Therefore, determining fair value for Level 1 instruments does not require significant management judgment, and the estimation is not difficult.

Level 2 instruments include observable inputs other than Level 1 prices, such as quoted prices for identical instruments in markets with insufficient volume or infrequent transactions (less active markets), issuer bank statements, credit ratings, non-binding market consensus prices that can be corroborated with observable market data, model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated with observable market data for substantially the full term of the assets or liabilities, or quoted prices for similar assets or liabilities. These Level 2 instruments require more management judgment and subjectivity compared to Level 1 instruments, including:

- Determining which instruments are most similar to the instrument being priced requires management to identify a sample of similar securities based on the coupon rates, maturity, issuer, credit rating, and instrument type, and subjectively select an individual security or multiple securities that are deemed most similar to the security being priced.
- Determining which model-derived valuations to use in determining fair value requires management judgment. When observable market prices for identical securities or similar securities are not available, we price our marketable debt instruments using non-binding market consensus prices that are corroborated with observable market data or pricing models, such as discounted cash flow models, with all significant inputs derived from or corroborated with observable market data.

Level 3 instruments include unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. The determination of fair value for Level 3 instruments requires the most management judgment and subjectivity.

We place short-term foreign currency hedges that are intended to offset the potential cash exposure related to fluctuations in the exchange rate between the United States dollar and Japanese yen. We measure the fair value of these foreign currency hedges at each month end and quarter end using current exchange rates and in accordance with generally accepted accounting principles. At quarter end any foreign currency hedges not settled are netted in “Accrued

liabilities” on the condensed consolidated balance sheet and classified as Level 3 assets and liabilities. As of June 30, 2018 the net change in fair value from the placement of the hedge to settlement at each month end during the quarter had a de minimis impact to the consolidated results.

There have been no transfers between fair value measurement levels during the three and six months ended June 30, 2018 and 2017.

Impairment of Long-Lived Assets

We evaluate the recoverability of property, equipment and intangible assets in accordance with ASC Topic 360, Property, Plant and Equipment (“ASC 360”). When events and circumstances indicate that long-lived assets may be impaired, we compare the carrying value of the long-lived assets to the projection of future undiscounted cash flows attributable to these assets. In the event that the carrying value exceeds the future undiscounted cash flows, we record an impairment charge against income equal to the excess of the carrying value over the assets’ fair value. Fair values are determined based on quoted market values, discounted cash flows or internal and external appraisals, as applicable. Assets held for sale are carried at the lower of carrying value or estimated net realizable value. We had no assets held for sale on the condensed consolidated balance sheets as of June 30, 2018 and December 31, 2017.

Table of Contents

Stock-based Compensation

We account for stock-based compensation in accordance with ASC Topic 718, Stock-based Compensation (“ASC 718”). Share-based awards granted include stock options and restricted stock awards. We utilize the Black-Scholes option pricing model to estimate the grant date fair value of stock options, which requires the input of highly subjective assumptions, including estimating stock price volatility and expected term. Historical volatility of our stock price was used while the expected term for our options was estimated based on historical option exercise behavior and post-vesting forfeitures of options, and the contractual term, the vesting period and the expected term of the outstanding options. Further, we apply an expected forfeiture rate in determining the amount of share-based compensation. We use historical forfeitures to estimate the rate of future forfeitures. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our stock compensation. The cost of restricted stock awards is determined using the fair value of our common stock on the date of grant.

We recognize the compensation costs net of an estimated forfeiture rate over the requisite service period of the options award, which is generally the vesting term of four years. Compensation expense for restricted stock awards is recognized over the vesting period, which is generally one, three or four years. Stock-based compensation expense is recorded in cost of revenue, research and development, and selling, general and administrative expenses.

Income Taxes

We account for income taxes in accordance with ASC Topic 740, Income Taxes (“ASC 740”), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. ASC 740 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. Our deferred tax assets have been reduced to zero by valuation allowance.

We provide for income taxes based upon the geographic composition of worldwide earnings and tax regulations governing each region, particularly China. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws, particularly in foreign countries such as China.

See Note 14—“Income Taxes” in the notes to condensed consolidated financial statements for additional information.

Table of Contents

Results of Operations

Revenue

	Three Months Ended		Increase			Six Months Ended		Increase		
	June 30, 2018	2017	(Decrease)	% Change		June 30, 2018	2017	(Decrease)	% Change	
Product Type:	(\$ in thousands)					(\$ in thousands)				
Substrates	\$ 21,603	\$ 19,109	\$ 2,494	13.1	%	\$ 40,967	\$ 35,718	\$ 5,249	14.7	%
Raw Materials and Others	5,517	4,448	1,069	24.0	%	10,572	8,455	2,117	25.0	%
Total revenue	\$ 27,120	\$ 23,557	\$ 3,563	15.1	%	\$ 51,539	\$ 44,173	\$ 7,366	16.7	%

Revenue increased \$3.6 million, or 15.1%, to \$27.1 million for the three months ended June 30, 2018 from \$23.6 million for the three months ended June 30, 2017. The revenue increase for the three months ended June 30, 2018 as compared to the same period in 2017 was primarily the result of a higher demand for all of our substrates wafers, especially for our InP and Ge substrates. Sales of InP and Ge each increased over 20% in the three months ended June 30, 2018 as compared to the same period in 2017. The increase in our substrate sales resulted from a higher number of overall units sold while average selling prices remained either flat or decreased slightly. Our InP substrate revenue increased in the three months ended June 30, 2018 as compared to the same period in 2017 primarily due to increased demand for the passive optical network (PON) market while our Ge substrate revenue increased primarily due to more planned satellite launches in 2018. Raw materials sales increased \$1.1 million, or 24.0%, to \$5.5 million for the three months ended June 30, 2018 from \$4.5 million for the three months ended June 30, 2017 primarily as a result of increased sales of pBN crucibles. In addition, the average selling prices of raw materials increased.

Revenue increased \$7.4 million, or 16.7%, to \$51.5 million for the six months ended June 30, 2018 from \$44.2 million for the six months ended June 30, 2017. The revenue increase for the six months ended June 30, 2018 as compared to the same period in 2017 was primarily the result of higher demand for all of our substrates wafers, especially for our InP and Ge substrates. Each of these wafer substrate products had over a 25% increase in sales in the six months ended June 30, 2018 as compared to the same period in 2017. The increase in our substrate sales resulted from a higher number of overall units sold while average selling prices remained either flat or decreased slightly. Our InP substrate revenue increased in the six months ended June 30, 2018 as compared to the same period in 2017 primarily due to increased demand for the PON market while our Ge substrate revenue increased primarily due to more planned satellite launches in 2018. Stronger raw materials sales in the six months ended June 30, 2018 as compared to the same period in 2017 resulted primarily from a higher number of pBN crucibles sold and an increase in the average selling price of pBN crucibles. Additionally, the average selling price of purified gallium (greater than 4N purity) stabilized as demand increased and the market was less oversupplied, which contributed to the stronger performance of our raw materials sales.

Table of Contents

Revenue by Geographic Region

	Three Months Ended					
	June 30,	2017		Increase	% Change	
	2018			(Decrease)		
	(\$ in thousands)					
China	\$ 8,820	\$ 6,324		\$ 2,496	39.5	%
% of total revenue	33	% 27	%			
Europe (primarily Germany)	6,685	5,848		837	14.3	%
% of total revenue	25	% 25	%			
Taiwan	4,280	4,195		85	2.0	%
% of total revenue	16	% 18	%			
Asia Pacific (excluding China, Taiwan and Japan)	2,571	2,645		(74)	(2.8)	%
% of total revenue	9	% 11	%			
Japan	2,524	2,862		(338)	(11.8)	%
% of total revenue	9	% 12	%			
North America (primarily the United States)	2,240	1,683		557	33.1	%
% of total revenue	8	% 7	%			
Total revenue	\$ 27,120	\$ 23,557		\$ 3,563	15.1	%

Revenue from customers in China increased by 39.5% in the three months ended June 30, 2018, primarily due to an increase of \$2.0 million, or 50%, from wafer substrate sales and an increase of \$0.5 million, or 22%, from raw materials and others sales. Sales of each of our three wafer substrate products in China grew by over 40% in the three months ended June 30, 2018 as compared to the same period in 2017. The growth of Ge substrate sales in China that we experienced in 2016 and 2017 continued into 2018 as the satellite solar cell market remained strong in the three months ended June 30, 2018. Revenue from customers in Europe increased by 14.3%, primarily due to strong demand for InP substrates and GaAs substrates, which was partially offset by a decrease in Ge sales as the European satellite solar cell market declined in the three months ended June 30, 2018. Revenue from customers in North America increased by 33.1% in the three months ended June 30, 2018, primarily due to strong demand for GaAs substrates used in LED applications. Revenue from Japan, Taiwan and the other Asian Pacific countries, in aggregate, decreased by \$0.3 million in the three months ended June 30, 2018 due to a decrease in our wafer substrate sales, which was partially offset by a stronger raw materials sales performance of our consolidated subsidiaries.

	Six Months Ended					
	June 30,	2017		Increase	% Change	
	2018			(Decrease)		
	(\$ in thousands)					
China	\$ 16,003	\$ 10,746		\$ 5,257	48.9	%
% of total revenue	31	% 24	%			
Europe (primarily Germany)	13,078	11,446		1,632	14.3	%

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% of total revenue	25	%	26	%			
Taiwan	9,329		7,513		1,816	24.2	%
% of total revenue	18	%	17	%			
Japan	4,979		6,002		(1,023)	(17.0)	%
% of total revenue	10	%	14	%			
North America (primarily the United States)	4,085		3,750		335	8.9	%
% of total revenue	8	%	8	%			
Asia Pacific (excluding China, Taiwan and Japan)	4,065		4,716		(651)	(13.8)	%
% of total revenue	8	%	11	%			
Total revenue	\$ 51,539		\$ 44,173		\$ 7,366	16.7	%

The combined revenue from China and Taiwan increased \$7.1 million to \$25.3 for the six months ended June 30, 2018 from \$18.3 million for the six months ended June 30, 2017. The revenue increase for the six months ended June 30, 2018 as compared to the same period in 2017 was a result of an increase in each of our substrate products and raw

Table of Contents

materials sales. However, the combined revenue from other Asian countries and Japan decreased \$1.7 million for the six months ended June 30, 2018 to \$9.0 million from \$10.7 million for the six months ended June 30, 2017. The revenue decrease from these countries for the six months ended June 30, 2018 as compared to the same period in 2017 was primarily due to a decrease in our substrate product sales in these regions, which was partially offset by an increase in raw materials sales in these regions in the six months ended June 30, 2018.

Gross Margin

	Three Months Ended					Six Months Ended				
	June 30, 2018	2017	Increase (Decrease)	% Change		June 30, 2018	2017	Increase (Decrease)	% Change	
	(\$ in thousands)					(\$ in thousands)				
Gross profit	\$ 11,010	\$ 7,256	\$ 3,754	51.7	%	\$ 20,583	\$ 13,544	\$ 7,039	52.0	%
Gross Margin										
%	40.6	%	30.8	%		39.9	%	30.7	%	

Gross profit increased \$3.8 million, or 51.7%, to \$11.0 million for the three months ended June 30, 2018 from \$7.3 million for the three months ended June 30, 2017. Gross margin increased primarily due to favorable product mix, higher production volume and overall improvements in yield and manufacturing efficiencies for the three months ended June 30, 2018 as compared to the same period in 2017.

Gross profit increased \$7.0 million, or 52.0%, to \$20.6 million for the six months ended June 30, 2018 from \$13.5 million for the six months ended June 30, 2017. Gross profit increased primarily due to overall improvements in yield and manufacturing efficiencies and higher production volume for the six months ended June 30, 2018 as compared to the same period in 2017.

Selling, General and Administrative Expenses

	Three Months Ended					Six Months Ended				
	June 30, 2018	2017	Increase (Decrease)	% Change		June 30, 2018	2017	Increase (Decrease)	% Change	
	(\$ in thousands)					(\$ in thousands)				
Selling, general and	\$ 4,987	\$ 3,942	\$ 1,045	26.5	%	\$ 9,209	\$ 7,735	\$ 1,474	19.1	%

administrative
expenses
% of total
revenue

18.4 % 16.7 %

17.9 % 17.5 %

Selling, general and administrative expenses increased \$1.0 million, or 26.5%, to \$5.0 million for the three months ended June 30, 2018 from \$3.9 million for the three months ended June 30, 2017. The higher selling, general and administrative expenses were primarily from higher personnel-related costs from hiring a new direct sales professional in Europe and higher travel expenses related to our new manufacturing sites, which were partially offset by the lower professional service fees and lower sales commission expense resulting from the termination of our European sales representative.

Selling, general and administrative expenses increased \$1.5 million, or 19.1%, to \$9.2 million for the six months ended June 30, 2018 from \$7.7 million for the six months ended June 30, 2017. The higher selling, general and administrative expenses incurred in the six months ended June 30, 2018 as compared to the same period of 2017 were primarily from higher personnel-related costs and higher travel expenses related to our new manufacturing sites which were partially offset by the lower professional service fees, lower in sales commission resulting from the terminations of our European sales representatives in Europe and the absence of expenses incurred as a result of business interruption caused by the electrical fire in our Beijing facility on the evening of March 15, 2017.

Table of Contents

Research and Development

	Three Months Ended					Six Months Ended				
	June 30, 2018	2017	Increase (Decrease)	% Change		June 30, 2018	2017	Increase (Decrease)	% Change	
	(\$ in thousands)					(\$ in thousands)				
Research and development	\$ 1,500	\$ 1,019	\$ 481	47.2	%	\$ 2,920	\$ 2,143	\$ 777	36.3	%
% of total revenue	5.5	%	4.3	%		5.7	%	4.9	%	

Research and development expenses increased \$0.5 million, or 47.2%, to \$1.5 million for the three months ended June 30, 2018 from \$1.0 million for the three months ended June 30, 2017. Research and development expenses increased \$0.8 million, or 36.3%, to \$2.9 million for the six months ended June 30, 2018 from \$2.1 million for the six months ended June 30, 2017. The increase in research and development expenses for the three and six months ended June 30, 2018 was primarily due to the increased use of raw materials for product development programs at two of our consolidated subsidiaries and higher personnel-related costs.

Interest Income, Net

	Three Months Ended					Six Months Ended				
	June 30, 2018	2017	Increase (Decrease)	% Change		June 30, 2018	2017	Increase (Decrease)	% Change	
	(\$ in thousands)					(\$ in thousands)				
Interest income, net	\$ 139	\$ 114	\$ 25	21.9	%	\$ 281	\$ 212	\$ 69	32.5	%
% of total revenue	0.5	%	0.5	%		0.5	%	0.5	%	

Interest income, net increased for the three and six months ended June 30, 2018 as compared to the same period in 2017 primarily due to the increased cash balance as a result of the secondary public offering in March 2017 and higher market interest rates.

Equity in Earnings (Loss) of Unconsolidated Joint Ventures

	Three Months Ended		Equity in Earnings		Six Months Ended		Equity in Loss			
	June 30, 2018	2017	Increase	% Change	June 30, 2018	2017	Decrease	% Change		
	(\$ in thousands)				(\$ in thousands)					
Equity in earnings (loss) of unconsolidated joint ventures	\$ 307	\$ (188)	\$ 495	263.3	% \$ (27)	\$ (1,121)	\$ 1,094	97.6		%
% of total revenue	1.1	% (0.8)	%		(0.1)	% (2.5)	%			

Equity in earnings (loss) of unconsolidated joint ventures is the aggregate net income (loss) from our seven minority-owned joint ventures that are not consolidated. Equity in earnings of unconsolidated joint ventures increased \$495,000 to earnings of \$307,000 for the three months ended June 30, 2018 from a loss of \$188,000 for the three months ended June 30, 2017 as our unconsolidated joint ventures reported better performance in the three months ended in June 30, 2018 as compared to the same period of 2017. The improvement is the result of price increases for raw materials. There were no impairment charges in the three months ended June 30, 2017.

Equity in loss of unconsolidated joint ventures decreased \$1.1 million to a loss of \$27,000 for the six months ended June 30, 2018 from a loss of \$1.1 million for the six months ended June 30, 2017 as a result of the absence of a \$313,000 impairment charge for one of the gallium companies in the six months ended June 30, 2017, better performance of our unconsolidated joint ventures and price increases for raw materials in the six months ended in June 30, 2018 as compared to the same period of 2017. There were no impairment charges in the six months ended June 30, 2018. The six months ended June 30, 2017 include an impairment charge of \$313,000 for one of the gallium companies. During the first quarter of 2017, management determined it is unlikely that this company will recover from the difficult pricing environment and we had written the investment down to zero.

Table of Contents

Other Expense, Net

	Three Months Ended				Six Months Ended			
	June 30, 2018 (\$ in thousands)	2017	(Increase) Decrease	% Change	June 30, 2018 (\$ in thousands)	2017	(Increase) Decrease	% Change
Other expense, net	\$ (51)	\$ (102)	\$ 51	50.0	% \$ (266)	\$ (54)	\$ (212)	392.6
% of total revenue	(0.2) %	(0.4) %			(0.5) %	(0.1) %		

Other expense, net decreased \$51,000 to a loss of \$51,000 for the three months ended June 30, 2018 from a loss of \$102,000 for the three months ended June 30, 2017. Other expense, net decreased primarily due to a higher government subsidies received by our wholly owned subsidiary and one of our consolidated subsidiaries in the three months ended June 30, 2018 as compared to the same period in 2017.

Other expense, net increased \$212,000 to a loss of \$266,000 for the six months ended June 30, 2018 from a loss of \$54,000 for the six months ended June 30, 2017. Other expense, net increased primarily due to an absence of the realized gain recognized from sales of GHI stock in the six months ended June 30, 2018. During the first quarter of 2017, we sold the remainder of our GHI stock. In addition, the foreign exchange loss for the six months ended June 30, 2018 was greater than the loss of the same period in 2017.

Provision for Income Taxes

	Three Months Ended				Six Months Ended			
	June 30, 2018 (\$ in thousands)	2017	Increase (Decrease)	% Change	June 30, 2018 (\$ in thousands)	2017	Increase (Decrease)	% Change
Provision for income taxes	\$ 367	\$ 321	\$ 46	14.3	% \$ 701	\$ 480	\$ 221	46.0
% of total revenue	1.4 %	1.4 %			1.4 %	1.1 %		

Provision for income taxes for the three and six months ended June 30, 2018 was \$367,000 and \$701,000, respectively, which was mostly related to higher profits in our China subsidiaries and our three consolidated joint venture companies in China. No income taxes or benefits have been provided for our U.S. operations as the income in the U.S. had been fully offset by utilization of federal and state net operating loss carryforwards. Additionally, there is uncertainty of generating future profit in the U.S. which has resulted in our deferred tax assets being fully reserved. Our estimated tax rate can vary greatly from year to year because of the change or benefit in the mix of taxable income between our U.S. and China based operations.

Due to our uncertainty regarding our future profitability in the U.S., we recorded a full valuation allowance against our net deferred tax assets of \$22 million in 2017, \$68 million in 2016 and \$66 million in 2015.

Net (Income) Loss Attributable to Noncontrolling Interests

	Three Months Ended		Net income attributable to Noncontrolling interests			Six Months Ended		Net income attributable to Noncontrolling interests		
	June 30, 2018	2017	Increase	% Change		June 30, 2018	2017	Increase	% Change	
	(\$ in thousands)					(\$ in thousands)				
Net (income) loss attributable to noncontrolling interests	\$ (650)	\$ 132	\$ 782	592.4	%	\$ (965)	\$ 372	\$ 1,337	359.4	%
% of total revenue	(2.4) %	0.6 %				(1.9) %	0.8 %			

The increase in noncontrolling interests' share of income for the three and six months ended June 30, 2018 as compared to the same period in 2017 was due to higher profitability from two of our three consolidated subsidiaries in China which was partially offset with lower profitability from our other consolidated subsidiary in China.

Table of Contents

Liquidity and Capital Resources

We consider cash and cash equivalents, short-term investments and long-term investments as liquid and available for use within two years in our current operations. Short-term investments and long-term investments are comprised of U.S. government securities and investment-grade corporate notes and bonds.

As of June 30, 2018, our principal source of liquidity was \$54.2 million, which consisted of cash and cash equivalents of \$29.7 million, short-term investments of \$18.8 million and long-term investments of \$5.7 million. In the six months ended June 30, 2018, cash and cash equivalents decreased by \$14.7 million and short-term and long-term investments decreased by \$8.1 million. The decrease in cash and cash equivalents of \$14.7 million in the six months ended June 30, 2018 was primarily due to net cash used in investing activities of \$14.0 million, net cash used in operating activities of \$0.5 million and the effect of exchange rate changes of \$0.2 million. As of June 30, 2018, we and our consolidated joint ventures held approximately \$18.5 million in cash and investments in foreign bank accounts. This consists of \$9.3 million held by our wholly owned subsidiaries in China and \$9.2 million held by our three partially-owned consolidated subsidiaries in China.

As of June 30, 2017, our principal source of liquidity was \$87.5 million, which consisted of cash and cash equivalents of \$56.5 million, short-term investments of \$22.5 million and long-term investments of \$8.6 million. In the six months ended June 30, 2017, cash and cash equivalents increased by \$20.3 million and short-term and long-term investments increased by \$13.5 million. The increase in cash and cash equivalents of \$20.3 million in the six months ended June 30, 2017 was primarily due to net cash provided by operating activities of \$3.2 million, net cash provided by financing activities of \$32.3 million, primarily due to the net proceeds of \$31.9 million received from the public offering of 5,307,692 shares of our common stock in March 2017 and the effect of exchange rate changes of \$0.2 million, which were partially offset by net cash used in investing activities of \$15.4 million. As of June 30, 2017, we and our consolidated joint ventures held approximately \$11.2 million in cash and investments in foreign bank accounts. This consists of \$5.0 million held by our wholly owned subsidiary in China and \$6.2 million held by our three partially-owned consolidated subsidiaries in China.

Net cash used in operating activities of \$0.5 million for the six months ended June 30, 2018 was primarily comprised of a net change of \$11.4 million in operating assets and liabilities which were partially offset by net income of \$7.7 million, adjusted for non-cash items of depreciation and amortization of \$2.2 million, stock-based compensation of \$0.9 million, amortization of marketable securities of \$0.1 million.

Net cash provided by operating activities of \$3.2 million for the six months ended June 30, 2017 was primarily comprised of a net income of \$2.2 million, adjusted for non-cash items of depreciation and amortization of \$2.3 million, loss on equity method investments of \$0.8 million, stock-based compensation of \$0.6 million, impairment charge on equity investee of \$0.3 million, which were partially offset by a net change of \$3.0 million in operating

assets and liabilities.

Net cash used in investing activities of \$14.0 million for the six months ended June 30, 2018 was primarily from the purchase of property, plant and equipment of \$21.9 million and the purchase of marketable investment securities totaling \$9.9 million, which were partially offset by proceeds from maturities and sales of available-for-sale securities of \$17.9 million.

Net cash used in investing activities of \$15.4 million for the six months ended June 30, 2017 was primarily from the purchase of marketable investment securities totaling \$23.8 million and the purchase of property, plant and equipment of \$1.8 million, which were partially offset by proceeds from maturities and sales of available-for-sale securities of \$10.2 million.

Net cash provided by financing activities was \$15,000 for the six months ended June 30, 2018, which consisted of net proceeds of \$178,000 on the issuance of common stock pursuant to stock option exercises which was partially offset by the purchase of subsidiary shares from noncontrolling interest of \$163,000.

Table of Contents

Net cash provided by financing activities was \$32.3 million for the six months ended June 30, 2017, which mainly consisted of \$31.9 million net proceeds from the issuance of 5,307,692 shares of common stock as a result of our March 2017 stock offering and net proceeds of \$0.9 million on the issuance of common stock pursuant to stock option exercises, which were partially offset by net dividends paid by our joint ventures of \$0.5 million.

On October 27, 2014, our Board of Directors approved a stock repurchase program pursuant to which we may repurchase up to \$5.0 million of our outstanding common stock. These repurchases could be made from time to time in the open market and could be funded from our existing cash balances and cash generated from operations. During 2015, we repurchased approximately 908,000 shares at an average price of \$2.52 per share for a total purchase price of approximately \$2.3 million under the stock repurchase program. No shares were repurchased during 2016 under this program. During six months ended June 30, 2018, we did not repurchase any shares under the approved stock repurchase program. As of June 30, 2018, approximately \$2.7 million remained available for future repurchases under this program. Currently, we do not plan to repurchase additional shares.

Dividends accrue on our outstanding Series A preferred stock, and are payable as and when declared by our board of directors. We have never paid or declared any dividends on the Series A preferred stock. By the terms of the Series A preferred stock, so long as any shares of Series A preferred stock are outstanding, neither the Company nor any subsidiary of the Company shall redeem, repurchase or otherwise acquire any shares of common stock, unless all accrued dividends on the Series A preferred stock have been paid. During 2013 and 2015, we repurchased shares of our outstanding common stock. As of December 31, 2015, the Series A preferred stock had cumulative dividends of \$2.9 million and we include such cumulative dividends in “Accrued liabilities” in our condensed consolidated balance sheets. If we are required to pay the cumulative dividends on the Series A preferred stock, our cash and cash equivalents would be reduced. We account for the cumulative year to date dividends on the Series A preferred stock when calculating our earnings per share.

The China central government is working with the Beijing city government to design a master development plan of the area where our manufacturing facility is located, which will result in the relocation of many of the manufacturing companies in our district. We are required to relocate our gallium arsenide production line. We are cooperating with the government and, in accordance with our relocation plan, are relocating our gallium arsenide production line as well as our germanium production line. We will consider relocating our indium phosphide production subsequently. On September 12, 2017, we announced that we completed the purchase of a new manufacturing site in the city of Dingxing, China. The Dingxing site is approximately 18.75 acres and currently has three existing buildings, which comprise approximately 140,000 sq. feet of production space and 50,000 sq. feet designated for offices and dormitories. We believe that 3D-sensing VCELs will require additional gallium arsenide capacity and we are developing plans to construct a fourth building at this site. In addition, we have acquired a second new site in city of Kazuo, located in the province in Liaoning near the Inner Mongolia Autonomous Region, which will initially be used for poly synthesis and ingot growth for gallium arsenide and germanium as well as possible expansion of indium phosphide ingot growth. We do not yet have comprehensive construction bids for further modifications to the existing buildings, the construction of new buildings or third party estimates for the complete relocation costs, but we believe these costs will be in the range of \$40 million to \$50 million, which includes the amount we have already paid for the purchase of our new manufacturing facilities and will extend into 2019. However, such costs could be higher than our current estimates.

One of our consolidated joint venture companies, JinMei, is in the process of relocating its manufacturing operation to Kazuo, very near our new site in Kazuo, and the estimated cost for the relocation is in the range of \$2 million to \$4 million. Another of our consolidated joint venture companies is also relocating its manufacturing operations to Kazuo and the estimated cost for the relocation is in the range of \$3 million to \$4 million.

We believe that we have adequate cash and investments to meet our operating needs over the next twelve months. If our sales decrease, however, our ability to generate cash from operations will be adversely affected which could adversely affect our future liquidity, require us to use cash at a more rapid rate than expected, and require us to seek additional capital.

Table of Contents

On October 24, 2016, we filed with the SEC a registration statement on Form S-3, pursuant to which we may offer up to \$60 million of common stock, preferred stock, depositary shares, warrants, debt securities and/or units in one or more offerings and in any combination. On November 4, 2016, the SEC declared the registration statement effective. A prospectus supplement, which we will provide each time we offer securities, will describe the specific amounts, prices and terms of the securities we determine to offer.

On March 2, 2017, we filed with the SEC a final prospectus supplement, pursuant to which we offered and sold 5,307,692 shares of our common stock. The net proceeds are being used for the relocation of our gallium arsenide production line, for equipment capital expenditures, working capital for accounts receivable and inventory, possible acquisitions of complementary products, technologies or businesses and other general purposes.

Cash from operations could be affected by various risks and uncertainties, including, but not limited to those set forth below under Item 1A “Risk Factors”.

Contractual Obligations and Operating Leases

We lease certain office space, warehouse facilities and equipment under long-term operating leases expiring at various dates through April 2023. The majority of our lease obligations relates to our lease agreement for the facility in Fremont, California with approximately 19,467 square feet.

We entered into a royalty agreement with a competitor effective December 3, 2010 with a term of eight years, terminating December 31, 2018. We and our related companies are granted a worldwide, nonexclusive, royalty bearing, irrevocable license to certain patents for the term of the agreement. We shall pay up to \$7.0 million of royalty payments over eight years that began in 2011 based on future royalty bearing sales. This agreement contains a clause that allows us to claim credit, starting in 2013, in the event that the royalty bearing sales for the year is lower than a pre-determined amount set forth in this agreement.

Outstanding contractual obligations as of June 30, 2018 are summarized as follows (in thousands):

	Payments due by period				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Contractual Obligations					
Operating leases	\$ 493	\$ 217	\$ 252	\$ 24	\$ —
Royalty agreement	288	288	—	—	—

Total	\$ 781	\$ 505	\$ 252	\$ 24	\$ —
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Purchase orders or contracts for the purchase of certain goods and services are not included in the preceding table. We cannot determine the aggregate amount of such purchase orders that represent contractual obligations because purchase orders may represent authorizations to purchase rather than binding agreements. For the purposes of this table, contractual obligations for purchase of goods or services are defined as agreements that are enforceable and legally binding and that specify all significant terms, including fixed or minimum quantities to be purchased; fixed, minimum, or variable price provisions; and the approximate timing of the transaction. Our purchase orders are based on our current needs and are fulfilled by our vendors within short time horizons. We also enter into contracts for outsourced services; however, the obligations under these contracts were not significant and the contracts generally contain clauses allowing for cancellation without significant penalty. Contractual obligations that are contingent upon the achievement of certain milestones are not included in the table above.

Land Purchase and Investment Agreement

We are in the process of relocating our gallium arsenide production line to Dingxing, China. In addition to a land rights and building purchase agreement that we entered into with a private real estate development company to acquire our new manufacturing facility, we also entered into a cooperation agreement with the Dingxing local government. In addition to pledging its full support and cooperation, the Dingxing local government will issue certain credits or rebates to us as we achieve certain milestones. We, in turn, agreed to hire local workers over time, pay taxes

Table of Contents

when due and eventually demonstrate a total investment of approximately \$90 million in value, assets and capital. The investment will include cash paid for the land and buildings, cash on deposit in our name at local banks, the gross value of new and used equipment (including future equipment that might be used for indium phosphide and germanium substrates production), the deemed value for our customer list or the end user of our substrates (for example, the end users of 3-D sensing VCSELs), a deemed value for employment of local citizens, a deemed value for our proprietary process technology, other intellectual property, other intangibles and additional items of value. There is no timeline or deadline by which this must be accomplished, rather it is a good faith covenant entered into between AXT and the Dingxing local government. Further, there is no specific penalty contemplated if either party breaches the agreement. However the agreement does state that each party has a right to seek from the other party compensation for losses. Under certain conditions, the Dingxing local government may purchase the land and building at the apprai