

APPLIED OPTOELECTRONICS, INC.

Form 10-Q

August 08, 2017

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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, 2017

OR

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

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

Commission File Number: 001-36083

Applied Optoelectronics, Inc.

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(Exact name of registrant as specified in its charter)

Delaware 76-0533927  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

13139 Jess Pirtle Blvd.

Sugar Land, TX 77478

(Address of principal executive offices)

(281) 295-1800

(Registrant's telephone number)

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 ("Exchange Act") 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 corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  
Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) 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: as of August 2, 2017 there were 19,303,210 shares of the registrant's Common Stock outstanding.

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## Part I. Financial Information

## Item 1. Condensed Consolidated Financial Statements

## Applied Optoelectronics, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

|  | June 30,<br>2017  | December 31,<br>2016 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Current Assets   |                   |                      |
| Cash and cash equivalents  | \$ 74,825         | \$ 50,224            |
| Restricted cash  | 1,054             | 1,732                |
| Short-term investments   | 42                | 44                   |
| Accounts receivable - trade, net of allowance of \$31 at June 30, 2017 and December 31, 2016, respectively                                   | 73,759            | 49,766               |
| Inventories  | 59,701            | 51,817               |
| Notes receivable   | —                 | —                    |
| Prepaid expenses and other current assets  | 9,131             | 3,969                |
| Total current assets   | 218,512           | 157,552              |
| Cash restricted for construction in progress   | —                 | 8                    |
| Property, plant and equipment, net of accumulated depreciation of \$58,596 and \$49,175 at June 30, 2017 and December 31, 2016, respectively | 165,154           | 144,098              |
| Land use rights, net   | 786               | 778                  |
| Intangible assets, net   | 4,007             | 3,993                |
| Deferred income tax assets   | 10,026            | 11,421               |
| Other assets, net  | 8,501             | 4,468                |
| <b>TOTAL ASSETS</b>  | <b>\$ 406,986</b> | <b>\$ 322,318</b>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                      |
| Current liabilities  |                   |                      |
| Current portion of notes payable and long-term debt  | \$ 4,552          | \$ 7,865             |
| Accounts payable   | 53,321            | 36,375               |
| Bank acceptance payable  | —                 | 307                  |
| Accrued income taxes   | 4,947             | 974                  |
| Accrued liabilities  | 13,850            | 14,452               |
| Total current liabilities  | 76,670            | 59,973               |
| Notes payable and long-term debt, less current portion   | 22,814            | 34,961               |
| <b>TOTAL LIABILITIES</b>   | <b>99,484</b>     | <b>94,934</b>        |
| Stockholders' equity:  |                   |                      |

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|   |            |            |
|---|------------|------------|
| Preferred Stock; 5,000 shares authorized at \$0.001 par value; no shares issued and outstanding at June 30, 2017 or December 31, 2016, respectively               | —          | —          |
| Common Stock; 45,000 shares authorized at \$0.001 par value; 19,192 and 18,400 shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively | 19         | 18         |
| Additional paid-in capital  | 290,067    | 265,264    |
| Accumulated other comprehensive gain (loss)   | 4,369      | (885)      |
| Retained earnings (accumulated deficit)   | 13,047     | (37,013)   |
| TOTAL STOCKHOLDERS' EQUITY  | 307,502    | 227,384    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY  | \$ 406,986 | \$ 322,318 |

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

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Applied Optoelectronics, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, in thousands, except share and per share data)

|  | Three months ended June 30, |            | Six months ended June 30, |            |
|--|-----------------------------|------------|---------------------------|------------|
|  | 2017                        | 2016       | 2017                      | 2016       |
| Revenue, net   | \$ 117,371                  | \$ 55,254  | \$ 213,595                | \$ 105,676 |
| Cost of goods sold   | 64,089                      | 37,952     | 118,841                   | 74,121     |
| Gross profit   | 53,282                      | 17,302     | 94,754                    | 31,555     |
| Operating expenses   |                             |            |                           |            |
| Research and development   | 8,073                       | 7,814      | 15,505                    | 16,210     |
| Sales and marketing  | 2,158                       | 1,610      | 4,061                     | 3,290      |
| General and administrative   | 8,786                       | 5,906      | 16,608                    | 11,639     |
| Total operating expenses   | 19,017                      | 15,330     | 36,174                    | 31,139     |
| Income from operations   | 34,265                      | 1,972      | 58,580                    | 416        |
| Other income (expense)   |                             |            |                           |            |
| Interest income  | 70                          | 65         | 105                       | 166        |
| Interest expense   | (245)                       | (450)      | (544)                     | (851)      |
| Other income (expense), net  | 64                          | (932)      | (544)                     | (598)      |
| Total other income (expense)   | (111)                       | (1,317)    | (983)                     | (1,283)    |
| Income (loss) before income taxes                                    | 34,154                      | 655        | 57,597                    | (867)      |
| Income tax (expense) benefit   | (5,083)                     | (52)       | (8,737)                   | 140        |
| Net income (loss)  | \$ 29,071                   | \$ 603     | \$ 48,860                 | \$ (727)   |
| Net income (loss) per share  |                             |            |                           |            |
| Basic  | \$ 1.52                     | \$ 0.04    | \$ 2.59                   | \$ (0.04)  |
| Diluted  | \$ 1.43                     | \$ 0.03    | \$ 2.45                   | \$ (0.04)  |
| Weighted average shares used to compute net income (loss) per share: |                             |            |                           |            |
| Basic  | 19,081,034                  | 17,090,750 | 18,840,656                | 17,010,506 |
| Diluted  | 20,367,127                  | 17,454,552 | 19,956,097                | 17,010,506 |

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



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Applied Optoelectronics, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited, in thousands)

|  | Three months ended |          | Six months ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30,           |          | June 30,         |          |
|  | 2017               | 2016     | 2017             | 2016     |
| Net income (loss)                                      | \$ 29,071          | \$ 603   | \$ 48,860        | \$ (727) |
| (Loss) gain on foreign currency translation adjustment | 797                | (956)    | 5,254            | (38)     |
| Comprehensive income (loss)                            | \$ 29,868          | \$ (353) | \$ 54,114        | \$ (765) |

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

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Applied Optoelectronics, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Six months ended June 30, 2017

(Unaudited, in thousands)

|  | Preferred Stock<br>Number<br><br>of shares | Amount | Common Stock<br>Number<br><br>of shares | Amount | Additional<br>paid-in<br>capital | Accumulated<br>other<br>comprehensive<br>gain<br>(loss) | Retained<br>earnings/<br>(accumulated<br>deficit) | Stockholders'<br>equity |
|--|--|--------|---|--------|----------------------------------|---|---|-------------------------|
| January 1,<br>2017   | —  | \$ —   | 18,400                                  | \$ 18  | \$ 265,264                       | \$ (885)  | \$ (37,013)                                       | \$ 227,384              |
| Public<br>offering of<br>common<br>stock, net  | —  | —      | 459                                     | 1      | 21,571                           | —   | —   | 21,572                  |
| Stock options<br>exercised, net<br>of shares<br>withheld for<br>employee tax         | —  | —      | 262                                     | —      | (176)                            | —   | —   | (176)                   |
| Issuance of<br>restricted<br>stock, net of<br>shares<br>withheld for<br>employee tax | —  | —      | 71                                      | —      | (366)                            | —   | —   | (366)                   |
| Stock based<br>compensation  | —  | —      | —                                       | —      | 3,767                            | —   | —   | 3,767                   |
| Cumulative<br>effect of<br>previously<br>unrecognized<br>tax benefits                | —  | —      | —                                       | —      | —                                | —   | 1,207   | 1,207                   |
| Foreign<br>currency<br>translation<br>adjustment                                     | —  | —      | —                                       | —      | —                                | 5,254   | —   | 5,254                   |
| Other  | —  | —      | —                                       | —      | 7                                | —   | (7)   | —                       |
| Net income   | —  | —      | —                                       | —      | —                                | —   | 48,860  | 48,860                  |
| June 30, 2017  | —  | \$ —   | 19,192                                  | \$ 19  | \$ 290,067                       | \$ 4,369  | \$ 13,047   | \$ 307,502              |

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

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Applied Optoelectronics, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

|  | Six months ended June 30, |          |
|--|---------------------------|----------|
|  | 2017                      | 2016     |
| Operating activities:  |                           |          |
| Net income (loss)  | \$ 48,860                 | \$ (727) |
| Adjustments to reconcile net income to net cash provided by operating activities:      |                           |          |
| Lower of cost or market adjustment to inventory  | 675                       | 1,794    |
| Depreciation and amortization  | 8,929                     | 6,241    |
| Deferred income taxes, net   | 2,638                     | —        |
| Loss on disposal of assets   | 40                        | 85       |
| Share-based compensation   | 3,767                     | 1,783    |
| Unrealized foreign exchange loss   | (254)                     | 767      |
| Changes in operating assets and liabilities:   |                           |          |
| Accounts receivable, trade   | (23,992)                  | (2,798)  |
| Inventories  | (6,357)                   | 4,743    |
| Other current assets   | (4,845)                   | 3,111    |
| Accounts payable   | 17,481                    | 4,862    |
| Accrued income taxes   | 3,870                     | —        |
| Accrued liabilities  | (928)                     | 2,276    |
| Net cash provided by operating activities  | 49,884                    | 22,137   |
| Investing activities:  |                           |          |
| Maturities of short-term investments   | 2                         | 7,749    |
| Change in restricted cash for construction in progress                                 | 8                         | —        |
| Purchase of property, plant and equipment  | (26,687)                  | (33,768) |
| Proceeds from disposal of equipment  | 170                       | 755      |
| Deposits and prepaid for equipment   | (3,838)                   | (863)    |
| Purchase of intangible assets  | (251)                     | (283)    |
| Net cash used in investing activities  | (30,596)                  | (26,410) |
| Financing activities:  |                           |          |
| Proceeds from issuance of notes payable and long-term debt                             | —                         | 24,864   |
| Principal payments of long-term debt and notes payable                                 | (15,911)                  | (2,200)  |
| Proceeds from line of credit borrowings  | —                         | 71,981   |
| Repayments of line of credit borrowings  | —                         | (75,243) |
| Proceeds from bank acceptance payable  | —                         | 3,501    |
| Repayments of bank acceptance payable  | (307)                     | (3,995)  |
| Repayments of note payable   | —                         | (500)    |
| Decrease (increase) in restricted cash   | 742                       | (271)    |
| Exercise of stock options  | 1,301                     | 219      |
| Payments of tax withholding on behalf of employees related to share-based compensation | (1,843)                   | —        |

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|  |           |           |
|--|-----------|-----------|
| Proceeds from common stock offering, net                                   | 21,572    | —         |
| Net cash provided by financing activities                                  | 5,554     | 18,356    |
| Effect of exchange rate changes on cash                                    | (241)     | 132       |
| Net increase in cash   | 24,601    | 14,215    |
| Cash and cash equivalents at beginning of period                           | 50,224    | 28,074    |
| Cash and cash equivalents at end of period                                 | \$ 74,825 | \$ 42,289 |
| Supplemental disclosure of cash flow information:                          |           |           |
| Cash paid for:   |           |           |
| Interest   | \$ 539    | \$ 443    |
| Income taxes   | 2,226     | 1         |
| Non-cash investing and financing activities:                               |           |           |
| Net change in accounts payable related to property and equipment additions | 535       | —         |

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

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Applied Optoelectronics, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Description of Business

Business Overview

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

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

Interim Financial Statements

The unaudited condensed consolidated financial statements of the Company as of June 30, 2017 and December 31, 2016 and for the three and six months ended June 30, 2017 and June 30, 2016, have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim information and with the instructions on Form 10-Q and Rule 10-01 of Regulation S-X pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). In accordance with those rules and regulations, the Company has omitted certain information and notes required by GAAP for annual consolidated financial statements. In the opinion of management, the condensed consolidated financial statements contain all adjustments, except as otherwise noted,

necessary for the fair presentation of the Company's financial position and results of operations for the periods presented. The year-end condensed balance sheet data was derived from audited financial statements. These condensed consolidated financial statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company's Annual Report on Form 10-K ("Annual Report") for the fiscal year ended December 31, 2016. The results of operations for the three and six months ended June 30, 2017 are not necessarily indicative of the results expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated.

#### Use of Estimates

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

#### Note 2. Significant Accounting Policies

There have been no changes in the Company's significant accounting policies for the three and six months ended June 30, 2017, as compared to the significant accounting policies described in its 2016 Annual Report, except as described below.

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Recent Accounting Pronouncements

Recent Accounting Pronouncements Adopted in 2017

In March 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, to simplify several aspects of accounting for share-based payment transactions, including the following areas: accounting for excess tax benefits and tax deficiencies; classifying excess tax benefits on the statement of cash flows; accounting for forfeitures; classifying awards that permit share repurchases to satisfy statutory tax withholding requirements; classifying tax payments on behalf of employees on the statement of cash flows; and, for nonpublic entities only, determining the expected term and electing the intrinsic value measurement alternative for stock option awards. The guidance is effective for public business entities in fiscal years beginning after December 15, 2016, and in the interim periods within those fiscal years. The guidance requires a mix of prospective, modified retrospective and retrospective transition. The Company adopted the provisions of ASU 2016-09 as of January 1, 2017. The impact from adoption of the provisions related to forfeiture rates was reflected in the Company's condensed consolidated financial statements on a modified retrospective basis, resulting in an adjustment of \$0.01 million to retained earnings. Provisions related to windfall tax benefits have been adopted prospectively resulting in an adjustment of \$1.2 million to retained earnings. Provisions related to the statement of cash flows remain unchanged from prior periods.

Recent Accounting Pronouncements Yet to be Adopted

In November 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-18, Statement of Cash Flows: Restricted Cash, providing guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows. ASU 2016-18 is effective for interim and annual periods beginning after December 15, 2017, with early adoption permitted. The amendments in this ASU would be applied using a retrospective approach. The Company is evaluating the impact of the accounting standard on the financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The ASU update addresses eight specific cash flow issues that currently result in diverse practices, including debt prepayment or debt extinguishment costs, contingent consideration payments made after a business combination and separately identifiable cash flows and applicability of the predominance principle. ASU 2016-15 is effective for interim and annual periods beginning after December 15, 2017, with early adoption permitted. The Company is evaluating the impact of the accounting standard on the financial statements.

The FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The guidance is intended to improve the recognition and measurement of financial instruments. The ASU affects public and private companies, not-for-profit organizations, and employee benefit plans that hold financial assets or owe financial liabilities. The guidance is effective for public



companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of the accounting standard on its financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company continues to evaluate the impact of the accounting standard on its financial statements. In order to determine the effect of the new standard, during 2016 the Company attended live and web-based training sessions hosted by experts on the new standard, identified key areas in our business that could be affected by the standard and hosted internal training sessions on the new standard for accounting staff. The Company has also begun to evaluate its internal controls framework to identify any new controls that may be necessary to comply with the new standard. Although this determination is subject to change as the Company continues to evaluate the new standard, based on our review to date, the Company does not believe that the new standard will have a material effect on its financial statements. The Company plans to adopt the new standards after December 15, 2017.

In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting, which clarifies when modification accounting should be applied for changes to terms or conditions of a share-based payment award. This ASU will be applied prospectively and is effective for fiscal years

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beginning after December 15, 2017, and interim periods within those years, with early adoption permitted. The Company does not expect this standard to have a material impact on its financial statements.

On February 25, 2016, the FASB released ASU No. 2016-02, Leases, to complete its project to overhaul lease accounting. The ASU codifies ASC 842, Leases, which will replace the guidance in ASC 840. The guidance will require lessees to recognize most leases on the balance sheet for capital and operating leases. The guidance is effective for public business entities in fiscal years beginning after December 15, 2018. The Company is evaluating the impact of the accounting standard on its financial statements by reviewing the standard itself, as well as reviewing literature about the new standard produced by nationally-recognized accounting firms and other third parties.

## Note 3. Fair Value of Financial Instruments

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

|                           | As of June 30, 2017 |           |           |           | As of December 31, 2016 |           |           |           |
|---------------------------|---------------------|-----------|-----------|-----------|-------------------------|-----------|-----------|-----------|
|                           | (Level 1)           | (Level 2) | (Level 3) | Total     | (Level 1)               | (Level 2) | (Level 3) | Total     |
| <b>Assets:</b>            |                     |           |           |           |                         |           |           |           |
| Cash and cash equivalents | \$ 74,825           | \$ —      | \$ —      | \$ 74,825 | \$ 50,224               | \$ —      | \$ —      | \$ 50,224 |
| Restricted cash           | 1,054               | —         | —         | 1,054     | 1,740                   | —         | —         | 1,740     |
| Short term investments    | 42                  | —         | —         | 42        | 44                      | —         | —         | 44        |
| Total assets              | \$ 75,921           | \$ —      | \$ —      | \$ 75,921 | \$ 52,008               | \$ —      | \$ —      | \$ 52,008 |
| <b>Liabilities:</b>       |                     |           |           |           |                         |           |           |           |
| Bank acceptance payable   | —                   | \$ —      | —         | \$ —      | —                       | \$ 307    | —         | \$ 307    |
| Total liabilities         | \$ —                | \$ —      | \$ —      | \$ —      | \$ —                    | \$ 307    | \$ —      | \$ 307    |

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

## Note 4. Earnings Per Share

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

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

|   | Three months ended<br>June 30, |         | Six months ended<br>June 30, |           |
|---|--------------------------------|---------|------------------------------|-----------|
|   | 2017                           | 2016    | 2017                         | 2016      |
| Numerator:  |                                |         |                              |           |
| Net income (loss)   | \$ 29,071                      | \$ 603  | \$ 48,860                    | \$ (727)  |
| Denominator:  |                                |         |                              |           |
| Weighted average shares used to compute net income (loss) per share |                                |         |                              |           |
| Basic   | 19,081                         | 17,091  | 18,841                       | 17,011    |
| Effective of dilutive options and restricted stock units            | 1,286                          | 364     | 1,115                        | —         |
| Diluted   | 20,367                         | 17,455  | 19,956                       | 17,011    |
| Net income (loss) per share   |                                |         |                              |           |
| Basic   | \$ 1.52                        | \$ 0.04 | \$ 2.59                      | \$ (0.04) |
| Diluted   | \$ 1.43                        | \$ 0.03 | \$ 2.45                      | \$ (0.04) |

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The following potentially dilutive securities were excluded from the computation of diluted net loss per share as their effect would have been anti-dilutive (in thousands):

|                        | Three months<br>ended<br>June 30,<br>2017 |   | 2016 |   | Six months<br>ended<br>June 30,<br>2017 |   | 2016 |   |
|------------------------|---|---|------|---|---|---|------|---|
| Employee stock options | —   | — | —    | — | —                                       | — | 898  | — |
| Restricted stock units | —   | — | —    | — | —                                       | — | 62   | — |
|                        | —   | — | —    | — | —                                       | — | 960  | — |

## Note 5. Inventories

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

|                                    | June 30, 2017 | December 31, 2016 |
|------------------------------------|---------------|-------------------|
| Raw materials                      | \$ 25,824     | \$ 21,518         |
| Work in process and sub-assemblies | 27,607        | 24,334            |
| Finished goods                     | 6,270         | 5,965             |
|                                    | \$ 59,701     | \$ 51,817         |

The lower of cost or market adjustment expensed for inventory for the three months ended June 30, 2017 and 2016 was \$0.2 million and \$1.5 million, respectively. The lower of cost or market adjustment expensed for inventory for the six months ended June 30, 2017 and 2016 was \$0.7 million and \$1.8 million, respectively.

## Note 6. Property, Plant &amp; Equipment

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

| June 30, 2017 | December 31, 2016 |
|---------------|-------------------|
|---------------|-------------------|

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|  |            |            |
|--|------------|------------|
| Land improvements                              | \$ 797     | \$ 792     |
| Building and improvements                      | 71,253     | 69,368     |
| Machinery and equipment                        | 130,851    | 108,724    |
| Furniture and fixtures                         | 4,510      | 4,227      |
| Computer equipment and software                | 7,502      | 6,836      |
| Transportation equipment                       | 645        | 236        |
|  | 215,558    | 190,183    |
| Less accumulated depreciation and amortization | (58,596)   | (49,175)   |
|  | 156,962    | 141,008    |
| Construction in progress                       | 7,091      | 1,989      |
| Land   | 1,101      | 1,101      |
| Property, plant and equipment, net             | \$ 165,154 | \$ 144,098 |

For the three months ended June 30, 2017 and 2016, depreciation expense of property, plant and equipment was \$4.5 million and \$3.2 million, respectively. For the six months ended June 30, 2017 and 2016, depreciation expense of property, plant and equipment was \$8.7 million and \$6.0 million, respectively.

Included in depreciation expense was \$2.8 million and \$2.1 million recorded as cost of sales for the three months ended June 30, 2017 and 2016, respectively. Included in depreciation expense was \$5.4 million and \$4.0 million recorded as cost of sales for the six months ended June 30, 2017 and 2016, respectively.

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## Note 7. Intangible Assets, net

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

|                         | June 30, 2017 |              |             |
|-------------------------|---------------|--------------|-------------|
|                         | Gross         | Accumulated  | Intangible  |
|                         | Amount        | amortization | assets, net |
| Patents                 | \$ 6,266      | \$ (2,262)   | \$ 4,004    |
| Trademarks              | 14            | (11)         | 3           |
| Total intangible assets | \$ 6,280      | \$ (2,273)   | \$ 4,007    |

|                         | December 31, 2016 |              |             |
|-------------------------|-------------------|--------------|-------------|
|                         | Gross             | Accumulated  | Intangible  |
|                         | Amount            | amortization | assets, net |
| Patents                 | \$ 5,987          | \$ (1,997)   | \$ 3,990    |
| Trademarks              | 14                | (11)         | 3           |
| Total intangible assets | \$ 6,001          | \$ (2,008)   | \$ 3,993    |

For the three months ended June 30, 2017 and 2016, amortization expense for intangible assets, included in general and administrative expenses on the income statement, was each \$0.1 million. For the six months ended June 30, 2017 and 2016, amortization expense for intangible assets, included in general and administrative expenses on the income statement, was \$0.3 million, respectively.

The remaining weighted average amortization period for intangible assets is approximately 8 years.

## Note 8. Notes Payable and Long-Term Debt

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

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|  | June 30, 2017 | December 31, 2016 |
|--|---------------|-------------------|
| Revolving line of credit with a U.S. bank up to \$40,000 with interest at LIBOR plus 2%, maturing June 30, 2018            | \$ —          | \$ —              |
| Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 2%, maturing July 31, 2019        | —             | 2,925             |
| Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 2%, maturing June 30, 2020        | —             | 9,500             |
| Term loan with a U.S. bank with monthly payments of principal and interest at LIBOR plus 2%, maturing January 26, 2022     | 21,370        | 21,670            |
| Notes payable to a finance company due in monthly installments with 4.5% interest, maturing May 27, 2018 and June 30, 2018 | 1,205         | 2,919             |
| Notes payable to a finance company due in monthly installments with 4% interest, maturing March 31, 2019                   | 4,791         | 5,812             |
| Total  | 27,366        | 42,826            |
| Less current portion   | (4,552)       | (7,865)           |
| Non-current portion  | \$ 22,814     | \$ 34,961         |
| <br>Bank Acceptance Notes Payable  |               |                   |
| Bank acceptance notes issued to vendors with a zero percent interest rate  | \$ —          | \$ 307            |

The current portion of long-term debt is the amount payable within one year of the balance sheet date of June 30, 2017. The one-month London Interbank Offered Rate (LIBOR) was 1.22389% on June 30, 2017.

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

|                     |           |
|---------------------|-----------|
| 2018                | \$ 4,552  |
| 2019                | 2,673     |
| 2020                | 641       |
| 2021                | 662       |
| 2022                | 18,838    |
| 2023 and thereafter | —         |
| Total outstanding   | \$ 27,366 |

On June 24, 2016, the Company entered into a First Amendment to the Credit Agreement with East West Bank and Comerica Bank (“First Amendment”), a second lien deed of trust, multiple security agreements and promissory notes evidencing two credit facilities and a term loan originally entered into on June 30, 2015. The First Amendment increased the Company’s revolving lines of credit from \$25 million to \$40 million, which mature on June 30, 2018, and retained a \$10.0 million term loan maturing on June 30, 2020. The First Amendment also provides for an additional \$10.0 million equipment term loan with a one year drawdown period commencing on April 1, 2016 and maturing five years from the closing date of the First Amendment. The interest rate on these loans was adjusted by the First Amendment from the LIBOR Borrowing Rate plus 2.75% or 3.0% to LIBOR Borrowing Rate plus 2.0%. As of June 30, 2017, no balance was outstanding under the revolving line of credit. On February 27, 2017, the Company repaid the outstanding balance of \$9.4 million under the term loan and terminated the loan.

The Company also had a term loan with East West Bank of \$5.0 million with monthly payments of principal and interest that matured on July 31, 2019. On February 27, 2017, the Company repaid the outstanding balance of \$2.8 million and terminated the loan.

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



On September 27, 2016, the Company executed a Change in Terms Agreement, Notice of Final Agreement and Second Modification to the Construction Loan Agreement (the “Second Modifications”) to the Construction Loan Agreement with East West Bank. The Second Modifications amends and restates in part the Company’s Promissory Note and Construction Loan Agreement, which was originally executed on January 26, 2015, and the Modification Agreement. The draw down period end date, under the Second Modifications, was amended from July 31, 2016 to September 30, 2016. And thereafter, the entire outstanding principal balance shall be converted to a sixty-four (64) month term loan, amended from a sixty (66) month term loan, with principal and interest payments due monthly amortized over three hundred (300) months. The first principal and interest payment was due on October 26, 2016 and will continue on the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. Except as expressly changed by the Second Modifications, the terms of the original obligation and the Modification Agreement remain unchanged. As of June 30, 2017, \$21.4 million was outstanding under the construction loan.

The loan and security agreements with East West Bank and Comerica Bank require the Company to maintain certain financial covenants, including a minimum cash balance, a current ratio, a maximum leverage ratio and a minimum fixed charge coverage ratio. Collateral for the U.S. bank loans and line of credit includes substantially all of

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the assets of the Company. As of June 30, 2017, the Company was in compliance with all covenants contained in these agreements.

On May 27, 2015, the Company's Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease Finance Co, Ltd. ("Chailease") in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the sale contract, the Company's Taiwan branch sold certain equipment to Chailease for a purchase price of 180,148,532 New Taiwan dollars, approximately \$6 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The monthly lease payments range from 3,784,000 New Taiwan dollars, approximately \$0.1 million, to 3,322,413 New Taiwan dollars, approximately \$0.1 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 60,148,532 New Taiwan dollars, approximately \$2 million. The Finance Lease Agreement has a three-year term, with monthly payments, maturing on May 27, 2018. The title to the equipment will be transferred to the Company's Taiwan branch upon the expiration of the Finance Lease Agreement. As of June 30, 2017, \$1.2 million was outstanding under this Finance Lease Agreement.

On March 31, 2016, the Company's Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the Purchase and Sale Contract, the Company's Taiwan branch sold certain equipment to Chailease for a purchase price of 312,927,180 New Taiwan dollars, approximately \$10.1 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The Finance Lease Agreement has a three-year term with monthly lease payments range from 6,772,500 New Taiwan dollars, approximately \$0.2 million, to 7,788,333 New Taiwan dollars, approximately \$0.3 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 62,927,180 New Taiwan dollars, approximately \$2.0 million. Based on the payments made under the Finance Lease Agreement, the annual interest rate is calculated to be 4.0%. The title to the equipment will be transferred to the Company's Taiwan branch upon the expiration of the Finance Lease Agreement. As of June 30, 2017, \$4.8 million was outstanding under this Finance Lease Agreement.

The Company's Chinese subsidiary had credit facilities with China Construction Bank totaling \$13.2 million, which could be drawn in U.S. currency, RMB currency, issuing bank acceptance notes to vendors with different interest rates or issuing standby letters of credit. The Company pledged the land use rights and buildings of its Chinese subsidiary as collateral for the credit facility. The Company's Chinese subsidiary used \$10.0 million of its credit facility to issue standby letters of credit as collateral for the Company's Taiwan branch line of credit with China Construction Bank. As of June 30, 2017, the Company had repaid all outstanding balances and terminated the loan agreement with China Construction Bank.

As of June 30, 2017 and December 31, 2016, the Company had \$50.0 million and \$75.8 million of unused borrowing capacity, respectively.

As of June 30, 2017, there was no restricted cash, investments or security deposit associated with the loan facilities. As of December 31, 2016, there was \$1.7 million of restricted cash, investments or security deposit associated with the loan facilities.

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## Note 9. Accrued Liabilities

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

|                               | June 30, 2017 | December 31, 2016 |
|-------------------------------|---------------|-------------------|
| Accrued payroll               | \$ 7,249      | \$ 9,231          |
| Accrued rent                  | 1,081         | 959               |
| Accrued employee benefits     | 1,292         | 1,572             |
| Accrued state and local taxes | 495           | 607               |
| Advance payments              | 490           | 252               |
| Accrued product warranty      | 853           | 705               |
| Accrued commission expenses   | 322           | 205               |
| Accrued professional fees     | 663           | 163               |
| Accrued capital expenditures  | 250           | —                 |
| Accrued other                 | 1,155         | 758               |
|                               | \$ 13,850     | \$ 14,452         |

## Note 10. Other Income and Expense

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

|                                   | Three months ended |          | Six months ended |          |
|-----------------------------------|--------------------|----------|------------------|----------|
|                                   | June 30,<br>2017   | 2016     | June 30,<br>2017 | 2016     |
| Foreign exchange transaction loss | (128)              | (877)    | (700)            | (545)    |
| Government subsidy income         | 75                 | 20       | 75               | 20       |
| Other non-operating gain          | 108                | 6        | 121              | 12       |
| Gain (loss) on disposal of assets | 9                  | (81)     | (40)             | (85)     |
|                                   | \$ 64              | \$ (932) | \$ (544)         | \$ (598) |

## Note 11. Share-Based Compensation

## Equity Plans

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

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

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

## Stock Options

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

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

|                                 | Number of<br>shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Share Price<br>on Date of<br>Exercise | Weighted<br>Average<br>Fair Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value |
|---------------------------------|---------------------|--|--|-----------------------------------|---|---------------------------------|
| Outstanding, January 1,<br>2017 | 1,130               | \$ 9.40                                  |  | \$ 4.90                           |   | \$ 15,872                       |
| Exercised                       | (262)               | 7.77                                     | \$ 51.56   | 4.14                              |   | 11,475                          |
| Forfeited                       | (41)                | 7.61                                     |  | 4.49                              |   | 2,230                           |
| Outstanding, June 30, 2017      | 827                 | \$ 10.00                                 |  | \$ 5.16                           | 6.16  | \$ 42,826                       |
| Exercisable, June 30, 2017      | 713                 | \$ 9.88                                  |  |                                   | 6.13  | \$ 37,021                       |
| Vested and expected to vest     | 827                 | \$ 10.00                                 |  |                                   | 6.16  | \$ 42,826                       |

As of June 30, 2017, there was approximately \$0.3 million of unrecognized stock option expense, which is expected to be recognized over 0.3 years.

## Restricted Stock Units/Awards

RSUs or RSAs have been granted to the Company's employees under the 2013 Plan and generally vest over a period of four years with 25% of the shares vesting over each of the one-year periods.

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

|                                | Number of<br>shares | Weighted<br>Average Share<br>Price on Date<br>of Release | Weighted<br>Average Fair<br>Value | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|---------------------|--|-----------------------------------|---------------------------------|
| Outstanding at January 1, 2017 | 517                 |  | \$ 14.79                          | \$ 12,128                       |
| Granted                        | 500                 |  | 38.08                             | 19,043                          |
| Released                       | (103)               | \$ 48.55   | 13.40                             | 4,987                           |
| Cancelled/Forfeited            | (25)                |  | 20.36                             | 1,537                           |
| Outstanding, June 30, 2017     | 889                 |  | \$ 27.88                          | \$ 54,986                       |
| Exercisable, June 30, 2017     | —                   |  |                                   | \$ —                            |

|                             |     |           |
|-----------------------------|-----|-----------|
| Vested and expected to vest | 889 | \$ 54,986 |
|-----------------------------|-----|-----------|

As of June 30, 2017, there was \$21.8 million of unrecognized compensation expense related to these RSUs and RSAs. This expense is expected to be recognized over 3.3 years.

### Share-Based Compensation

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

|  | Three months ended |        | Six months ended |          |
|--|--------------------|--------|------------------|----------|
|  | June 30,<br>2017   | 2016   | June 30,<br>2017 | 2016     |
| Share-Based compensation - by expense type |                    |        |                  |          |
| Cost of goods sold                         | \$ 134             | \$ 50  | \$ 212           | \$ 87    |
| Research and development                   | 441                | 154    | 706              | 272      |
| Sales and marketing                        | 169                | 94     | 249              | 167      |
| General and administrative                 | 1,516              | 677    | 2,600            | 1,257    |
| Total share-based compensation expense     | \$ 2,260           | \$ 975 | \$ 3,767         | \$ 1,783 |

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|  | Three months ended |        | Six months ended |          |
|--|--------------------|--------|------------------|----------|
|  | June 30,           |        | June 30,         |          |
|  | 2017               | 2016   | 2017             | 2016     |
| Share-Based compensation - by award type |                    |        |                  |          |
| Employee stock options                   | \$ 268             | \$ 359 | \$ 547           | \$ 737   |
| Restricted stock units                   | 1,992              | 616    | 3,220            | 1,046    |
| Total share-based compensation expense   | \$ 2,260           | \$ 975 | \$ 3,767         | \$ 1,783 |

## Note 12. Stockholders' Equity

## Common Stock

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

## Preferred Stock

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

## Public Offerings of Common Stock

On October 17, 2016, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission effective November 1, 2016, providing for the public offer and sale of certain securities of the Company from time to time, at its discretion, up to an aggregate amount of \$250 million. In connection with such Form S-3, the Company entered into an Equity Distribution Agreement with Raymond James & Associates, Inc. pursuant to which the Company may issue and sell shares of the Company's stock having an aggregate offering price of up to \$50.0 million (the "ATM Offering") from time to time through Raymond James & Associates, Inc. On November 22, 2016, the Company commenced sales of common stock through the ATM Offering. The Company completed its ATM Offering in March 2017 and sold 1.6 million shares of common stock at a weighted average price of \$31.55 per share, providing proceeds of \$48.8 million, net of expenses and underwriting discounts and commissions.



## Note 13. Geographic Information

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

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

|               | Three months ended |           | Six months ended June 30, |            |
|---------------|--------------------|-----------|---------------------------|------------|
|               | June 30,<br>2017   | 2016      | 2017                      | 2016       |
| Revenues:     |                    |           |                           |            |
| United States | \$ 4,112           | \$ 18,018 | \$ 8,631                  | \$ 41,257  |
| Taiwan        | 67,696             | 28,470    | 119,321                   | 52,288     |
| China         | 45,563             | 8,766     | 85,643                    | 12,131     |
|               | \$ 117,371         | \$ 55,254 | \$ 213,595                | \$ 105,676 |

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|                    | As of the period ended |                      |
|--------------------|------------------------|----------------------|
|                    | June 30,<br>2017       | December 31,<br>2016 |
| Long-lived assets: |                        |                      |
| United States      | \$ 68,515              | \$ 66,028            |
| Taiwan             | 57,335                 | 48,728               |
| China              | 44,097                 | 34,113               |
|                    | \$ 169,947             | \$ 148,869           |

## Note 14. Contingencies

## Litigation

## Overview

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

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

## Class Action and Shareholder Derivative Litigation

On August 5, 2017, a lawsuit was filed in the U.S. District Court for the Southern District of Texas against the Company and two of its officers in *Mona Abouzied v. Applied Optoelectronics, Inc., Chih-Hsiang (Thompson) Lin, and Stefan J. Murry, et al.*, Case No. 4:17-cv-02399. The complaint in this matter seeks class action status on behalf of the Company's shareholders, alleging violations of Sections 10(b) and 20(a) of the Exchange Act against the Company, its chief executive officer, and its chief financial officer, arising out of its announcement on August 3, 2017 that "we see softer than expected demand for our 40G solutions with one of our large customers that will offset the sequential growth and increased demand we expect in 100G." The complaint requests unspecified damages and other relief. The Company disputes the allegations and intends to vigorously contest the matter.

## Note 15. Subsequent Events

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



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

You should read the following discussion and analysis of our financial condition and results of operations in conjunction with our consolidated financial statements and the accompanying notes appearing elsewhere in this Quarterly Report on Form 10-Q for the period ended June 30, 2017 and the audited consolidated financial statements and notes thereto and management's discussion and analysis of financial condition and results of operations for the fiscal year ended December 31, 2016 included in our Annual Report on Form 10-K. References to "Applied Optoelectronics" "we," "our" and "us" are to Applied Optoelectronics, Inc. and its subsidiaries unless otherwise specified or the context otherwise requires.

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

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

Overview

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

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

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

Our vertically integrated manufacturing model provides us several advantages, including rapid product development, fast response times to customer requests and control over product quality and manufacturing costs. We design, manufacture and integrate our own analog and digital lasers using a proprietary Molecular Beam Epitaxy, or MBE, and Metal Organic Chemical Vapor Deposition (MOCVD) fabrication process, which we believe is unique in our industry. We manufacture the majority of the laser chips and optical components that are used in our products. The lasers

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we manufacture are proven to be reliable over time and highly tolerant of changes in temperature and humidity, making them well-suited to the CATV and FTTH markets where networking equipment is often installed outdoors.

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

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

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

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## Results of Operations

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

|   | Three months<br>ended June 30,<br>2017 |         |  | Three months<br>ended June 30,<br>2016 |         |  | Six months ended<br>June 30,<br>2017 |         |  | Six months ended<br>June 30,<br>2016 |         |  |
|---|--|---------|--|--|---------|--|--------------------------------------|---------|--|--------------------------------------|---------|--|
| Revenue, net                            | \$ 117,371                             | 100.0 % |  | \$ 55,254                              | 100.0 % |  | \$ 213,595                           | 100.0 % |  | \$ 105,676                           | 100.0 % |  |
| Cost of goods<br>sold                   | 64,089                                 | 54.6 %  |  | 37,952                                 | 68.7 %  |  | 118,841                              | 55.6 %  |  | 74,121                               | 70.1 %  |  |
| Gross profit                            | 53,282                                 | 45.4 %  |  | 17,302                                 | 31.3 %  |  | 94,754                               | 44.4 %  |  | 31,555                               | 29.9 %  |  |
| Operating<br>expenses                   |  |         |  |  |         |  |                                      |         |  |                                      |         |  |
| Research and<br>development             | 8,073                                  | 6.9 %   |  | 7,814                                  | 14.1 %  |  | 15,505                               | 7.3 %   |  | 16,210                               | 15.3 %  |  |
| Sales and<br>marketing                  | 2,158                                  | 1.8 %   |  | 1,610                                  | 2.9 %   |  | 4,061                                | 1.9 %   |  | 3,290                                | 3.1 %   |  |
| General and<br>administrative           | 8,786                                  | 7.5 %   |  | 5,906                                  | 10.7 %  |  | 16,608                               | 7.8 %   |  | 11,639                               | 11.0 %  |  |
| Total<br>operating<br>expenses          | 19,017                                 | 16.2 %  |  | 15,330                                 | 27.7 %  |  | 36,174                               | 16.9 %  |  | 31,139                               | 29.5 %  |  |
| Income (loss)<br>from<br>operations     | 34,265                                 | 29.2 %  |  | 1,972                                  | 3.6 %   |  | 58,580                               | 27.4 %  |  | 416                                  | 0.4 %   |  |
| Other income<br>(expense)               |  |         |  |  |         |  |                                      |         |  |                                      |         |  |
| Interest<br>income                      | 70                                     | 0.1 %   |  | 65                                     | 0.1 %   |  | 105                                  | 0.0 %   |  | 166                                  | 0.2 %   |  |
| Interest<br>expense                     | (245)                                  | (0.2) % |  | (450)                                  | (0.8) % |  | (544)                                | (0.3) % |  | (851)                                | (0.8) % |  |
| Other income<br>(expense), net          | 64                                     | 0.1 %   |  | (932)                                  | (1.7) % |  | (544)                                | (0.3) % |  | (598)                                | (0.6) % |  |
| Total other<br>income<br>(expense)      | (111)                                  | (0.1) % |  | (1,317)                                | (2.4) % |  | (983)                                | (0.5) % |  | (1,283)                              | (1.2) % |  |
| Income (loss)<br>before income<br>taxes | 34,154                                 | 29.1 %  |  | 655                                    | 1.2 %   |  | 57,597                               | 27.0 %  |  | (867)                                | (0.8) % |  |
| Income tax<br>(expense)<br>benefit      | (5,083)                                | (4.3) % |  | (52)                                   | (0.1) % |  | (8,737)                              | (4.1) % |  | 140                                  | 0.1 %   |  |
|   | \$ 29,071                              | 24.8 %  |  | \$ 603                                 | 1.1 %   |  | \$ 48,860                            | 22.9 %  |  | \$ (727)                             | (0.7) % |  |

Net income  
(loss)

## Comparison of Financial Results

### Revenue

We generate revenue through the sale of our products to equipment providers and network operators for the internet data center, CATV, FTTH and telecom markets. We derive a significant portion of our revenue from our top ten customers, and we anticipate that we will continue to do so for the foreseeable future. The following charts provide the revenue contribution from each of the markets we served for the three and six months ended June 30, 2017 and 2016 (in thousands):

|             | Three months ended |   |       |   | Six months ended |   |       |   |
|-------------|--------------------|---|-------|---|------------------|---|-------|---|
|             | June 30,           |   | 2016  |   | June 30,         |   | 2016  |   |
|             | 2017               | % | 2016  | % | 2017             | % | 2016  | % |
| CATV        | 12.3               | % | 17.2  | % | 12.9             | % | 16.3  | % |
| Data Center | 84.6               | % | 74.7  | % | 83.8             | % | 75.9  | % |
| FTTH        | 0.1                | % | 0.8   | % | 0.1              | % | 0.8   | % |
| Telecom     | 2.6                | % | 6.4   | % | 2.9              | % | 6.3   | % |
| Other       | 0.4                | % | 0.8   | % | 0.3              | % | 0.6   | % |
|             | 100.0              | % | 100.0 | % | 100.0            | % | 100.0 | % |



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|               | Three months ended |           |                  |          | Six months ended |            |                  |          |
|---------------|--------------------|-----------|------------------|----------|------------------|------------|------------------|----------|
|               | June 30,<br>2017   | 2016      | Change<br>Amount | %        | June 30,<br>2017 | 2016       | Change<br>Amount | %        |
| CATV          | \$ 14,404          | \$ 9,521  | \$ 4,883         | 51.3 %   | \$ 27,498        | \$ 17,252  | \$ 10,246        | 59.4 %   |
| Data Center   | 99,298             | 41,280    | 58,018           | 140.5 %  | 178,892          | 80,260     | 98,632           | 122.9 %  |
| FTTH          | 125                | 436       | (311)            | (71.3) % | 223              | 857        | (634)            | (74.0) % |
| Telecom       | 3,077              | 3,563     | (486)            | (13.6) % | 6,248            | 6,641      | (393)            | (5.9) %  |
| Other         | 467                | 454       | 13               | 2.9 %    | 734              | 666        | 68               | 10.2 %   |
| Total Revenue | \$ 117,371         | \$ 55,254 | \$ 62,117        | 112.4 %  | \$ 213,595       | \$ 105,676 | \$ 107,919       | 102.1 %  |

Growth in the three and six months ended June 30, 2017 was driven primarily by increasing revenue from our internet data center customers, and we also anticipate that our revenue derived from this market will continue to increase as a percentage of our revenue as we further penetrate and extend our products into this market.

During the three and six months ended June 30, 2017, revenues in the internet data center market were driven primarily by increasing demand for our 40 gigabits per second, or Gbps, and 100 Gbps transceivers as our customers continued to upgrade their technology infrastructure. The decrease in revenue in our FTTH market is due to a decline in demand for certain older legacy products. Demand for these legacy products is expected to continue to fluctuate. The increase in revenues in the CATV market for the three and six month ended June 30, 2017 was a result of increased demand from customers who are supplying equipment for CATV network upgrades which began during the year. Revenue in our telecom market decreased modestly for the the three and six month periods ended June 30, 2017, compared to the prior year. The decrease is primarily attributable to reduced orders for some of our telecom customers, particularly in China. Revenue in the telecom and other markets remained relatively unchanged during the three and six months ended June 30, 2017.

For the three months ended June 30, 2017 and 2016, our top ten customers represented 95.4% and 91.6%, respectively. For the six months ended June 30, 2017 and 2016, our top ten customers represented 96.2% and 91.5%, respectively.

## Cost of goods sold and gross margin

|                    | Three months ended June 30,        |           |         |         | Change    |        |
|--------------------|------------------------------------|-----------|---------|---------|-----------|--------|
|                    | 2017                               | 2016      | % of    | % of    | Amount    | %      |
|                    | Amount                             | Amount    | Revenue | Revenue |           |        |
|                    | (in thousands, except percentages) |           |         |         |           |        |
| Cost of goods sold | \$ 64,089                          | \$ 37,952 | 54.6 %  | 68.7 %  | \$ 26,137 | 68.9 % |

|              |        |      |   |        |      |   |
|--------------|--------|------|---|--------|------|---|
| Gross margin | 53,282 | 45.4 | % | 17,302 | 31.3 | % |
|--------------|--------|------|---|--------|------|---|

|                    | Six months ended June 30,<br>2017            |                 | 2016        |                 | Change      |      |
|--------------------|--|-----------------|-------------|-----------------|-------------|------|
|                    | Amount<br>(in thousands, except percentages) | % of<br>Revenue | Amount      | % of<br>Revenue | Amount      | %    |
| Cost of goods sold | \$ 118,841                                   | 55.6            | % \$ 74,121 | 70.1            | % \$ 44,720 | 60.3 |
| Gross margin       | 94,754                                       | 44.4            | % 31,555    | 29.9            | %           |      |

Cost of goods sold increased by \$26.1 million, or 68.9%, for the three months ended June 30, 2017, as compared to the three months ended June 30, 2016, primarily due to the increase in sales over the prior year. Cost of goods sold increased by \$44.7 million, or 60.3%, for the six months ended June 30, 2017, as compared to the six months ended June 30, 2016, primarily due to the increase in sales over the prior year. The increase in gross margin for the three and six months ended June 30, 2017 compared to the same periods ended June 30, 2016 was primarily the result of lower production costs associated with certain 40 Gbps and 100 Gbps products. Production costs were reduced due mainly to improved product yields, related to process improvements and automation, as well as raw material cost reduction.

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## Operating expenses

|                            | Three months ended June 30,        |        | 2016      |         | Change   |         |        |   |
|----------------------------|------------------------------------|--------|-----------|---------|----------|---------|--------|---|
|                            | 2017                               |        | Amount    | % of    | Amount   | % of    |        |   |
|                            | Amount                             | % of   | Amount    | revenue | Amount   | revenue | Amount | % |
|                            | (in thousands, except percentages) |        |           |         |          |         |        |   |
| Research and development   | \$ 8,073                           | 6.9 %  | \$ 7,814  | 14.1 %  | \$ 259   |         | 3.3 %  |   |
| Sales and marketing        | 2,158                              | 1.8 %  | 1,610     | 2.9 %   | 548      |         | 34.0 % |   |
| General and administrative | 8,786                              | 7.5 %  | 5,906     | 10.7 %  | 2,880    |         | 48.8 % |   |
| Total operating expenses   | \$ 19,017                          | 16.2 % | \$ 15,330 | 27.7 %  | \$ 3,687 |         | 24.1 % |   |

  

|                            | Six months ended June 30,          |        | 2016      |         | Change   |         |         |   |
|----------------------------|------------------------------------|--------|-----------|---------|----------|---------|---------|---|
|                            | 2017                               |        | Amount    | % of    | Amount   | % of    |         |   |
|                            | Amount                             | % of   | Amount    | revenue | Amount   | revenue | Amount  | % |
|                            | (in thousands, except percentages) |        |           |         |          |         |         |   |
| Research and development   | \$ 15,505                          | 7.3 %  | \$ 16,210 | 15.3 %  | \$ (705) |         | (4.3) % |   |
| Sales and marketing        | 4,061                              | 1.9 %  | 3,290     | 3.1 %   | 771      |         | 23.4 %  |   |
| General and administrative | 16,608                             | 7.8 %  | 11,639    | 11.0 %  | 4,969    |         | 42.7 %  |   |
| Total operating expenses   | \$ 36,174                          | 16.9 % | \$ 31,139 | 29.5 %  | \$ 5,035 |         | 16.2 %  |   |

## Research and development expense

Research and development expense increased by \$0.3 million, or 3.3%, for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016. Research and development expense decreased by \$0.7 million, or 4.3%, for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016. Research and development costs consist of R&D work orders, R&D material usage and other project related costs related to 40 Gbps, 100 Gbps, and 200/400 Gbps data center products, DOCSIS 3.1-capable CATV products, including remote-PHY products, and other new product development, and depreciation expense resulting from R&D equipment investments. Research and development costs increased for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016 due mainly to an increase in materials and supplies used in R&D activities and an increase in personnel-related costs and increased overhead costs associated with our new building in Sugar Land. Research and development costs decreased for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016 due mainly to a decrease in materials and supplies used in R&D activities, partially offset by an increase in personnel-related costs and increased overhead costs associated with our new building in Sugar Land.

## Sales and marketing expense

Sales and marketing expense increased by \$0.5 million, or 34.0%, for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016. Sales and marketing expense increased by \$0.8 million, or 23.4%, for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016. These increases were due to an increase in personnel costs, including sales commissions, partially offset by decreased commissions payable to third parties.

#### General and administrative expense

General and administrative expense increased by \$2.9 million, or 48.8%, for the three months ended June 30, 2017 compared to the three months ended June 30, 2016. General and administrative expense increased by \$5.0 million, or 42.7%, for the six months ended June 30, 2017 compared to the six months ended June 30, 2016. These increases were primarily due to an increase in personnel-related costs, share-based compensation expenses, overhead costs due to our new building in Sugar Land, and additional professional service fees.

General and administrative expenses include costs to comply with Section 404 of the Sarbanes-Oxley Act, or SOX, and other regulations governing public companies, costs of directors' and officers' liability insurance and investor relations activities. As of June 30, 2017, the market value of our common stock held by non-affiliates exceeded \$700 million. Commencing December 31, 2017, we will be a "large accelerated filer" and, accordingly, will no longer qualify as an emerging growth company and no longer be able to rely on certain exemptions that were available to us as an emerging growth company. We anticipate that general and administrative expenses will continue to increase in absolute

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dollars in the future as we continue to incur both increased external audit fees as well as additional spending to ensure continued SOX and other regulatory compliance. We expect such expenses to decline as a percentage of our revenues over time as our revenues grow.

## Other income (expense), net

|                             | Three months ended June 30,        |         | 2016       |         | Change   |           |
|-----------------------------|------------------------------------|---------|------------|---------|----------|-----------|
|                             | 2017                               | % of    | 2016       | % of    | Amount   | %         |
|                             | Amount                             | revenue | Amount     | revenue | Amount   | %         |
|                             | (in thousands, except percentages) |         |            |         |          |           |
| Interest income             | \$ 70                              | 0.1 %   | \$ 65      | 0.1 %   | \$ 5     | 7.7 %     |
| Interest expense            | (245)                              | (0.2) % | (450)      | (0.8) % | 205      | (45.6) %  |
| Other income (expense), net | 64                                 | 0.1 %   | (932)      | (1.7) % | 996      | (106.9) % |
| Total other expense, net    | \$ (111)                           | (0.1) % | \$ (1,317) | (2.4) % | \$ 1,206 | (91.6) %  |

|                             | Six months ended June 30,          |         | 2016       |         | Change  |          |
|-----------------------------|------------------------------------|---------|------------|---------|---------|----------|
|                             | 2017                               | % of    | 2016       | % of    | Amount  | %        |
|                             | Amount                             | revenue | Amount     | revenue | Amount  | %        |
|                             | (in thousands, except percentages) |         |            |         |         |          |
| Interest income             | \$ 105                             | 0.0 %   | \$ 166     | 0.2 %   | \$ (61) | (36.7) % |
| Interest expense            | (544)                              | (0.3) % | (851)      | (0.8) % | 307     | (36.1) % |
| Other income (expense), net | (544)                              | (0.3) % | (598)      | (0.6) % | 54      | (9.0) %  |
| Total other expense, net    | \$ (983)                           | (0.5) % | \$ (1,283) | (1.2) % | \$ 300  | (23.4) % |

Interest income increased 7.7% for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016, due to larger cash balances. Interest income decreased 36.7% for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016, due to lower investment balances during the period.

Interest expense decreased 45.6% for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016. Interest expense decreased 36.1% for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016. These decreases were due to repayment of debt that had been previously borrowed to fund expansion projects.

Other income (expense) increased by \$1.0 million, or 106.9% for the three months ended June 30, 2017 compared to the three months ended June 30, 2016. Other income (expense) increased by \$0.1 million, or 9.0% for the six months

ended June 30, 2017 compared to the six months ended June 30, 2016. These increases were due to the reduction of foreign exchange losses resulting from the favorable fluctuation of certain Asian currencies against the U.S. dollar. We qualify as a high-tech enterprise in China, as determined by the Chinese government, and are paid subsidies from time to time by the Chinese government to foster local high-tech manufacturing. We received \$0.1 million of government subsidies during the three and six months ended June 30, 2017, and no subsidies during the three and six months ended June 30, 2016, respectively.

Benefit (provision) for income taxes

|                            | Three months ended June 30,        |         |         |           |
|----------------------------|------------------------------------|---------|---------|-----------|
|                            | 2017                               | 2016    | Change  |           |
|                            | (in thousands, except percentages) |         |         |           |
| Provision for income taxes | \$ (5,083)                         | \$ (52) | (5,031) | 9,675.0 % |

|                                      | Six months ended June 30,          |        |         |           |
|--------------------------------------|------------------------------------|--------|---------|-----------|
|                                      | 2017                               | 2016   | Change  |           |
|                                      | (in thousands, except percentages) |        |         |           |
| Benefit (provision) for income taxes | \$ (8,737)                         | \$ 140 | (8,877) | 6,340.7 % |

Our tax provision or benefit from income taxes for interim periods is determined using an estimate of our annual effective tax rate, adjusted for discrete items, if any, that are taken into account in the relevant period. Our quarterly tax provision, and our quarterly estimate of our annual effective tax rate, is subject to significant variation due

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to several factors, including variability in accurately predicting our pre-tax income and loss and the mix of jurisdictions to which they relate, tax law developments, and relative changes in permanent tax benefits or expenses.

Our effective tax rate for the three months ended June 30, 2017 and 2016 was 14.88% and 7.94%, respectively. For the three months ended June 30, 2017, the effective tax rate varied from the federal statutory rate of 35% primarily due to the level and mix of earnings among tax jurisdictions. Additionally, we recognized a tax benefit of \$3.0 million for excess tax benefits due to employee share-based compensation in accordance with ASU 2016-09 and a tax benefit of \$0.3 million related to the release of our valuation allowance on deferred tax assets in China. For the three months ended June 30, 2016, the effective tax rate varied from the federal statutory rate of 35% primarily due to the level and mix of earnings among tax jurisdictions and as a result of valuation allowances recorded on the deferred tax assets in the US and our foreign jurisdictions.

Our effective tax rate for the six months ended June 30, 2017 and 2016 was 15.17% and 16.15%, respectively. For the six months ending June 30, 2017, the effective tax rate varied from the federal statutory rate of 35% primarily due to the level and mix of earnings among tax jurisdictions. Additionally, we recognized a tax benefit of \$3.5 million for excess tax benefits due to employee share-based compensation in accordance with ASU 2016-09 and a tax benefit of \$0.3 million related to the release of our valuation allowance on deferred tax assets in China. For the six months ended June 30, 2016, the effective tax rate varied from the federal statutory rate of 35% primarily due to the level and mix of earnings among tax jurisdictions and as a result of valuation allowances recorded on the deferred tax assets in the US and our foreign jurisdictions.

On January 1, 2017, we adopted ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting." The new standard requires that the tax impact related to the difference between share-based compensation for book and tax purposes be recognized as income tax benefit or expense in our condensed consolidated statement of operations in the reporting period in which such awards vest. The standard also required a modified retrospective adoption for previously unrecognized excess tax benefits. Accordingly, we recognized a deferred tax asset of \$1.2 million and a corresponding credit to retained earnings in conjunction with the adoption. The effects of adopting the other provisions of ASU 2016-09 were not significant. See also Note 2 —Significant Accounting Policies —Recent Accounting Pronouncements for additional information.

We recorded a valuation allowance against our deferred tax assets in China as of March 31, 2017 and December 31, 2016. During the three months ending June 30, 2017, we removed the valuation allowance that had been recorded against our China deferred tax assets. Release of the valuation allowance resulted in the recognition of \$0.3 million of deferred tax assets and a decrease to income tax expense for the same amount.

As of each reporting date, management considers new evidence, both positive and negative, that could affect its view of the future realization of deferred tax assets. During the second quarter of 2017, in part because in the current period we achieved cumulative pretax income in China and anticipate future earnings, we determined that there is sufficient positive evidence to conclude that it is more likely than not that additional deferred taxes of \$0.3 million are

realizable. We therefore reduced the valuation allowance accordingly.

## Liquidity and Capital Resources

From inception until our initial public offering in September 2013, we financed our operations through private sales of equity securities, cash generated from operations and from various lending arrangements. As of June 30, 2017, we had \$50.0 million of unused borrowing capacity from all of our loan agreements. As of June 30, 2017, our cash, cash equivalents, restricted cash and short-term investments totaled \$75.9 million. Cash and cash equivalents are held for working capital purposes and are invested primarily in money market or time deposit funds. We do not enter into investments for trading or speculative purposes. On October 17, 2016, we filed a Registration Statement on Form S-3 with the Securities and Exchange Commission, which was declared effective on November 1, 2016, providing for the public offer and sale of certain securities of the Company from time to time, at our discretion, up to an aggregate amount of \$250 million. Between November 22, 2016 and March 2, 2017, the Company sold 1.6 million shares of common stock at a weighted average price of \$31.55 per share, providing proceeds of \$48.8 million, net of expenses and underwriting discounts and commissions.



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

|   | Six months ended June 30, |           |
|---|---------------------------|-----------|
|   | 2017                      | 2016      |
| Net cash provided by operating activities             | \$ 49,884                 | \$ 22,137 |
| Net cash used in investing activities                 | (30,596)                  | (26,410)  |
| Net cash provided by financing activities             | 5,554                     | 18,356    |
| Effect of exchange rates on cash and cash equivalents | (241)                     | 132       |
| Net increase in cash                                  | \$ 24,601                 | \$ 14,215 |

## Operating activities

For the six months ended June 30, 2017, net cash provided by operating activities was \$49.9 million. Net cash provided by operating activities consisted of our net income of \$48.9 million, after the exclusion of non-cash items of \$15.6 million as well as an increase in accounts payable to our vendors of \$17.5 million and an increase in accrued income taxes of \$3.9 million. These cash increases were offset by an increase in accounts receivable from our customers of \$24.0 million, an increase in inventories of \$6.4 million, an increase in prepaid assets of \$4.8 million and a decrease in accrued liabilities of \$0.9 million.

For the six months ended June 30, 2016, net cash provided by operating activities was \$22.1 million. During the six months ended June 30, 2016, we recorded a net loss of \$0.7 million. The net loss included non-cash charges, including depreciation and amortization of \$6.2 million, share-based compensation expense of \$1.8 million and non-cash increases to our inventory reserve account of \$1.8 million. Cash provided by operating activities primarily related to a \$4.7 million decrease in inventory related to sales orders, cash provided by the increase of accounts payable to our vendors of \$4.9 million and cash provided by the increase in accrued expenses of \$2.3 million. These increases were offset by an increase in our accounts receivable of \$2.8 million from the sale of our products in excess of collection of trade receivables.

## Investing activities

For the six months ended June 30, 2017, net cash used in investing activities was \$30.6 million mainly for the purchase of additional machinery and equipment.

For the six months ended June 30, 2016, net cash used in investing activities was \$26.4 million mainly for the purchase of additional machinery and equipment and investment in construction of our U.S. plant of \$33.8 million,

offset by the maturity of short term investments of \$7.8 million.

#### Financing activities

For the six months ended June 30, 2017, our financing activities provided \$5.6 million in cash. We received \$21.6 million in net proceeds from the sale of our common stock pursuant to an at-the market offering. In addition, we repaid \$15.9 million of notes payable, offset by a decrease in restricted cash related to the repayment of notes payable.

For the six months ended June 30, 2016, our financing activities provided \$18.4 million in cash. We received \$19.4 million in net borrowings associated with our bank loans, offset by \$0.5 million of net repayments of acceptance payable and \$0.5 million repayment of notes payable and \$0.2 million in increase to restricted cash.

#### Loans and commitments

We have lending arrangements with several financial institutions, including a revolving line of credit and a term loan with East West Bank and Comerica Bank in the U.S., lines of credit and financing agreements for our Taiwan branch and several lines of credit arrangements for our China subsidiary. As of June 30, 2017, we had \$50.0 million of unused borrowing capacity.

On June 24, 2016, we entered into a First Amendment to the Credit Agreement with East West Bank and Comerica Bank (the "First Amendment"), a second lien deed of trust, multiple security agreements and promissory notes evidencing two credit facilities and a term loan originally entered into on June 30, 2015. The First Amendment increased

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our revolving lines of credit from \$25 million to \$40 million, which mature on June 30, 2018, and retained a \$10.0 million term loan maturing on June 30, 2020. The First Amendment also provides for an additional \$10.0 million equipment term loan with a one year drawdown period commencing on April 1, 2016 and maturing five years from the closing date of the First Amendment. The interest rate on these loans was adjusted by the First Amendment from the LIBOR Borrowing Rate plus 2.75% or 3.0% to LIBOR Borrowing Rate plus 2.0%. As of June 30, 2017, no balance was outstanding under the revolving line of credit. On February 27, 2017, we repaid the outstanding balance of \$9.4 million under the term loan and terminated the loan.

We also had a term loan with East West Bank of \$5.0 million with monthly payments of principal and interest that matured on July 31, 2019. On February 27, 2017, we repaid the outstanding balance of \$2.8 million and terminated the loan.

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

On September 27, 2016, we executed a Change in Terms Agreement, Notice of Final Agreement and Second Modification to the Construction Loan Agreement (the "Second Modifications") to the Construction Loan Agreement with East West Bank. The Second Modifications amends and restates in part our Promissory Note and Construction Loan Agreement, which was originally executed on January 26, 2015, and the Modification Agreement. The draw down period end date, under the Second Modifications, was amended from July 31, 2016 to September 30, 2016. And thereafter, the entire outstanding principal balance shall be converted to a sixty-four (64) month term loan, amended from a sixty (66) month term loan, with principal and interest payments due monthly amortized over three hundred (300) months. The first principal and interest payment was due on October 26, 2016 and will continue on the same day of each month thereafter. The final principal and interest payment is due on January 26, 2022 and will include all unpaid principal and all accrued and unpaid interest. Except as expressly changed by the Second Modifications, the terms of the original obligation and the Modification Agreement remain unchanged. As of June 30, 2017, \$21.4 million was outstanding under the construction loan.

The loan and security agreements with East West Bank and Comerica Bank require us to maintain certain financial covenants, including a minimum cash balance, a current ratio, a maximum leverage ratio and a minimum fixed charge coverage ratio. Collateral for the U.S. bank loans and line of credit includes substantially all of the assets of the Company. As of June 30, 2017, we were in compliance with all covenants contained in these agreements.

On May 27, 2015, our Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease Finance Co, Ltd. (“Chailease”) in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the sale contract, our Taiwan branch sold certain equipment to Chailease for a purchase price of 180,148,532 New Taiwan dollars, approximately \$6 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The monthly lease payments range from 3,784,000 New Taiwan dollars, approximately \$0.1 million, to 3,322,413 New Taiwan dollars, approximately \$0.1 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 60,148,532 New Taiwan dollars, approximately \$2 million. The Finance Lease Agreement has a three-year term, with monthly payments, maturing on May 27, 2018. The title to the equipment will be transferred to our Taiwan branch upon the expiration of the Finance Lease Agreement. As of June 30, 2017, \$1.2 million was outstanding under this Finance Lease Agreement.

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On March 31, 2016, our Taiwan branch entered into a Purchase and Sale Contract and a Finance Lease Agreement with Chailease in connection with certain equipment, structured as a sale lease-back transaction. Pursuant to the Purchase and Sale Contract, our Taiwan branch sold certain equipment to Chailease for a purchase price of 312,927,180 New Taiwan dollars, approximately \$10.1 million, and simultaneously leased the equipment back from Chailease pursuant to the Finance Lease Agreement. The Finance Lease Agreement has a three-year term with monthly lease payments range from 6,772,500 New Taiwan dollars, approximately \$0.2 million, to 7,788,333 New Taiwan dollars, approximately \$0.3 million, during the term of the Finance Lease Agreement, including an initial payment in an amount of 62,927,180 New Taiwan dollars, approximately \$2.0 million. Based on the payments made under the Finance Lease Agreement, the annual interest rate is calculated to be 4.0%. The title to the equipment will be transferred to our Taiwan branch upon the expiration of the Finance Lease Agreement. As of June 30, 2017, \$4.8 million was outstanding under this Finance Lease Agreement.

Our Chinese subsidiary had credit facilities with China Construction Bank totaling \$13.2 million, which could be drawn in U.S. currency, RMB currency, issuing bank acceptance notes to vendors with different interest rates or issuing standby letters of credit. We pledged the land use rights and buildings of our Chinese subsidiary as collateral for the credit facility. Our Chinese subsidiary used \$10.0 million of its credit facility to issue standby letters of credit as collateral for our Taiwan branch line of credit with China Construction Bank. As of June 30, 2017, we had repaid all outstanding balances and terminated the loan agreement with China Construction Bank.

As of June 30, 2017, there were no security deposits associated with the loan facilities.

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

## Future liquidity needs

We believe that our existing cash and cash equivalents, and cash flows from our operating activities and borrowings from our lenders, will be sufficient to meet our anticipated cash needs for the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending to support our research and development efforts, the expansion of our sales and marketing activities, the introduction of new and enhanced products, the expansion of our manufacturing capacity and the continuing market acceptance of our products. In the event that additional liquidity is required to meet our long-term investments, we may need to explore additional sources of liquidity by additional bank credit facilities or raising capital through additional equity or debt financing including our equity financing under our Registration Statement filed with the SEC in October 2016. The

sale of additional equity or debt security could result in additional dilution to our stockholders, and its terms and prices may not be acceptable to us. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

### Contractual Obligations and Commitments

The following summarizes our contractual obligations as of June 30, 2017:

|                                     | Payments due by period  |                     |           |           |                      |
|-------------------------------------|-------------------------|---------------------|-----------|-----------|----------------------|
|                                     | Total<br>(in thousands) | Less than 1<br>Year | 1-3 Years | 3-5 Years | More than<br>5 Years |
| Notes payable and long-term debt(1) | \$ 30,386               | \$ 5,368            | \$ 4,590  | \$ 20,428 | \$ —                 |
| Operating leases(2)                 | 12,988                  | 968                 | 2,115     | 2,120     | 7,785                |
| Total commitments                   | \$ 43,374               | \$ 6,336            | \$ 6,705  | \$ 22,548 | \$ 7,785             |

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

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

## Inflation

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

## Off-Balance Sheet Arrangements

For the three and six months ended June 30, 2017, we did not, and we do not currently, have any off-balance sheet arrangements.

## Critical Accounting Policies and Estimates

In our annual report on Form 10-K for the year ended December 31, 2016 and in the Notes to the Financial Statements herein, we identify our most critical accounting policies. In preparing the financial statements, we make assumptions, estimates and judgments that affect the amounts reported. We periodically evaluate our estimates and judgments that are most critical in nature which are related to revenue recognition under long-term construction contracts; allowance for doubtful accounts; inventory reserves; impairment of long-lived assets (excluding goodwill and other indefinite-lived intangible assets); goodwill and other indefinite-lived intangible assets; purchase price allocation of acquisitions; service and product warranties; and income taxes. Our estimates are based on historical experience and on our future expectations that we believe are reasonable. The combination of these factors forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results are likely to differ from our current estimates and those differences may be material.

## JOBS Act

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

- the last day of its fiscal year following the fifth anniversary of the date of its initial public offering of common equity securities;
- the last day of its fiscal year in which it has annual gross revenue of \$1.07 billion or more;
- the date on which it has, during the previous three-year period, issued more than \$1.0 billion in non-convertible debt; and
- the date on which it is deemed to be a “large accelerated filer,” which will occur at such time as the company (a) has an aggregate worldwide market value of common equity securities held by non-affiliates of \$700 million or more as of the last business day of its most recently completed second fiscal quarter, (b) has been required to file annual and quarterly reports under the Exchange Act for a period of at least 12 months and (c) has filed at least one annual report pursuant to the Securities Act of 1934, as amended.

Under this definition, we are an “emerging growth company.” On June 30, 2017, the last day of our second fiscal quarter, the value of common equity securities held by non-affiliates exceeded \$700 million. As such, we will no longer be an “emerging growth company” after December 31, 2017.

As an “emerging growth company” we have chosen to rely on such exemptions and are therefore not required to, among other things, (i) provide an auditor’s attestation report on our system of internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, (ii) provide all of the compensation disclosure that may be required of non-emerging growth public companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act, (iii) comply with any requirement that may be adopted by the Public Company Accounting Oversight Board, or



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PCAOB, regarding mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements (auditor discussion and analysis) and (iv) disclose certain executive compensation-related items such as the correlation between executive compensation and performance and comparisons of the Chief Executive Officer's compensation to median employee compensation. Commencing December 31, 2017, we can no longer qualify as an emerging growth company and are no longer able to rely on such exemptions.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

For quantitative and qualitative disclosures about market risk affecting the Company, see Item 7A – Quantitative and Qualitative Disclosures about Market Risk in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. We do not believe the Company's exposure to market risk has changed materially since December 31, 2016.

Item 4. Controls and Procedures

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2017. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting

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

affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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### Part II. Other Information

#### Item 1. Legal Proceedings

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

On August 5, 2017, a lawsuit was filed in the U.S. District Court for the Southern District of Texas against us and two of our officers in *Mona Abouzied v. Applied Optoelectronics, Inc., Chih-Hsiang (Thompson) Lin, and Stefan J. Murry, et al.*, Case No. 4:17-cv-02399. The complaint in this matter seeks class action status on behalf of our shareholders, alleging violations of Sections 10(b) and 20(a) of the Exchange Act against the Company, our chief executive officer, and our chief financial officer, arising out of our announcement on August 3, 2017 that “we see softer than expected demand for our 40G solutions with one of our large customers that will offset the sequential growth and increased demand we expect in 100G.” The complaint requests unspecified damages and other relief. We dispute the allegations and intend to vigorously contest the matter.

#### Item 1A. Risk Factors

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

##### Risks Inherent in Our Business

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

We generate much of our revenue from a limited number of customers. In 2016, 2015 and 2014 and the three and six months ended June 30, 2017, our top ten customers represented 95.5%, 88.7%, 87.2%, 95.4% and 96.2% of our revenue, respectively. In 2016, Amazon represented 54.6% of our revenue and Microsoft represented 18.3% of our revenue. As a result, the loss of, or a significant reduction in orders from any of our key customers would materially and adversely affect our revenue and results of operations. We typically do not have long-term contracts with our

customers and instead rely on recurring purchase orders. If our key customers do not continue to purchase our existing products or fail to purchase additional products from us, our revenue would decline and our results of operations would be adversely affected.

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

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

We make planning and spending decisions, including determining the levels of business that we will seek and accept, production schedules, component procurement commitments, personnel needs and other resource requirements,

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

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

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

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

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

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

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

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

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

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

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

Product development delays may result from numerous factors, including:

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

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

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

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

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

In each of our target markets, including the CATV market, our sales depend on the aggregate capital expenditures of service providers as they build out and upgrade their network infrastructure. These markets are highly cyclical and characterized by constant and rapid technological change, price erosion, evolving standards and wide fluctuations in product supply and demand. In the past, these markets have experienced significant downturns, often connected with, or in anticipation of, the maturation of product cycles. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling



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prices. Our historical results of operations have been subject to these cyclical fluctuations, and we may experience substantial period-to-period fluctuations in our future results of operations. Any future downturn in any of the markets in which we compete could significantly reduce the demand for our products and therefore may result in a significant reduction in our revenue. Our revenue and results of operations may be materially and adversely affected in the future due to changes in demand from individual customers or cyclical changes in any of the markets utilizing our products. We may not be able to accurately predict these cyclical fluctuations and the impact of these fluctuations may have on our revenue and operating results.

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

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

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

Historically, we have generated much of our revenue from the CATV market. In 2016, 2015 and 2014, the CATV market represented 16.7%, 28.3% and 36.3% of our revenue, respectively. In the CATV market, we are relying on expected increasing demand for bandwidth-intensive services and applications such as on-demand television programs, high-definition television channels, or HDTV, social media, peer-to-peer file sharing and online video creation and viewing from network service providers. Without network and bandwidth growth, the need for our products will not increase and may decline, adversely affecting our financial condition and results of operations. Although demand for broadband access is increasing, network and bandwidth growth may be limited by several factors, including an uncertain regulatory environment, high infrastructure costs to purchase and install equipment and uncertainty as to which competing content delivery solution, such as telecommunications, wireless or satellite, will gain the most widespread acceptance. If the trend of outsourcing for the design and manufacture of CATV equipment does not continue, or continues at a slower pace than currently expected, our customers' demand for our design and manufacturing services may not grow as quickly as expected. If expectations for the growth of the CATV market are not realized, our financial condition or results of operations will be adversely affected. In addition, if the CATV market is adversely impacted, whether due to competitive pressure from telecommunication service providers, regulatory changes, or otherwise, our business would be adversely affected. We may not be able to offset any potential decline in revenue from the CATV market with revenue from new customers in other markets.

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

For 2016 and 2015, respectively, we generated 0.6%, and 1.3% of our revenue from the FTTH market. We have only recently begun offering products to the FTTH market, and our WDM-PON products designed for this market have not yet, and may never, gain widespread acceptance by large internet service providers. Our business in this market is dependent on the deployment of our optical components, modules and subassemblies. We are relying on increasing demand for bandwidth-intensive services and telecommunications service providers' acceptance and deployment of WDM-PON as a technology supporting 1 Gbps service to the home. Without network and bandwidth growth and adoption of our solutions by operators in these markets, we will not be able to sell our products in these markets in high volume or at our targeted margins, which would adversely affect our financial condition and results of operations. For example, WDM-PON technology may not be adopted by equipment and service providers in the FTTH market as rapidly as we expect or in the volumes we need to achieve acceptable margins. Network and bandwidth growth may be limited by several factors, including an uncertain regulatory environment, high infrastructure costs to purchase and install equipment and uncertainty as to which competing content delivery solution, such as CATV, will gain the most widespread acceptance. In addition, as we enter new markets or expand our product offerings in existing markets, our margins may be adversely affected due to competition in those markets and commoditization of competing products. If our expectations for the growth of these markets are not realized, our financial condition or results of operations will be adversely affected.

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

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

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

We have a high fixed cost base due to our vertically integrated business model, including the fact that 2,171 of our employees as of December 31, 2016 were employed in manufacturing and research and development operations. We may not be able to adjust these fixed costs quickly to adapt to rapidly changing market conditions. Our gross profit and gross margin are greatly affected by our sales volume and volatility on a quarterly basis and the corresponding absorption of fixed manufacturing overhead expenses. In addition, because we are a vertically integrated manufacturer, insufficient demand for our products may subject us to the risk of high inventory carrying costs and increased inventory obsolescence. Given our vertical integration, the rate at which we turn inventory has historically been low when compared to our cost of sales. We do not expect this to change significantly in the future and believe that we will have to maintain a relatively high level of inventory compared to our cost of sales. As a result, we continue to expect to have a significant amount of working capital invested in inventory. We may be required to write down inventory costs in the future and our high inventory costs may have an adverse effect on our gross profits and our results of operations.

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

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

- the timing, size and mix of sales of our products;
- fluctuations in demand for our products, including the increase, decrease, rescheduling or cancellation of significant customer orders;
- our ability to design, manufacture and deliver products which meet customer requirements in a timely and cost-effective manner;
- new product introductions and enhancements by us or our competitors;
- the gain or loss of key customers;
- the rate at which our present and potential customers and end users adopt our technologies;
- changes in our pricing and sales policies or the pricing and sales policies of our competitors;
- seasonality of certain of our products;

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- quality control or yield problems in our manufacturing operations;
- supply disruption for certain raw materials and components used in our products;
- capacity constraints of our outside contract manufacturers for a portion of the manufacturing process for some of our products;
- length and variability of the sales cycles of our products;
- unanticipated increases in costs or expenses;
- the loss of key employees;
- different capital expenditure and budget cycles for our customers, affecting the timing of their spending for our products;
- political stability in the areas of the world in which we operate;
- fluctuations in foreign currency exchange rates;
- changes in accounting rules;
- the evolving and unpredictable nature of the markets for products incorporating our solutions; and
- general economic conditions and changes in such conditions specific to our target markets.

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

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

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

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

We depend on a limited number of suppliers for certain raw materials and components used in our products. Some of these suppliers could disrupt our business if they stop, decrease or delay shipments or if the materials or

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

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

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

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

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

Our products are complex and undergo quality testing as well as formal qualification by our customers. Our customers' testing procedures are limited to evaluating our products under likely and foreseeable failure scenarios and over varying amounts of time. For various reasons, such as the occurrence of performance problems that are unforeseeable in testing or that are detected only when products age or are operated under peak stress conditions, our products may fail to perform as expected long after customer acceptance. Failures could result from faulty components or design,

problems in manufacturing or other unforeseen reasons. As a result, we could incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. Our products are typically embedded in, or deployed in conjunction with, our customers' products, which incorporate a variety of components, modules and subsystems and may be expected to interoperate with modules produced by third parties. As a result, not all defects are immediately detectable and when problems occur, it may be difficult to identify the source of the problem. While we have not experienced material failures in the past, we will continue to face this risk going forward because our products are widely deployed in many demanding environments and applications worldwide. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty to maintain customer relationships. Any significant product failure could result in litigation, damages, repair costs and lost future sales of the affected product and other products, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems, all of which would harm our business. Although we carry product liability insurance, this insurance may not adequately cover our costs arising from defects in our products or otherwise.



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

We currently derive, and expect to continue to derive, a significant portion of our revenue from sales to international customers. In 2016, 2015 and 2014, 15.8%, 19.0% and 29.5% of our revenue was derived from sales that occurred outside of North America, respectively. In addition, a significant portion of our manufacturing operations is based in Ningbo, China and Taipei, Taiwan. Our international revenue and operations are subject to a number of material risks, including:

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

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

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

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

Although we primarily sell our products through direct sales, we also sell our products to some of our customers through third party sales representatives and distributors. Many of such third parties also market and sell products from our competitors. Our third party sales representatives and distributors may terminate their relationships with us at any time, or with short notice. Our future performance will also depend, in part, on our ability to attract additional third party sales representatives and distributors that will be able to market and support our products effectively, especially in

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markets in which we have not previously distributed our products. If our current third party sales representatives and distributors fail to perform as expected, our revenue and results of operations could be harmed.

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

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

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

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

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

We operate in a market that makes our prospects difficult to evaluate and, to remain competitive, we will be required to make continued investments in capital equipment, facilities and technological improvements. We expect that

substantial capital will be required to expand our manufacturing capacity and fund working capital for anticipated growth. If we do not generate sufficient cash flow from operations or otherwise have the capital resources to meet our future capital needs, we may need additional financing to implement our business strategy, which includes:

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

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

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

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

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

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

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

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

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

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

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

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

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

Natural disasters or other catastrophic events could harm our operations.

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

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

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

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

We are, and in the future may be, subject to legal actions in the ordinary course of our operations, both domestically and internationally. There can be no assurances as to the favorable outcome of any litigation. In addition it can be costly to defend litigation and these costs could negatively impact our financial results. As disclosed in "Item 1. Legal Proceedings," on August 5, 2017, a purported shareholder class action lawsuit was filed in the U.S. District Court for

the Southern District of Texas against us and two of our officers. The complaint in this matter alleges that we made materially false and misleading statements or failed to disclose material facts and requests damages and other relief. Such lawsuit and any other such litigation could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

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

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



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patents or trademark registrations or a successful challenge to our registrations in the U.S. or other foreign countries may limit our ability to protect the intellectual property rights that these applications and registrations intended to cover.

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

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

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

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

Participants in the markets in which we sell our products have experienced frequent litigation regarding patent and other intellectual property rights. While we have a policy in place that is designed to reduce the risk of infringement of intellectual property rights of others and we have conducted a limited review of other companies' relevant patents, there can be no assurance that third parties will not assert infringement claims against us. We cannot be certain that

our products would not be found infringing on the intellectual property rights of others. Regardless of their merit, responding to such claims can be time consuming, divert management's attention and resources and may cause us to incur significant expenses. Intellectual property claims against us could force us to do one or more of the following:

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

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

In any potential intellectual property dispute, our customers could also become the target of litigation. Because we often indemnify our customers for intellectual property claims made against them with respect to our products, any claims against our customers could trigger indemnification claims against us. These obligations could result in

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substantial expenses such as legal expenses, damages for past infringement or royalties for future use. Any indemnity claim could also adversely affect our relationships with our customers and result in substantial costs to us.

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

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

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

Preparing our consolidated financial statements involves a number of complex manual and automated processes, which are dependent upon individual data input or review and require significant management judgment. One or more of these elements may result in errors that may not be detected and could result in a material misstatement of our consolidated financial statements. The Sarbanes-Oxley Act requires, among other things, that as a publicly-traded company we disclose whether our internal control over financial reporting and disclosure controls and procedures are effective.

In addition, since we will no longer qualify as an “emerging growth company” under the JOBS Act as of January 1, 2018, we will have to provide an auditor’s attestation report on our internal controls in future annual reports on Form 10-K as required by Section 404(b) of the Sarbanes-Oxley Act. During the course of any evaluation, documentation or attestation, we or our independent registered public accounting firm may identify weaknesses and deficiencies that we may not otherwise identify in a timely manner or at all as a result of the deferred implementation of this additional level of review.

We have implemented internal controls that we believe provide reasonable assurance that we will be able to avoid accounting errors or material weaknesses in future periods. However, our internal controls cannot guarantee that no accounting errors exist or that all accounting errors, no matter how immaterial, will be detected because a control system, no matter how well designed and operated, can provide only reasonable, but not absolute assurance that the control system’s objectives will be met. If we are unable to implement and maintain effective internal control over

financial reporting, our ability to accurately and timely report our financial results could be adversely impacted. This could result in late filings of our annual and quarterly reports under the Securities Exchange Act of 1934, or the Exchange Act, restatements of our consolidated financial statements, a decline in our stock price, suspension or delisting of our common stock by NASDAQ, or other material adverse effects on our business, reputation, results of operations or financial condition.

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

As of December 31, 2016, we had U.S. accumulated net operating losses, or NOLs, of approximately \$37.7 million for U.S. federal income tax purposes. Under Section 382 of the Internal Revenue Code of 1986, as amended, if a corporation undergoes an “ownership change,” the corporation’s ability to use its pre-change NOLs, R&D credits and other pre-change tax attributes to offset its post-change income may be limited. An ownership change is generally defined as a greater than 50% change in equity ownership by value over a 3-year period. Based upon an analysis of our equity ownership, we believe that we have experienced ownership changes and therefore our annual utilization of our NOLs is limited. In addition, should we experience additional ownership changes, our NOL carry forwards may be further limited.

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

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

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

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

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

Following the lead of the European Union, or EU, various governmental agencies have either already put into place or are planning to introduce regulations that regulate the permissible levels of hazardous substances in products sold in various regions of the world. For example, the RoHS directive for EU took effect on July 1, 2006. The labeling

provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU have required their suppliers to be compliant with the new directive. Many of our customers have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort in planning and executing our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such events, we could experience the following consequences: loss of revenue, damages reputation, diversion of resources, monetary penalties, and legal action.

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

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

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

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

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

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

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

Public companies are required to disclose the use of tin, tantalum, tungsten and gold (collectively, "conflict minerals") mined from the Democratic Republic of the Congo and adjoining countries (the "covered countries") if a conflict

mineral(s) is necessary to the functionality of a product manufactured, or contracted to be manufactured, by the company. We filed our latest conflict minerals report on Form SD on May 26, 2017. We may determine, as part of our compliance efforts, that certain products or components we obtain from our suppliers contain conflict minerals. If we are unable to conclude that all our products are free from conflict minerals originating from covered countries, this could have a negative impact on our business, reputation and/or results of operations. We may also encounter challenges to satisfy customers who require that our products be certified as conflict free, which could place us at a competitive disadvantage if we are unable to substantiate such a claim. Compliance with these rules could also affect the sourcing and availability of some of the minerals used in the manufacture of products or components we obtain from our suppliers, including our ability to obtain products or components in sufficient quantities and/or at competitive prices. Certain of our customers are requiring additional information from us regarding the origin of our raw materials, and complying with these customer requirements may cause us to incur additional costs, such as costs related to determining the origin of any minerals used in our products. Our supply chain is complex and we may be unable to verify the origins for all metals used in our products. We may also encounter challenges with our customers and stockholders if we are unable to certify that our products are conflict free.

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

Certain provisions contained in our employment agreements with our named executive officers regarding change of control or separation of service may obligate us to make lump sum severance payments and related payments



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upon the termination of their employment with us, other than such executive officer's resignation without good reason or our termination of their employment as a result of their disability or for cause. In the event we are required to make these separation payments, it could have a material adverse effect on our results of operations for the fiscal period in which such payments are made.

## Risks Related to Our Operations in China

Our business operations conducted in China are critical to our success. A total of \$57.4 million, \$20.6 million and \$22.0 million or 22.0%, 11.0% and 16.9%, of our revenue in the years ended December 31, 2016, 2015 and 2014 was attributable to our product manufacturing plants in China, respectively. Additionally, a substantial portion of our property, plant and equipment, 23% and 22% as of December 31, 2016 and 2015, was located in China, respectively. We expect to make further investments in China in the foreseeable future. Therefore, our business, financial condition, results of operations and prospects are to a significant degree subject to economic, political, legal, and social events and developments in China.

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

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

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

Furthermore, while China's economy has experienced rapid growth in the past 20 years, growth has been uneven across different regions, among various economic sectors and over time. China has also in the past and may in the

future experience economic downturns due to, for example, government austerity measures, changes in government policies relating to capital spending, limitations placed on the ability of commercial banks to make loans, reduced levels of exports and international trade, inflation, lack of financial liquidity, stock market volatility and global economic conditions. Any of these developments could contribute to a decline in business and consumer spending in addition to other adverse market conditions, which could adversely affect our business.

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

Prior to January 1, 2008, entities established in China were generally subject to a 30% state and 3% local enterprise income tax rate. In accordance with the China Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, effective through December 31, 2007, our China subsidiary enjoyed preferential income tax rates. Effective January 1, 2008, the China Enterprise Income Tax Law, or the EIT law, imposes a single uniform income tax rate of 25% on all Chinese enterprises, including FIEs, and eliminates or modifies most of the tax exemptions, reductions and preferential treatment available under the previous tax laws and regulations. As a result, our China subsidiary may be subject to the uniform income tax rate of 25% unless we are able to qualify for preferential status. Currently, we have qualified for a preferential 15% tax rate that is available for state-encouraged new high technology enterprises. The preferential rate has applied to calendar years 2012 through 2016. We have not yet realized any benefit from the 10% reduction in income tax rate due to losses incurred by our China subsidiary; however, if we fail to continue to qualify for this preferential rate in the future, we may incur higher tax rates on our income in China. In order to retain the preferential tax rate, we must meet certain operating conditions, satisfy certain product requirements, meet certain

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headcount requirements and maintain certain levels of research expenditures. We applied for an additional three years of preferential status with the Chinese government in 2014 and received approval as a high-technology enterprise through September 2017. Any future increase in the enterprise income tax rate applicable to us or the expiration or other limitation of preferential tax rates available to us could increase our tax liabilities and reduce our net income.

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

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

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

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

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

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

The China Labor Contract Law, together with its implementing rules, provides increased rights to Chinese employees. Previously, an employer had discretionary power in deciding the probation period, not to exceed six months. Additionally, the employment contract could only be terminated for cause. Under these rules, the probation period

varies depending on contract terms and the employment contract can only be terminated during the probation period for cause upon three days' notice. Additionally, an employer may not be able to terminate a contract during the probation period on the grounds of a material change of circumstances or a mass layoff. The law also has specific provisions on conditions when an employer has to sign an employment contract with open-ended terms. If an employer fails to enter into an open-ended contract in certain circumstances, the employer must pay the employee twice their monthly wage beginning from the time the employer should have executed an open-ended contract. Additionally, an employer must pay severance for nearly all terminations, including when an employer decides not to renew a fixed-term contract. These laws may increase our costs and reduce our flexibility.

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

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

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

Businesses in China have historically not adopted a western style of management and financial reporting concepts and practices, which includes strong corporate governance, internal controls and computer, financial and other control systems. Moreover, familiarity with U.S. GAAP principles and reporting procedures is less common in China. As

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a consequence, we may have difficulty finding accounting personnel experienced with U.S. GAAP, and we may have difficulty training and integrating our China-based accounting staff with our U.S.-based finance organization. As a result of these factors, we may experience difficulty in establishing management and financial controls over our China operations. These difficulties include collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet U.S. public-company reporting requirements. We may, in turn, experience difficulties in implementing and maintaining adequate internal controls as required under Section 404 of the Sarbanes-Oxley Act.

## Risks Related to Our Common Stock

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

The market price of our common stock has been and is likely to be subject to wide fluctuations in response to, among other things, the risk factors described in this section of this Quarterly Report on Form 10-Q, and other factors beyond our control, such as fluctuations in the valuation of companies perceived by investors to be comparable to us. For example, announcements made by competitors regarding factors influencing their business may cause fluctuations in the valuation of companies throughout our industry, including fluctuations in the valuation of our stock.

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

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We have been and may become the target of this type of litigation in the future. For example, on August 3, 2017 we provided guidance for the third quarter of 2017, and on August 4, 2017 the market price of our stock decreased significantly. We subsequently learned of potential class action litigation based on volatility in the market price for our stock. See “Item 1. Legal Proceedings.” Securities litigation against us could result in substantial costs and divert our management’s attention from other business concerns, which could seriously harm our business.

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

We face increased legal, accounting, administrative and other costs and expenses as a public company that we did not incur as a private company, and greater expenditures may be necessary in the future with the advent of new laws, regulations and stock exchange listing requirements pertaining to public companies. These increased costs will require us to divert a significant amount of money that we could otherwise use to expand our business and achieve our strategic objectives. The Sarbanes-Oxley Act, including the requirements of Section 404, as well as rules and regulations subsequently implemented by the SEC, the Public Company Accounting Oversight Board and the NASDAQ Global Market, impose additional reporting and other obligations on public companies. Compliance with public company requirements has increased our costs and made some activities more time-consuming. For example, we have created board committees and adopted internal controls and disclosure controls and procedures. In addition, we will have incurred and will continue to incur additional expenses associated with our SEC reporting requirements. Furthermore, if we identify any issues in complying with those requirements (for example, if we or our auditors identify a material weakness or significant deficiency in our internal control over financial reporting), we could incur additional costs rectifying those issues, and the existence of those issues could adversely affect us, our reputation or investor perceptions of us. Advocacy efforts by stockholders and third parties may also prompt additional changes in governance and reporting requirements, which could further increase our costs. Commencing December 31, 2017, we will be a "large accelerated filer" and, accordingly, will no longer qualify as an emerging growth company and will no longer be able to rely on certain exemptions that were available to us as an emerging growth company. Legal, accounting, administrative and other costs and expenses may increase in the future as we continue to incur both increased external audit fees as well as additional spending to ensure continued regulatory compliance.

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

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

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

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

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

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

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

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

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



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

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

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

We cannot predict if investors will find our common stock less attractive because we will rely on these exemptions. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be more volatile. We will cease to be an “emerging growth company” on the date that we become a “large accelerated filer” as defined in Rule 12b-2 under the Exchange Act, which will occur on December 31, 2017 because the market value of our common stock that was held by non-affiliates exceeded \$700 million as of the last business day of our most recently completed second fiscal quarter.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index.

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SIGNATURES

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

APPLIED OPTOELECTRONICS, INC.

Date: August 8, 2017 By: /s/ Stefan J. Murry  
Stefan J. Murry  
Chief Financial Officer  
(principal financial officer and principal accounting officer)

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EXHIBIT INDEX

| Number    | Description  |
|-----------|--|
| 3.1*      | Amended and Restated Certificate of Incorporation, as currently in effect (filed as Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2013). |
| 3.2*      | Amended and Restated Bylaws, as currently in effect (filed as Exhibit 3.2 to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2013).                       |
| 4.1*      | Common Stock Specimen (filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 15, 2015).  |
| 31.1**    | Certification of Chief Executive Officer pursuant to Exchange Act Rule, 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2**    | Certification of Chief Financial Officer pursuant to Exchange Act Rule, 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1**    | Certification pursuant to 18 U.S.C. 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Executive Officer and Chief Financial Officer  |
| 101.INS** | XBRL Instance Document.  |
| 101.SCH** | XBRL Taxonomy Extension Schema Document.   |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document.   |
| 101.DEF** | XBRL Taxonomy Extension Definition Linkbase Document.  |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document.   |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document.  |

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\* Incorporated herein by reference to the indicated filing.

\*\* Filed herewith.