Kraton Performance Polymers, Inc.
Form DEF 14A
April 08, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

(RULE 14a-101)

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the

Securities Exchange Act of 1934

Filed by the Registrant x Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨ Preliminary Proxy Statement.

¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2)).**

x Definitive Proxy Statement.

¨ Definitive Additional Materials.

¨ Soliciting Material Pursuant to §240.14a-12.

Kraton Performance Polymers, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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¨ Fee paid previously with preliminary materials.

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the form or schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

Table of Contents

Kraton Performance Polymers, Inc.

15710 John F. Kennedy Boulevard, Suite 300

Houston, Texas 77032

To Our Stockholders:

We are pleased to invite you to attend the Annual Meeting of the Stockholders of Kraton Performance Polymers, Inc., which will be held Wednesday, May 25, 2011 at 3:00 p.m., central time, at The Sheraton North Houston, 15700 John F. Kennedy Boulevard, Houston, Texas 77032.

The following pages include a formal notice of the meeting and our proxy statement. The proxy statement describes various matters on the agenda for the meeting. Please read these materials so that you will know what we plan to do at the meeting. It is important that your shares be represented at our Annual Meeting regardless of whether you plan to attend the meeting in person. Please vote your shares as soon as possible through any of the voting options available to you as described in this proxy statement.

On behalf of management and the board of directors, we thank you for your continued interest in Kraton Performance Polymers, Inc.

Sincerely,

Kevin M. Fogarty,

President and Chief Executive Officer

Houston, Texas

April 8, 2011

Table of Contents

KRATON PERFORMANCE POLYMERS, INC.

15710 John F. Kennedy Boulevard, Suite 300

Houston, Texas 77032

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

To Be Held May 25, 2011, at 3:00 p.m. central time

NOTICE IS HEREBY GIVEN that the Annual Meeting of Stockholders of Kraton Performance Polymers, Inc. will be held on Wednesday, May 25, 2011, at 3:00 p.m. central time, at The Sheraton North Houston, 15700 John F. Kennedy Boulevard, Houston, Texas 77032 for the following purposes:

1. To elect one Class II director to serve for a three-year term and until a successor is duly elected and qualified.

2. To approve the amendment and restatement of our 2009 Equity Incentive Plan.

3. To conduct an advisory vote on the compensation of our named executive officers.

4. To conduct an advisory vote on the frequency, in future years, of the advisory vote on the compensation of our named executive officers.

5. To ratify the appointment of KPMG LLP as our independent registered public accounting firm for the 2011 fiscal year.

6. To transact other business that may properly come before the meeting and any postponement or adjournment of the meeting.

Our board of directors has fixed the close of business on April 1, 2011 as the record date for determining those stockholders who are entitled to notice of, and to vote at, the Annual Meeting of Stockholders. A list of such stockholders will be open to examination by any stockholder at the annual meeting and for a period of ten days prior to the date of the annual meeting during ordinary business hours at our executive offices located at 15710 John F. Kennedy Boulevard, Suite 300, Houston, Texas 77032. A copy of the Annual Report of Kraton Performance Polymers, Inc. for the year ended December 31, 2010 is enclosed. We plan to commence mailing our proxies, along with this proxy statement and our 2011 annual report, on or about April 13, 2011.

By Order of the Board of Directors,

STEPHEN W. DUFFY,

Vice President, General Counsel and Secretary

HOUSTON, TEXAS

April 8, 2011

<u>Your vote is important</u>! We hope you will vote by telephone, over the Internet or by marking, signing and returning your proxy or voting instruction card as soon as possible, whether or not you plan to attend the meeting.

Table of Contents

TABLE OF CONTENTS

Table of Contents

Recent Developments

On April 6, 2011, entities affiliated with TPG Capital, L.P. (collectively, TPG) and J.P. Morgan Partners, LLC (collectively, JPMP) sold all of their common stock of Kraton Performance Polymers, Inc. in a public offering. Prior to the sale, and as of April 1, 2011, which is the record date for determining the Kraton stockholders who are entitled to vote at the Annual Meeting of Stockholders, TPG owned approximately 18.80% of our outstanding common stock, and JPMP owned approximately 12.53%. TPG and JPMP have informed us that they each retained and did not transfer in the sale transaction the right to vote the Kraton common stock held by them on the record date.

Three of the four Class II directors whose terms expire at the 2011 Annual Meeting of Stockholders, Kelvin L. Davis, Kevin G. O Brien and Nathan H. Wright, were designees of TPG or JPMP under a Registration Rights and Shareholders Agreement with us. As a result of the sale, TPG and JPMP no longer have the right to designate nominees for director under the agreement, and on or about April 4, 2011, Messrs. Davis, O Brien and Wright notified Kraton of their intention not to stand for reelection at the 2011 annual meeting. Our other directors who were designees of TPG and JPMP under the agreement, Timothy J. Walsh and Michael G. MacDougall, have terms that do not expire this year. They are expected to resign before their terms expire, but will remain on our board of directors at the present time.

Our Nominating and Corporate Governance Committee had retained Korn-Ferry International in January 2011 to assist it in identifying and evaluating nominees for director. We anticipate adding two new Class II Directors at a future date from the pool of nominees currently being developed by Korn-Ferry.

Table of Contents

KRATON PERFORMANCE POLYMERS, INC.

15710 John F. Kennedy Boulevard, Suite 300

Houston, Texas 77032

PROXY STATEMENT

ANNUAL MEETING OF STOCKHOLDERS

May 25, 2011

QUESTIONS AND ANSWERS ABOUT THE MEETING AND VOTING

Q: Who is making this solicitation of proxies?

A: This solicitation is made by Kraton Performance Polymers, Inc. on behalf of its board of directors. This proxy statement is first being mailed on or about April 11, 2011 to stockholders of Kraton Performance Polymers, Inc., which is sometimes referred to in this proxy statement as Kraton, we, us, our, or the company. As used in this proxy statement and as the context requires, references to Kraton i our direct and indirect subsidiaries, including our direct, wholly-owned subsidiary Kraton Polymers LLC, through which substantially all of our business and operations are conducted.

Kraton will bear the cost of this proxy solicitation. We may furnish copies of our proxy solicitation material to brokers, custodians, nominees and other fiduciaries for forwarding to beneficial owners of shares of our common stock, and ordinary course handling charges may be paid for such forwarding service. Our officers and other management employees, who will receive no additional compensation for their services, may solicit proxies by mail, email, Internet, facsimile or telephone or in person. We have retained Georgeson Shareholder Communications, Inc., 199 Water Street, 26th Floor, New York, NY 10038, to provide services in connection with our annual meeting, including the solicitation of proxies, at an anticipated cost of $7,000, plus reimbursement of out-of-pocket expenses.

Q: Where will the annual meeting of stockholders take place?

A: The annual meeting of stockholders will be held on Wednesday, May 25, 2011, at 3:00 p.m. central time, at The Sheraton North Houston, 15700 John F. Kennedy Boulevard, Houston, Texas 77032.

Q: Who may vote?

A: All stockholders of record as of the close of business on April 1, 2011, the record date for the meeting, are entitled to vote at the meeting. Holders of our common stock are entitled to one vote per share. At the close of business on the record date there were 31,851,129 shares of our common stock outstanding.

Q: Who may attend the meeting?

A: All stockholders as of the record date, or their duly appointed proxies, may attend the meeting.

Table of Contents

Q: How do I vote?

A: Because many stockholders cannot attend the annual meeting, it is necessary that a large number of stockholders be represented by proxy. You may vote your proxy in one of the following ways:

- you may cast your vote by telephone using the toll-free number provided below;
- you may vote online at **www.investorvote.com/kra**; or
- you may vote by signing and returning the enclosed proxy card. If you return the proxy card, the persons named on the card will vote your shares in the manner you indicate.

If you hold shares through a brokerage firm, bank or other custodian, you may vote by telephone or the Internet only if the custodian offers that option. Please refer to your proxy card or the information provided by your brokerage firm, bank or other custodian to determine which options are available for voting the proxy.

You may receive more than one proxy card, depending on how you hold your Kraton shares. You should vote each proxy card provided to you using one of the methods described above.

Q: What am I being asked to vote on?

A: We are asking you to consider and vote your proxies in order to:

- elect one Class II director to serve until the 2014 annual meeting of stockholders (Proposal No. 1);
- approve the amendment and restatement of our 2009 Equity Incentive Plan (Proposal No. 2);
- hold an advisory vote on named executive officer compensation (Proposal No. 3);
- hold an advisory vote to determine the frequency with which to hold future advisory votes on named executive officer compensation (Proposal No. 4);
- ratify our Audit Committee s appointment of KPMG LLP as our independent registered public accounting firm for the year ending December 31, 2011 (Proposal No. 5); and
- transact other business that may properly come before the meeting or any postponement or adjournment of the meeting.

All of these items are discussed in more detail in this proxy statement.

Q: What is the recommendation of the Kraton board of directors?

A: Our board of directors recommends that stockholders vote:

FOR our nominee for Class II Director;

FOR the approval of the amendment and restatement of our 2009 Equity Incentive Plan;

FOR the advisory vote on the resolution to approve named executive officer compensation;

FOR the option of EVERY YEAR for the advisory vote on the frequency of future advisory votes to approve named executive officer compensation; and

FOR the ratification of the appointment of KPMG LLP as our independent registered public accounting firm for the year ending December 31, 2011.

Table of Contents

Q: What happens if I do not indicate how I wish to vote on one or more of the proposals?

A: If you return your signed proxy card but do not indicate how you wish to vote, the persons named as proxies will vote your shares

- FOR the election of our director nominee (Proposal No. 1), FOR the amendment and restatement of our 2009 Equity Incentive Plan (Proposal No. 2), FOR the resolution to approve our named executive officer compensation (Proposal No. 4), FOR the ratification of the appointment of KPMG LLP (Proposal No. 5); and

- FOR the option of EVERY YEAR for the advisory vote on the frequency of future advisory votes on named executive officer compensation (Proposal No. 3).

We are not aware of any other matters that may come before the annual meeting. If any other matter properly comes before the annual meeting, the proxy holders will vote the proxies according to their judgment.

Q: What happens if I vote by proxy and later change my mind?

A: If you are the record holder of your shares, you may revoke your proxy by:

- writing to our Corporate Secretary at the mailing address in the answer to the last question below;

- delivering a properly executed proxy card dated after the date of the proxy card you want to revoke;

- voting at a later time, but prior to 11:59 p.m. eastern time on May 24, 2011, by telephone or the Internet; or

- attending the annual meeting and casting your vote in person.

If you are a beneficial owner of your shares, you must contact your brokerage firm, bank or other custodian to revoke any prior voting instructions.

Q: Who are the proxies for the annual meeting?

A: The named proxies for the annual meeting, Kevin M. Fogarty and Stephen W. Duffy (or their duly authorized designees), will follow submitted proxy voting instructions. They will vote as the board of directors recommends as to any submitted proxies that do not direct how to vote on any item, and will vote on any other matters properly presented at the annual meeting in their judgment.

Q: What constitutes a quorum?

A: We need a quorum of stockholders in order to transact business at our annual meeting. The presence, in person or by proxy, of the holders of record of a majority in voting power of the outstanding shares of common stock entitled to vote at the meeting constitutes a quorum. If you have properly voted by proxy, via mail, telephone or the Internet, you will be considered part of the quorum. We will count abstentions, withhold votes and broker non-votes as present for the purpose of establishing a quorum. A broker non-vote occurs when a broker holding shares for a beneficial owner votes on some matters on the proxy card, but not on others, because the broker does not have instructions from the beneficial owner or discretionary authority (or declines to exercise discretionary authority) with respect to those other matters. If a quorum is not present, the chairman or the holders of a majority of the shares of common stock present in person or by proxy at the annual meeting may adjourn the meeting, without notice other than an announcement at the meeting, until the required quorum is present.

Table of Contents

Q: If my broker holds my shares in street name, will my broker automatically vote my shares for me?

A: Under the rules of the New York Stock Exchange (NYSE), if your broker holds your shares in its name and you do not instruct your broker how to vote, your broker will nevertheless have discretion to vote your shares on our sole routine matter the ratification of the appointment of our independent registered public accounting firm. Your broker **will not** have discretion to vote on any of the other proposals, absent direction from you, because they are considered non-routine matters. It is therefore very important that you vote your proxy or voting instruction card so that your vote can be counted.

Q: What vote is required for the passage of each of the proposals up for consideration at the annual meeting?

A: Provided a quorum is present, directors are elected by a plurality of the votes represented at the meeting and voted for nominee(s) in the election. Broker non-votes will not affect the outcome of the voting on the election, and a proxy marked withhold with respect to a director nominee will result in such director nominee s receiving fewer FOR votes.

The affirmative vote of the majority of shares represented at the meeting and voting on the proposal will determine the outcome of the advisory vote on executive compensation and the ratification of our independent registered public accounting firm. For each of these proposals, abstentions and broker non-votes will have no effect on the outcome of the vote.

With respect to the proposal relating to the frequency of advisory votes to approve named executive officer compensation, because this item seeks input from our stockholders and provides stockholders with multiple options from which to vote, there is no minimum vote required on this proposal. Abstentions and broker non-votes will not be counted as expressing any preference.

With respect to the proposal to approve the amendment and restatement of our 2009 Equity Incentive Plan, approval requires the affirmative vote of a majority of the votes cast, and the total number of votes cast must represent over 50% of the total shares outstanding as of the record date. With respect to this proposal, abstentions will have the same effect as votes cast against the proposal. Broker non-votes, on the other hand, will not affect the outcome of the voting, except that they could prevent the total votes cast with respect to the proposal from representing a majority of the shares outstanding and entitled to vote on the proposal, in which event the amendment and restatement would not be approved.

Q: Who will count the votes?

A: Representatives of Georgeson Shareholder Communications, Inc. will tabulate the votes.

Q: What shares are reflected on my proxy card?

A: The shares listed on your proxy card represent, as of the record date, all the shares of common stock held in your name, as distinguished from shares held by a broker in street name. You should receive a separate voting instruction card from your broker if you hold shares in street name.

Q: What is Kraton s contact information for purposes of the proxy solicitation?

A: You can contact us by mail sent to the attention of The Corporate Secretary at our principal executive offices located at 15710 John F. Kennedy Boulevard, Suite 300 Houston, Texas 77032. You can call us by dialing 281-504-4700. You can access our proxy materials online at **www.investorvote.com/kra**.

5

Table of Contents

PROPOSAL 1 ELECTION OF CLASS II DIRECTOR

Our board is presently composed of eleven directors, divided into three classes, designated as Class I, Class II and Class III, each serving staggered three-year terms. Immediately following the 2011 annual meeting of stockholders, our board of directors will be comprised on eight members.

The board has nominated for re-election Richard C. Brown, as Class II director, to serve until his successor is duly elected and qualified at the annual meeting of stockholders held in 2014 or until his earlier death, resignation or removal. Mr. Brown is currently a director of Kraton. On or about April 4, 2011, our other Class II directors notified us of their intention not to stand for reelection at the 2011 annual meeting. For further information on recent ownership changes and our current board composition, please refer to *Recent Developments*.

Mr. Brown has consented to being named in this proxy statement and to serving as director if elected at the Annual Meeting. If for any reason, Mr. Brown becomes unable or unwilling to serve at the time of the Annual Meeting, the board may reduce the size of the board accordingly, or the persons named as proxies in the proxy will have the authority to vote for substitute nominees. We do not anticipate that Mr. Brown will be unable or unwilling to serve.

The board has determined that Mr. Brown is independent under the listing standards of the NYSE.

The board recommends that stockholders vote FOR the Company s nominee for Class II Director.

Biographical Information

Set forth below is a brief biography of Mr. Brown and for all other members of the board of directors who will continue in office. In addition, set forth below is a biography of each of our executive officers who is not a director. Where applicable, the date a director joined our board refers to the date he joined Polymer Holdings LLC, which converted into Kraton Performance Polymers, Inc. in connection with our initial public offering in December 2009. Mr. Brown and each of our incumbent Class I and Class III directors is also a director of our principal operating subsidiary, Kraton Polymers LLC.

Also included below following each biography is a brief discussion of the specific experience, qualifications, attributes or skills that led our Nominating and Corporate Governance Committee to conclude that the applicable director should serve on our board at this time. In addition to those criteria discussed below, each of our nominees and directors meets the requirements of applicable law and NYSE listing standards, is judged by the committee as a person of the highest character and integrity, and serves our goal of having a well-rounded board, including our consideration of principles of diversity. For a further discussion of the guidelines and qualifications our Nominating and Corporate Governance Committee considers, please see *Director Nominations*, below.

Nominee for Election as Class II Director

Richard C. Brown. Mr. Brown, age 51, was named a director of our principal operating subsidiary Kraton Polymers LLC in May 2008 and as a director of Kraton Performance Polymers, Inc. in September 2009. Mr. Brown is Chief Executive Officer of Performance Fibers, Inc., a global leader in high-performance industrial fibers and related materials, a position he has held since 2008. Prior to joining Performance Fibers, Mr. Brown was a vice president of W.R. Grace & Co. and President of the Grace Performance Chemicals business, which business included Grace Construction Products, Grace Residential Building Products and Darex Packaging Technologies. Previously, he spent 19 years with General Electric Co. in a series of positions with increasing responsibilities, including President of GE Silicones, Core Products Business and President of GE Sealants & Adhesives. Mr. Brown is a director of Ferro Corporation. Mr. Brown has a B.S. degree from Plymouth State University (University of New Hampshire system).

Table of Contents

Mr. Brown has extensive experience in the chemical industry, including experience in the specialty chemicals business that is applicable to our business in general as well as to specific lines of our business. He has business leadership experience at the highest levels, currently serving as the CEO of Performance Fibers and having served in senior executive positions with major companies. Mr. Brown also has significant international business experience.

Incumbent Class I Directors: Term Expiring 2013

Dan F. Smith. Mr. Smith, age 64, was named a director and Chairman of our principal operating subsidiary Kraton Polymers LLC in February 2008 and as a director of Kraton Performance Polymers, Inc. in September 2009. He began his career with ARCO (Atlantic Richfield Company) in 1968 as an engineer. He was elected President of Lyondell Chemical Company in August 1994, Chief Executive Officer in December 1996, and Chairman of the Board of Directors in May 2007. Mr. Smith retired in December 2007 as Chairman, President and Chief Executive Officer of Lyondell Chemical Company following the acquisition of Lyondell by Basell. Mr. Smith also served as Chief Executive Officer of Equistar Chemicals, LP from December 1997 through December 2007 and as Chief Executive Officer of Millennium Chemicals Inc. from November 2004 until December 2007. Equistar and Millennium are wholly-owned subsidiaries of Lyondell. Mr. Smith is a director of Cooper Industries plc. He also serves as a member of the College of Engineering Advisory Council at Lamar University and as a member of the Board of Trustees of the Lamar University Foundation. Mr. Smith is a graduate of Lamar University with a B.S. degree in Chemical Engineering.

Mr. Smith has a long and distinguished career in the chemical industry and is widely recognized as an expert in the field. He has extensive executive experience at the highest levels, including several years of experience as the Chief Executive Officer of a major chemical company. Mr. Smith has international business experience, together with chemical engineering expertise that is of value to the board.

Barry J. Goldstein. Mr. Goldstein, age 68, was named a director of our principal operating subsidiary Kraton Polymers LLC in May 2008 and as a director of Kraton Performance Polymers, Inc. in September 2009. Mr. Goldstein retired as Executive Vice President and Chief Financial Officer of Office Depot, Inc. in October 2000, which he first joined as Chief Financial Officer in May 1987. Mr. Goldstein was previously with Grant Thornton from 1969 through May 1987, where he was named a Partner in 1976. Mr. Goldstein is a director of Interline Brands, Inc. and Generac Holdings, Inc. During the past five years, Mr. Goldstein served on the boards of directors of PQ Corp., Brand Energy & Infrastructure Services, Inc. and Noble Environmental Power, LLC. He received a B.S. degree in Economics from the Wharton School at the University of Pennsylvania.

Mr. Goldstein has public company accounting experience at the highest levels, having served as the Chief Financial Officer for Office Depot for over a decade, having been a partner in a major public accounting firm, and having served on numerous corporate audit committees. Mr. Goldstein also has strong corporate finance experience, demonstrated business leadership experience, and board experience in early stage public companies.

Michael G. MacDougall. Mr. MacDougall, age 40, was named a director of our principal operating subsidiary Kraton Polymers LLC and Kraton Performance Polymers, Inc. in December 2003. Mr. MacDougall is a partner of TPG. Prior to joining TPG in 2002, Mr. MacDougall was a vice president in the Principal Investment Area of the Merchant Banking Division of Goldman, Sachs & Co., where he focused on private equity and mezzanine investments. He is a director of Graphic Packaging Holding Company, Energy Future Holdings Corp. (formerly TXU Corp.) and Copano Energy L.L.C. He also serves as the Chairman of the Board of The Opportunity Network and is a member of the board of directors of the Dwight School Foundation and Iselsboro Affordable Property. Mr. MacDougall is a graduate of The University of Texas at Austin and received his M.B.A. with distinction from Harvard Business School.

Mr. MacDougall has strong skills and experience in corporate finance, having over a decade of experience in investment banking and private equity finance. He has board experience in early stage public companies. Mr. MacDougall also has a longstanding tenure on our board, which provides an institutional knowledge base that is beneficial to the board as a whole.

Table of Contents

Timothy J. Walsh. Mr. Walsh, age 47, was named a director of our principal operating subsidiary Kraton Polymers LLC and Kraton Performance Polymers, Inc. in December 2003. Mr. Walsh is a Managing Director of CCMP Capital Advisors, LLC, a private equity firm formed in August 2006 by the former buyout/growth equity investment team of J.P. Morgan Partners, LLC, a private equity division of JPMorgan Chase & Co. Prior to his role with CCMP, Mr. Walsh was a partner with J.P. Morgan Partners, LLC. Prior to joining J.P. Morgan Partners, LLC in 1993, he was a vice president of J.P. Morgan Chase & Co. (formerly The Chase Manhattan Corporation). Mr. Walsh is a director of Generac Holdings, Inc. During the past five years, Mr. Walsh served on the boards of directors of Pliant Corp and PQ Corp. Mr. Walsh received his B.S. in Economics from Trinity College, Hartford and his M.B.A. from the University of Chicago.

Mr. Walsh has deep skills and expertise in corporate finance, having over two decades of experience in banking, investment banking and private equity finance. He has board experience in early stage public companies and significant board experience managing private companies. Mr. Walsh also has a longstanding tenure on our board, which provides an institutional knowledge base that is beneficial to the board as a whole.

Incumbent Class III Directors: Term Expiring 2012

Steven J. Demetriou. Mr. Demetriou, age 52, was named a director of our principal operating subsidiary Kraton Polymers LLC and as a director of Kraton Performance Polymers, Inc. in December 2004. Mr. Demetriou is currently the Chairman and Chief Executive Officer of Aleris International, Inc., a global leader in the production and sale of aluminum rolled and extruded products, recycled aluminum, and specifications alloy manufacturing, a position he has held since 2004. Previously, Mr. Demetriou was appointed President and Chief Executive Officer of Commonwealth Industries, Inc. (a predecessor by merger to Aleris) in June 2004, after serving as a member of that company s board of directors from 2002. Before joining Commonwealth in 2004, Mr. Demetriou was President and Chief Executive Officer of Noveon, Inc. Before that, from 1999 to 2001, he was Executive Vice President of IMC Global Inc. From 1997 to 1999, Mr. Demetriou held various leadership positions with Cytec Industries Inc., a specialty chemicals company. From 1981 to 1997, he served in management positions with ExxonMobil Corporation. Mr. Demetriou is a director of Foster Wheeler AG and OM Group, Inc. He has a B.S. degree in Chemical Engineering from Tufts University.

Mr. Demetriou has business leadership experience at the highest levels, is currently serving as the CEO of Aleris International, and has prior CEO experience before his tenure at Aleris. He has significant experience in the specialty chemicals industry and a chemical engineering background, together with substantial public company board experience. Mr. Demetriou also has a longstanding tenure on our board, which provides an institutional knowledge base that is beneficial to the board as a whole.

Kevin M. Fogarty. Mr. Fogarty, age 45, was named a director of our principal operating subsidiary Kraton Polymers LLC in January 2008 and as a director of Kraton Performance Polymers, Inc. in September 2009. Mr. Fogarty was appointed our President and Chief Executive Officer on January 14, 2008. Prior to being appointed President and Chief Executive Officer, Mr. Fogarty served as our Executive Vice President of Global Sales and Marketing from June 15, 2005. Mr. Fogarty joined us from Invista, where he had served as President for Polymer and Resins since May 2004. For the 13 years prior to his most recent position with Invista, Mr. Fogarty held a variety of roles within the Koch Industries, Inc. family of companies, including KoSa. Mr. Fogarty earned a B.S. degree in Engineering from the Technical University of Nova Scotia.

The Nominating and Corporate Governance Committee believes the Chief Executive Officer should serve on our board. As the Chief Executive Officer of our company, Mr. Fogarty sets the strategic direction of our company under the guidance of the board and provides valuable insight to the board into the day to day business issues facing our company. Mr. Fogarty has extensive sales, marketing and leadership experience in the chemical industry, including experience in the specialty chemicals business, and has broad international business experience. His strong chemical company expertise in marketing is of particular value to our board. In addition, Mr. Fogarty has high-level leadership experience in several prior positions.

Table of Contents

Karen A. Twitchell. Ms. Twitchell, age 55, was named as a director of our principal operating subsidiary Kraton Polymers LLC and Kraton Performance Polymers, Inc. in December 2009. Since December 2010, Ms. Twitchell has been the Executive Vice President and Chief Financial Officer of Landmark Aviation, a fixed base operator in the aviation industry. Ms. Twitchell was a Vice President and Treasurer of LyondellBasell Industries and Lyondell Chemical Company from 2001 to 2009. She previously served as a Vice President and Treasurer of Kaiser Aluminum Corporation and Southdown, Inc. Before joining Southdown, Ms. Twitchell was an investment banker with Credit Suisse First Boston in its corporate finance department. Ms. Twitchell serves on the board of directors of KMG Chemicals, Inc. Ms. Twitchell holds a B.A. in Economics from Wellesley College and an M.B.A. from Harvard University.

Ms. Twitchell has broad experience in financial management and corporate finance, including investment banking and treasury. She draws on her experience as a Chief Financial Officer to assist in the oversight of the financial management of Kraton by its management team. Ms. Twitchell also has extensive chemical industry experience and approximately 30 years experience in senior corporate positions.

Information Regarding Executive Officers Who Are Not Directors

Biographical Information

Set forth below is a brief biography of each of our executive officers who is not a director.

Stephen E. Tremblay. Mr. Tremblay, age 52, was appointed Vice President and Chief Financial Officer in January 2008. From 1997 to 2007, Mr. Tremblay held various financial positions, including Chief Financial Officer at Vertis, Inc., a provider of print advertising and media technology. Mr. Tremblay held senior finance positions at Wellman, Inc., a provider of polyester fiber and resins, from 1990 to 1997 and was a member of the accounting and auditing practice at Ernst & Young, from 1983 to 1990. Mr. Tremblay earned a B.S. degree in Business Administration from Bryant University and is a Certified Public Accountant.

Stephen W. Duffy. Mr. Duffy, age 57, was appointed Vice President, General Counsel and Secretary in February 2008. For two and one-half years, prior to his appointment, Mr. Duffy served as Counsel to Curtis, Mallet-Prevost, Colt & Mosle, LLP, an international law firm, where he was responsible for domestic and international energy sector transactions. Mr. Duffy previously served as Senior Vice President, Legal and Government Affairs for Paramount Petroleum Corporation from July 2004 to July 2005, and as Vice President, Global General Counsel and Secretary for KoSa B.V. from December 2000 to April 2004. Mr. Duffy earned an A.B. degree from Duke University and his J.D. degree from Southern Methodist University.

Larry R. Frazier. Mr. Frazier, age 65, was appointed as Chief Information Officer in November 2008. Prior to joining us, Mr. Frazier was Chief Information Officer for Chevron Phillips Chemical Company, a position he had held since July 2000. Previous to this, Mr. Frazier was employed in various management positions with Phillips Petroleum Company (now ConocoPhillips). Earlier in his career, Mr. Frazier worked for the U.S. federal government as a statistician/mathematician. Mr. Frazier earned a B.S. degree in Mathematics from Northeastern Oklahoma State University, a Master s Degree in Electrical Engineering from University of New Mexico and a Masters in Public Administration from Harvard University.

Lothar P. F. Freund. Dr. Freund, age 51, has served as our Vice President of Technology since 2005. He is responsible for Kraton s global R&D programs and technical service as well as the implementation of the company-wide innovation process. Dr. Freund joined us from Koch Industries, where he served from 1989 in a variety of operating and technical positions in the polyester businesses acquired from Hoechst in 1998, most recently as the manufacturing and technology director of the PET & Nylon Polymer business of Invista, a Koch subsidiary. Dr. Freund holds a Master s Degree and a Ph.D. in Polymer Chemistry from the University of Marburg in Germany.

Table of Contents

Holger R. Jung. Dr. Jung, age 48, was named Vice President, Sales and Marketing, on March 14, 2011. He is responsible for all sales, marketing and market development activities globally for Kraton. Dr. Jung joined us from Invista, a Koch Industries subsidiary, where he held a number of positions of increasing responsibility, serving most recently since 2008 as Vice President of Invista s North American Polyester & Intermediates business, overseeing the successful sale of that business to Indorama in 2011. Dr. Jung commenced his employment with Hoechst AG in 1990 prior to the sale of Hoechst s polyester businesses to Koch in 1998, in positions including research and development chemist, technical service manager, and positions with oversight for quality management, strategic planning, and for the marketing and sales functions of KoSa s European Polyester Specialty Polymer Business. Dr. Jung holds a Ph.D. in Polymer Chemistry from the University of Marburg in Germany.

G. Scott Lee. Mr. Lee, age 48, was named Vice President of Operations effective January 1, 2011 and is responsible for Kraton s global manufacturing, supply planning and procurement activities. He began his career with Shell Oil Company in 1985, progressing through engineering and operational leadership roles of increasing responsibility. Following our separation from Shell Chemicals in 2001, Mr. Lee served as Global Supply Chain Manager, Master Black Belt, Global Procurement Director, General Manager USBC Products, and most recently as Vice President of Products and Supply. Mr. Lee is a graduate of Louisiana Tech University with a Bachelor of Science in mechanical engineering.

Richard A. Ott. Mr. Ott, age 57, has been our Vice President of Human Resources and Corporate Communications since December 2, 2004. Mr. Ott was the Vice President of Operations and Human Resources from June 2000 to December 2004. From 1998 to 2002, he also served as the Site Manager for our Belpre plant. Mr. Ott started with Shell Chemicals in 1976, where he held various positions in operations and business strategy. He holds a B.S. degree in Industrial Engineering from West Virginia University.

CORPORATE GOVERNANCE

Our Board of Directors

Board Composition

Our board of directors is currently comprised of eleven members. After the 2011 annual meeting of stockholders, it will be comprised of eight directors. The exact number of members of our board of directors will be determined from time to time by resolution of a majority of our full board of directors, but may at no time consist of fewer than three members.

Our board of directors is divided into three classes, with each director serving a three-year term and one class being elected at each year s annual meeting of stockholders.

Messrs. Goldstein, MacDougall, Smith and Walsh serve as Class I directors (with a term expiring in 2013). Messrs. Brown, Davis, O Brien and Wright serve as Class II directors (with a term expiring in 2011). Messrs. Demetriou and Fogarty and Ms. Twitchell serve as Class III directors (with a term expiring in 2012).

Board Structure and Operation Prior to our Initial Public Offering

Prior to our initial public offering in December 2009, Kraton Polymers LLC was the operating entity that conducted our daily business. Polymer Holdings, LLC (which converted into Kraton Performance Polymers, Inc. in connection with our initial public offering) was the sole member of Kraton Polymers LLC. Prior to 2010, relevant corporate governance at the board level was undertaken at the operating company level at Kraton Polymers LLC.

Meetings and Attendance

Our board of directors met six times during 2010, and acted on various occasions by written consent. During the last full fiscal year, no incumbent director attended fewer than 75 percent of the aggregate of the total number of meetings of the board of directors (held during the period for which he has been a director) and the total number of meetings held by all committees of the board on which he or she served (during the periods that he or she served).

Board Leadership Structure and Role in Risk Oversight

Our board believes it is preferable at this time for one of our independent Directors to serve as Chairman of the Board; therefore, we separate the roles of Chairman of the Board and Chief Executive Officer. Our Chairman of the Board presides at meetings of the board of directors and the stockholders. He leads the board s oversight of the management of our company. Our Chief Executive Officer is responsible for implementing the policies adopted by the board and exercising general superintendence over all the business and affairs of the company. We believe our leadership structure is appropriate for our company because our independent Chairman, Dan F. Smith, can bring his extensive experience in the petrochemical industry, and in executive management generally, to bear on matters relating to our board s oversight of our execution of our strategy, while Mr. Fogarty is able to use his extensive experience in the chemical industry and knowledge of the day to day operations of our business to focus his abilities on executing that strategy.

Our executive management is responsible for managing the risks inherent in our business, and our board of directors oversees our executive team in the execution of its risk management function. To assist in this oversight function, our board of directors has adopted a risk management oversight matrix. This matrix identifies principal categories of risk inherent in our business, including strategic risk, operational risk, legal and compliance risk, financial statement risk, fraud risk, market risk, supply chain risk, product risk, security risk, information technology risk and project risk. Then, material risks to our business are identified under each broad risk category. For example, risk from competition is a material risk under the broad category of strategic risk. Each

Table of Contents

material risk has been either assigned to the full board for oversight, or oversight for the risk has been delegated to a committee of the board because our board believes that for that area of risk, our company is better served by having the initial risk evaluation and risk monitoring undertaken by a subset of the entire board that is more focused on the issues pertaining to the particular risk. In addition, a member of our executive management team has been assigned as a liaison to the board or committee with respect to each material risk identified in the matrix. This liaison reports periodically, as necessary, on steps our management is taking to mitigate each material risk identified. Our management monitors the material risks facing our company and recommends updates to the risk oversight matrix as necessary to account for new material risks to our business.

Executive Sessions of the Board of Directors

Our non-management directors, all of whom are independent (as determined under the NYSE listing standards) meet regularly in executive session. Dan F. Smith, as the independent Chairman of the Board, serves as the presiding director at each executive session.

Communications with Directors

Our board of directors has established procedures whereby our stockholders and other interested parties may communicate with any member of our board of directors, the Chairman of any of our board committees or with our non-management directors as a group by mail addressed to the applicable directors or director group, in the care of: The Secretary of the Company, Kraton Performance Polymers, Inc., 15710 John F. Kennedy Boulevard, Suite 300, Houston, Texas 77032. Such communications should specify the intended recipient or recipients. All such communications, other than unsolicited commercial solicitations, will be forwarded to the appropriate director, or directors, for review.

Board Attendance at the Annual Meeting

Our policy is to encourage our directors to attend our annual meeting; however, such attendance is not required at this time. Eight of our directors attended the 2010 Annual Meeting of Stockholders.

Corporate Governance Guidelines

We are committed to having sound corporate governance practices that maximize stockholder value in a manner consistent with legal requirements and the standards of integrity. In that regard, our board has adopted guidelines that provide a framework for the governance of our company. In addition, we periodically review these guidelines and regularly monitor developments in the area of corporate governance. Our Corporate Governance Guidelines are posted under the Corporate Governance portion of the Investor Relations section on our website at *www.kraton.com* and are available to any stockholder upon request.

Independence

Our board has determined that each of Ms. Twitchell and Messrs. Brown, Davis, Demetriou, Goldstein, MacDougall, O Brien, Smith, Walsh and Wright is independent under the listing standards of the NYSE. Such directors are collectively referenced in this proxy statement as the Independent Directors. Mr. Fogarty is not considered to be an Independent Director because he is an employee of our company.

The NYSE listing standards include objective tests that can disqualify a director from being treated as independent, as well as a subjective element, under which the board must affirmatively determine that each independent director has no material relationship with us, either directly or as a partner, stockholder or officer of an organization that has a relationship with us. In making its subjective determination that each non-employee director is independent, the board reviewed and discussed information provided by the directors with regard to each director s business and personal activities as they may relate to our company and management. The board also considered the information in the context of the NYSE s objective listing standards, as well as the types of relationships addressed in the NYSE listing standards and disclosure rules of the SEC regarding transactions with related parties.

Table of Contents

As part of its analysis to determine director independence, the board reviewed the affiliations of Messrs. Davis, MacDougall and Wright with TPG, which is affiliated with TPG Advisors III, Inc. and TPG Group Holdings (SBS) Advisors, Inc., which were two of our stockholders at the time of the determination. In addition, the board reviewed the affiliations of Messrs. O Brien and Walsh with JP Morgan Partners, which is affiliated with JPMP Capital Corp, one of our stockholders at the time of the determination. Based on the foregoing, the board made a subjective determination as contemplated by NYSE listing standards that, in light of the nature of the director s relationship with the entity and/or the amount involved, those directors did not have relationships that, in the opinion of the board, would impair their independence under the NYSE listing standards.

Committees of the Board of Directors

We currently have four standing committees: the Audit Committee, the Compensation Committee, the Nominating and Corporate Governance Committee and the Executive Committee. The charters for each of these committees can be found in the Investor Relations section of our website located at *www.kraton.com*.

Director	Audit Committee	Compensation Committee	Nominating and Corporate Governance Committee	Executive Committee
Richard C. Brown	X	X		
Kelvin L. Davis				
Steven J. Demetriou			X	
Kevin M Fogarty				X
Barry J. Goldstein	X			
Michael G. MacDougall			X	X
Kevin G. O Brien			X	
Dan F. Smith		X		X
Karen A. Twitchell	X			
Timothy J. Walsh		X		X
Nathan H. Wright		X		

Committee Chair

Audit Committee

Our Audit Committee consists of Messrs. Goldstein (Chair) and Brown and Ms. Twitchell. Mr. Brown replaced Mr. O Brien on the Audit Committee on December 15, 2010. Our board of directors has affirmatively determined that Messrs. Goldstein and Brown and Ms. Twitchell meet the definition of independent director for purposes of serving on an audit committee under applicable SEC rules and NYSE listing standards. In addition, our board of directors has determined that Mr. Goldstein and Ms. Twitchell qualify as audit committee financial experts. The Audit Committee had 11 meetings during 2010.

The Audit Committee is responsible for, among other things:

selecting and hiring our independent registered public accounting firm, and pre-approving the audit and non-audit services to be performed by our independent registered public accounting firm;

reviewing the performance of the internal audit services function and reviewing auditor independence;

discussing the scope and results of the audit with the independent registered public accounting firm and reviewing with management and the independent registered public accounting firm our interim and year-end operating results;

reviewing the adequacy and effectiveness of our internal control policies and procedures;

preparing the Audit Committee report required by the SEC to be included in our annual proxy statement;

- monitoring the integrity of our financial statements and our compliance with legal and regulatory requirements as they relate to financial statements or accounting matters;
- setting policies regarding the hiring of current and former employees of the independent registered public accounting firm;
- reviewing or discussing types of information to be disclosed in earnings press releases and provided to analysts and rating agencies;
- establishing procedures for receipt, retention and treatment of complaints received by the company regarding accounting or internal controls and the submission of anonymous employee concerns regarding accounting;
- reviewing with our general counsel and other appropriate legal staff material legal affairs and our compliance with applicable law and listing standards;
- reviewing the policy with respect to related party transactions and approving or rejecting proposed related party transactions; and
- undertaking such other tasks delegated to the committee by the board of directors, including matters relating to risk oversight.

Compensation Committee

Our Compensation Committee consists of Messrs. Brown, Smith, Walsh (Chair) and Wright. Our board of directors has determined that all the committee members are independent for purposes of applicable NYSE listing standards. The Compensation Committee met six times in 2010.

The Compensation Committee is responsible for, among other things:

- reviewing and approving corporate goals and objectives relevant to compensation of our executive officers and other members of management;
- determining the compensation of our executive officers and management;
- recommending, when appropriate, changes to our compensation philosophy and principles;
- evaluating our overall compensation and benefits programs;
- making recommendations to our board with respect to the establishment and terms of incentive compensation and equity-based plans and administering such plans;
- reviewing and discussing with management, prior to the filing of the proxy statement, the disclosure prepared regarding executive compensation, including the Compensation Discussion and Analysis and the compensation tables (in addition to preparing a report on executive compensation for the proxy statement); and

undertaking such other tasks delegated to the committee by the board of directors, including matters relating to risk oversight.

Under its charter, our Compensation Committee may delegate any of its responsibilities to one or more subcommittees comprised of one or more members of the Compensation Committee. Without limiting the foregoing, the Compensation Committee may establish a committee comprised of our officers, directors or employees to administer defined benefit and other pension plans as may be provided in plan documentation or otherwise.

See the *Compensation Discussion and Analysis* below for information on our process and procedures for determining 2010 executive officer compensation.

Table of Contents

Nominating and Corporate Governance Committee

Our Nominating and Corporate Governance Committee consists of Messrs. Demetriou, MacDougall (Chair) and O Brien. Our board of directors has determined that all of the committee members are independent for purposes of applicable NYSE listing standards. The Nominating and Corporate Governance Committee met three times in 2010.

The Nominating and Corporate Governance Committee is responsible for, among other things:

- assisting our board of directors in identifying prospective director nominees, and recommending nominees to the board of directors;
- reviewing developments in corporate governance practices and developing and recommending governance principles applicable to our board of directors;
- advising the board of directors with respect to the compensation and perquisites of our directors;
- overseeing the evaluation of our board of directors and executive officers; and
- recommending members for each committee of our board of directors.

Executive Committee

Our Executive Committee consists of Messrs. Fogarty, MacDougall, Smith (Chair) and Walsh. The Executive Committee did not meet in 2010.

Subject to the limitations specified in the committee s charter, by Delaware law and in our Certificate of Incorporation and Bylaws, the purpose and responsibility of the committee is to act, between meetings of the board with respect to matters arising with respect to the company in the ordinary course of business and specified from time to time by the board and with respect to such other matters as may be delegated to the committee by the board.

Director Nominations

Our Nominating and Corporate Governance Committee identifies director candidates through the recommendations of directors, management and stockholders. The committee commences its process by evaluating the needs of the board going forward and then considering those directors who wish to continue to serve on the board. Then, if necessary, the committee seeks out additional candidates for board service.

The committee evaluates all director nominees, regardless of the person or firm recommending such candidate and all incumbent directors being considered for re-nomination according to established criteria, approved by the board, for selecting nominees to stand for election as directors. The committee considers all director candidates in light of the entirety of their credentials and other relevant considerations, including the quality and quantity of information about the candidate made available to the committee.

The committee is also authorized to retain search firms to identify and evaluate candidates, including for purposes of performing background reviews of potential candidates. The committee provides guidance to search firms it retains about the particular qualifications the board is then seeking. In January 2011, the committee retained Korn-Ferry International to assist it in identifying and evaluating nominees for director. For further information on recent ownership changes and our current board composition, please refer to *Recent Developments*.

In compliance with our Nominating and Corporate Governance Committee s charter, our board has established guidelines for nominees selected to serve on our board of directors. Generally, these include:

the nominee s ability to meet any requirements of applicable law;

the nominee s ability to meet any requirements of the listing standards for the NYSE;

15

Table of Contents

- the nominee s character and integrity;
- the nominee s business experience;
- the nominee s specific areas of expertise;
- the composition of the board as a whole; and
- principles of diversity.

In addition, our board has also determined that nominees to serve on our board should exhibit exemplary qualifications in one or more of the following areas:

- business leadership experience, especially at the highest executive levels;
- financial reporting experience, especially as it relates to public companies;
- corporate finance experience;
- experience in the chemical industry;
- expertise in marketing; and/or
- international business experience.

Diversity

Our Nominating and Corporate Governance Committee has not adopted a specific policy with respect to diversity. However, as noted above, the committee does consider principles of diversity as a factor in evaluating nominees to recommend for service on our board. When considering diversity for the purposes of overall board composition, the committee considers diversity in a broader context, including, without limitation, race, age, sex, nationality, business experience, skills, international experience, education, other public company board experience and other relevant factors. In addition, the board considers diversity factors such race, sex and national origin as important factors in evaluating individual nominees for board service and includes such factors as important criteria in identifying candidates for board service.

Stockholder Recommendations

Our Nominating and Corporate Governance Committee will consider director candidates recommended by our stockholders. Our Bylaws provide the procedures to be followed by a stockholder desiring to make a director nomination. In order for a stockholder to properly bring any item of business before a meeting of stockholders, including nominations to serve as a director, such stockholder must give timely notice thereof in writing to our Secretary in compliance with the requirements of our Bylaws. Stockholder notices or nominations for director should be made in writing to The Secretary of the Company, Kraton Performance Polymers, Inc., 15710 John F. Kennedy Boulevard, Suite 300, Houston, Texas 77032. Please refer to the text of our Bylaws (including Section 1.12 *Notice of Stockholder Business and Nominations*) which are on file with the SEC, and *Stockholder Proposals and Nominations for 2012 Annual Meeting* in this proxy statement for additional information.

Compensation Committee Interlocks and Insider Participation

None of our Compensation Committee members was formerly or during 2010 an officer of or employed by us. No executive officer serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving as a member of our board of directors or our Compensation Committee. No member of our Compensation Committee had any relationship requiring disclosure under Item 404 of Regulation S-K under the Exchange Act.

Table of Contents

Code of Ethics and Business Conduct

We have adopted a Code of Ethics and Business Conduct that is applicable to all of our directors, officers and other employees. The Code is posted under the Corporate Governance portion of the Investor Relations section on our website at *www.kraton.com* and is available to any stockholder upon request. If there are any material changes to or material waivers of the Code of Ethics and Business Conduct that apply to our Chief Executive Officer and/or Senior Financial Officers, we will disclose them on our website in the same location. No information on our website or any other website is incorporated by reference into or otherwise made a part of this proxy statement.

Involvement in Certain Legal Proceedings

Steven J. Demetriou, one of our directors, is the Chief Executive Officer of Aleris International, Inc. On February 12, 2009, Aleris International and its wholly-owned U.S. subsidiaries filed petitions for voluntary reorganization under Chapter 11 of the U.S. Bankruptcy Code, in the U.S. Bankruptcy Court in the State of Delaware.

Election of Officers

Our board of directors elects our officers, and our officers serve until their resignation or termination or until their successors are duly elected and qualified.

Certain Relationships and Related Party Transactions

Registration Rights and Shareholders Agreement. Entities affiliated TPG and JPMP, our former stockholders, are party to a Registration Rights and Shareholders Agreement with us. Under that agreement, while TPG and JPMP s ownership of our stock remained above specified thresholds, TPG and JPMP had the right to cause us to register their sale of our common stock with the SEC under a shelf registration statement and the right to designate nominees to our board of directors. Pursuant to these registration rights, we filed shelf registration statements with the SEC in September 2010 and March 2011, under which TPG and JPMP subsequently sold in the aggregate 11,512,843 Kraton shares and 7,675,229 Kraton shares, respectively. We were a party to the underwriting agreements for these offerings and provided the underwriters with customary indemnities. As a result of these sales, TPG and JPMP no longer own Kraton common stock and accordingly do not have registration or director nomination rights under the Registration Rights and Shareholders Agreement.

Policy Concerning Related Party Transactions

Our board has adopted a written policy relating to the approval of related party transactions. Under our policy, our employees, officers and directors are encouraged to avoid entering into any transaction that may cause a conflict of interest for us. In addition, they must report any potential conflict of interest, including related party transactions, to their supervisors or our law department. Pursuant to its charter, our Audit Committee is required to evaluate each related person transaction for the purpose of recommending to the disinterested members of our board of directors that the transactions are fair, reasonable and within our policy, and should be ratified and approved by the board.

In evaluating such proposed transactions, the Audit Committee is required to consider the relevant facts and circumstances and the controls implemented to protect our interests and the interests of our stockholders, including:

- the benefits of the transaction to our company;

- the terms of the transaction and whether they are arm s-length and in the ordinary course of our company s business;

the direct or indirect nature of the related person s interest in the transaction;

the size and expected term of the transaction; and

other facts and circumstances that bear on the materiality of the related person transaction under applicable law and listing standards.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires our directors and executive officers, as defined under the Exchange Act, and persons who own more than 10% of a registered class of our equity securities to file initial reports of ownership and reports of changes in ownership with the SEC. Such executive officers, directors and stockholders are required by SEC regulations to furnish us with copies of all Section 16(a) forms they file. Based solely upon a review of the copies of such forms furnished to us and written representations from our directors and executive officers, all persons subject to the reporting requirements of Section 16(a) filed all required reports on a timely basis in 2010.

Table of Contents

SECURITIES OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Beneficial ownership is determined in accordance with the rules and regulations of the SEC. These rules generally provide that a person is the beneficial owner of securities if such person has or shares the power to vote or direct the voting thereof, or to dispose or direct the disposition thereof or has the right to acquire such powers within 60 days. Percentage of beneficial ownership is based on 31,862,629 shares of common stock outstanding on the April 6, 2011, plus, with respect to any person, the number of shares that may be acquired pursuant to stock options that are or will become exercisable by such person within 60 days. Except as disclosed in the footnotes to this table and subject to applicable community property laws, we believe that each stockholder identified in the table possesses sole voting and investment power over all shares of common stock shown as beneficially owned by the stockholder.

Except as otherwise updated or specified in the footnotes to the table below, the following table sets forth information regarding the beneficial ownership of our common stock as of April 1, 2011 of:

- each person or group who is known by us to own beneficially more than 5% of our outstanding shares of common stock;
- each of our named executive officers;
- each of our directors and each director nominee; and
- all of the executive officers, directors and director nominees as a group.

As of April 1, 2011, affiliates of TPG and JPMP owned approximately 5,992,843 shares, or 18.80%, and 3,995,229 shares, or 12.53% of our outstanding common stock, respectively. As described more fully under *Recent Developments*, TPG and JPMP sold all of their shares of our common stock in a public offering on April 6, 2011.

Name and Address of Beneficial Owner (1)	Amount and Nature of Beneficial Ownership (2)	Percent of Class
Five-Percent Stockholders:		
GMT Capital Corp. (3) 2100 Riveredge Parkway, Suite 840 Atlanta, GA 30328	3,358,335(4)	10.54%
FMR, LLC (5) 82 Devonshire Street Boston, MA 02109	2,181,800(6)	6.85%
Directors and Named Executive Officers:		
David A. Bradley		*
Richard C. Brown	22,186	*
Kelvin L. Davis	5,535	*
Steven J. Demetriou	26,811	*
Stephen W. Duffy	6,125	*
Kevin M. Fogarty	104,406	*
Lothar P. F. Freund	29,922	*
Barry J. Goldstein	22,186	*
Michael G. MacDougall	5,535	*

Kevin G. O Brien	5,535(7)	*
Dan F. Smith	51,805	*
Stephen E. Tremblay	30,162	*
Karen A. Twitchell	5,535	*
Timothy J. Walsh	5,535(7)	*
Nathan H. Wright	5,535	*
All Directors and Executive Officers as a Group	402,249	1.25%

Table of Contents

* Represents beneficial ownership of less than 1%

(1) Unless otherwise provided in the table, the address for the beneficial owners is 15710 John F. Kennedy Boulevard, Suite 300 Houston, Texas 77032.

(2) Shares shown in the table above include shares held in the beneficial owner s name or jointly with others, or in the name of a bank, nominee or trustee for the beneficial owner s account. The totals in this column include the following shares, beneficial ownership of which the officer or director has the right to acquire within sixty days of the Record Date: Mr. Brown 16,651; Mr. Demetriou 10,175; Mr. Fogarty 35,523; Mr. Duffy 3,700; Dr. Freund 25,981; Mr. Goldstein 16,651; Mr. Smith 14,801; and Mr. Tremblay 10,813.

(3) GMT Capital Corp., a Georgia corporation (GMT Capital), is the general partner of Bay Resource Partners, L.P., a Delaware limited partnership (Bay) and Bay II Resource Partners, L.P., a Delaware limited partnership (Bay II) and has the power to direct the affairs of Bay and Bay II, including the voting and disposition of shares. As the discretionary investment manager of Bay Resource Partners Offshore Master Fund, L.P., an exempted limited partnership organized under the laws of the Cayman Islands (Offshore Fund) and certain other accounts, GMT Capital has power to direct the voting and disposition of shares held by the Offshore Fund and such accounts. Thomas E. Claugus is the President of GMT Capital and in that capacity directs the operations of each of Bay and Bay II and the voting and disposition of shares held by the Offshore Fund and separate client accounts managed by GMT Capital. GMT Capital and Mr. Claugus may be deemed to beneficially own indirect pecuniary interest as the result of performance-based fees and profit allocations. Each of GMT Capital and Mr. Claugus disclaims such beneficial ownership except to the extent ultimately realized.

(4) This share information was obtained from a Form 4 filed with the SEC on February 2, 2011.

(5) Pursuant to the instructions in Item 7 of Schedule 13G, Fidelity Management & Research Company (Fidelity), a wholly-owned subsidiary of FMR LLC and an investment adviser registered under Section 203 of the Investment Advisers Act of 1940, is the beneficial owner of these shares of the common stock of Kraton as a result of acting as investment adviser to various investment companies registered under Section 8 of the Investment Company Act of 1940. At December 31, 2010, the ownership of one investment company, Fidelity Disciplined Equity Fund, amounted to 1,600,000 shares or 5.02% of the Common Stock outstanding. Edward C. Johnson 3d and FMR LLC, through its control of Fidelity, and the funds each has sole power to dispose of the shares. Members of the family of Edward C. Johnson 3d, Chairman of FMR LLC, are the predominant owners, directly or through trusts, of Series B voting common shares of FMR LLC, representing 49% of the voting power of FMR LLC. The Johnson family group and all other Series B shareholders have entered into a shareholders voting agreement under which all Series B voting common shares will be voted in accordance with the majority vote of Series B voting common shares. Accordingly, through their ownership of voting common shares and the execution of the shareholders voting agreement, members of the Johnson family may be deemed, under the Investment Company Act of 1940, to form a controlling group with respect to FMR LLC. Neither FMR LLC nor Edward C. Johnson 3d, Chairman of FMR LLC, has the sole power to vote or direct the voting of the shares owned directly by the Fidelity funds, which power resides with the funds boards of trustees. Fidelity carries out the voting of the shares under written guidelines established by the funds boards of trustees.

(6) This share information was obtained from a Schedule 13G filed with the SEC on February 14, 2011. Based on our records, FMR, LLC or its affiliates purchased an additional 1,500,000 shares on April 6, 2011 in the recently concluded secondary offering by entities affiliated with TPG Capital, L.P. and J.P. Morgan Partners LLC. For further information on the secondary offering, please refer to *Recent Developments*.

(7) Messrs. Walsh and O Brien are each one of our directors and are also Managing Directors of CCMP Capital Advisors, LLC, a private equity firm comprised of the former buyout/growth equity professionals of J.P. Morgan Partners who separated from JPMorgan Chase to form an independent private equity platform. Messrs. Walsh and O Brien are serving as directors at the request of J.P. Morgan Partners and JPMP Capital Corp. beneficially owns these shares. Messrs. Walsh and O Brien disclaim any beneficial ownership of any shares beneficially owned by JPMP Capital Corp. and related entities. The address of each of Messrs. Walsh and O Brien is c/o CCMP Capital Advisors, LLC, 245 Park Avenue, New York, New York 10167.

Table of Contents

EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

We do not directly employ any executive officers. The executives who run our company are employed by our principal operating subsidiary Kraton Polymers LLC, and, therefore, the disclosure in this section relates to those executives. References to our compensation policies in this proxy statement refer to the joint policies and practices of us and Kraton Polymers LLC, and references to our Compensation Committee refers to both the Compensation Committees of us and Kraton Polymers LLC. Executive officers named in the Summary Compensation Table below are referred to in this proxy statement as the named executive officers. This section includes information and analysis related to such compensation arrangements of our named executive officers. Mr. David A. Bradley, formerly our Chief Operating Officer and a named executive officer during 2010, resigned on January 15, 2011. Information has been included below with respect to Mr. Bradley s 2010 compensation in accordance with the requirements of the proxy rules.

Executive Summary

Elements of Compensation Paid in 2010. Material elements of compensation paid to our named executive officers in 2010 consisted of:

Element of Compensation	Performance-Based?	Purpose
Base Salary	No	To attract and retain executive talent
Annual Cash Incentive Payments	Yes	To incentivize the achievement of short-term performance goals
Long-Term Equity Incentive Grants (in the form of stock options)	Yes	To incentivize the achievement of long-term performance goals To incentivize the achievement of long-term stock appreciation To align the interests of management and stockholders To aid retention of executive talent
Other Compensation (consisting of contribution to our Savings Plan and, for Dr. Freund, certain perquisites)	No	To attract and retain executive talent To provide market-competitive benefits To serve as an additional employment incentive

Named Executive Officers. Our named executive officers for 2010 were:

- Kevin M. Fogarty, President and Chief Executive Officer;
- David A. Bradley, Chief Operating Officer;
- Stephen E. Tremblay, Vice President and Chief Financial Officer;
- Lothar P. F. Freund, Vice President Technology; and
- Stephen W. Duffy, Vice President and General Counsel.

2010 Operating Results. By several key financial measures, our business returned excellent results in 2010.

- Sales volume increased 18% compared to 2009 to 307 kilotons;
- Sales revenue increased 33% compared to 2009 to approximately $1,228 million;

Net income was $96.7 million, compared to a net loss of $(0.3) million in 2009;

Earnings per share were $3.07, compared to a loss of $(0.1) in 2009; and

Adjusted EBITDA[1] was $194.9 million, or 16% of revenue, compared to $91.4 million, or 9% of revenue, in 2009.

Pay-for-Performance: Increased Levels of Total Compensation. The Compensation Committee emphasizes pay for performance in determining annual compensation for our named executive officers. Due to our significantly improved 2010 results, in 2010, the aggregate total compensation paid to our named executive officers as a group and the total compensation paid to our chief executive officer increased significantly over 2009 levels, during which our business was negatively impacted by the global economic recession. Even with these increases, 2010 aggregate compensation remained below 2008 levels, when our performance was at then-record levels.

Pay-for-Performance: Significant Proportion of Total Compensation Paid in Incentive Compensation. Aggregate total compensation and aggregate cash compensation to our named executive officers and chief executive officer for 2010 reflected our Compensation Committee s belief that a significant portion of total compensation should be in the form of incentive compensation. In 2010,

Aggregate incentive compensation, which was comprised of long-term equity incentive compensation (in the form of stock options) and cash incentive compensation (in the form of payments under the Polymer Holdings LLC Cash Incentive Plan), that was paid to our named executive officers as a group accounted for approximately 67% of their aggregate total compensation;

Total incentive compensation paid to our chief executive officer accounted for approximately 77% of his total annual compensation;

Aggregate cash incentive compensation paid to our named executive officers as a group accounted for approximately 51% of their total cash compensation (which consisted of base salary and cash incentive compensation); and

Cash incentive compensation paid to our chief executive officer accounted for approximately 60% of his total cash compensation.

Compensation Philosophy and Objectives

Our Compensation Committee looks to the aggregate compensation package for each named executive officer to determine the individual elements of each such named executive officer s pay. Our executive compensation policy, as established by our Compensation Committee, is designed to provide a base salary and incentive compensation that attracts, motivates, retains and rewards high quality executives by being competitive in the marketplace with other publicly-owned chemical companies whose revenue is similar to ours.

We consider compensation to named executives of our peer companies (described below) in setting total compensation for our named executive officers. In past years, including 2010, we did not seek to benchmark our named executive officers compensation against that of our peer group. Commencing in 2011, our general objective will be to benchmark our named executive officers compensation at or near the median of the peer group we have identified because our Compensation Committee has determined that such a benchmark reflects an objective means of determining a competitive level of executive compensation.

Our Compensation Committee and our board of directors approve annual cash incentive compensation under the terms of a cash incentive compensation plan (the Cash Incentive Plan) targeted to pay competitive cash incentives to our named executive officers provided that pre-established individual and company

[1] For a reconciliation of Net Income/(Net Loss) to EBITDA and Adjusted EBITDA, please refer to Compensation Discussion and Analysis *Reconciliation Net Income/(Net Loss) to EBITDA and Adjusted EBITDA.*

performance goals are achieved. It is our intention that a significant portion of our named executive officers total compensation be comprised of performance-based compensation tied to the Company s overall performance in a given year.

Our Compensation Committee may also approve the grant of options, or other equity or equity-based awards from time to time. Each of our named executive officers has one or more of the types of awards described under the section entitled *Components of Direct Compensation Equity* below. These awards are intended to motivate our named executive officers and align their long-term interests with those of our company and our stockholders by linking this portion of the executive s compensation with the performance of our company, while also promoting retention by utilizing multi-year vesting periods. Generally, we will also grant equity awards to executives in connection with their commencement of employment with us.

For 2010 and 2009, our Compensation Committee determined the value of such grants of equity compensation by reviewing compensation practices of peer companies, reviewing our past practice, and through individual negotiations with the executive. In addition, our Compensation Committee had the discretion to grant additional equity awards to executives, including our named executive officers, based on the individual s contributions to our company and/or based on the results of our survey against the compensation practices of our peer group. Commencing in 2011 and consistent with our objective of benchmarking executive compensation at or near the median for our peer group going forward, our Compensation Committee has adopted a policy of annual long-term equity incentive compensation grants valued with reference to long-term incentive compensation paid by our peer group. Our Compensation Committee has the discretion to grant such awards throughout the year.

Role of the Compensation Committee

Our Compensation Committee discharges the responsibility of the board of directors relating to the compensation of our executive officers, including our named executive officers. The Compensation Committee s charter contains detailed information on the Compensation Committee s duties and function and is available under the Corporate Governance portion of the Investor Relations section on our website at *www.kraton.com*.

Our Compensation Committee no less frequently than annually reviews our goals and objectives related to the compensation of our named executive officers. During that review, the Compensation Committee considers the balance between short-term compensation and long-term incentive compensation, evaluates the performance of our named executive officers in light of pre-established goals and objectives and sets the compensation levels of our named executive officers based on that evaluation. In determining appropriate compensation levels, our Compensation Committee considers our performance and relative stockholder return, the compensation levels of persons holding comparable positions at our peer companies (described below) and the compensation given to our named executive officers in previous years. Our Compensation Committee has the ultimate authority and responsibility to engage and terminate any outside consultant to assist in determining appropriate compensation levels for our named executive officers. Our Compensation Committee uses information provided by such advisors and consultants to determine the appropriate compensation of our named executive officers. Our Chief Executive Officer is typically consulted regarding the compensation of the named executive officers other than himself. Our Vice President of Human Resources and Corporate Communications regularly attends the meetings of the committee and provides input on compensation matters as requested by the committee. Our Compensation Committee then reviews and recommends any changes for subsequent approval by our board of directors.

Compensation Consultants. In November 2009, our Compensation Committee directly engaged Hewitt Associates LLC as a compensation consultant. Hewitt Associates was instructed to perform an overall assessment of our compensation practices as well as to provide recommendations regarding best practices regarding governance issues. Hewitt Associates selected a peer group of companies in the chemical industry of similar size and complexity to the company for the purposes of providing a reference point as one of many factors to consider when reviewing and advising on the compensatory scheme of the company. The peer group consisted of Arch Chemicals Inc., H.B. Fuller Co., Koppers Holdings Inc., Kronos Worldwide Inc., Minerals Technologies Inc., OM Group Inc.,

Table of Contents

OMNOVA Solutions Inc., A Schulman Inc., Spartech Corp. and Stepan Co. We did not benchmark any element of executive compensation for 2010 to members of the peer group or otherwise. Based in part on the information, feedback and advice our Compensation Committee received from Hewitt Associates, as well as the committee s overall review of the current compensation arrangements of our named executive officers, the committee determined that certain increases in base salaries and severance benefits were appropriate as well as additional grants of restricted stock and options in connection with the closing of our initial public offering in December 2009, each as described in more detail below. Hewitt and Associates did not provide any further services to the company relating to compensation for 2010.

In December 2010, our Compensation Committee engaged Pearl Meyer & Partners to evaluate the competitiveness of Kraton s then-current executive compensation levels, to review the Polymer Holdings LLC 2009 Equity Incentive Plan and to provide long-term incentive compensation recommendations for our executive officers, including the named executive officers. Pearl Meyer conducted its analysis using the same peer group as was established in 2009 and evaluated the base salary, total compensation, long-term incentive compensation value and total direct annual compensation paid to our executive officers against that paid to similarly situated executives at the peer group companies. Based on this review and recommendations by Pearl Meyer, our Compensation Committee has determined that it is appropriate for our retention and recruitment goals to benchmark total annual compensation and long-term incentive compensation for our executives at or near the market median for our peer group. Based on this determination, the Compensation Committee has implemented certain salary increases and granted long-term incentive compensation in 2011 as described more fully below.

Components of Direct Compensation

Base Salary. Employment contracts for our named executive officers are established as a result of negotiation between the individual and the company at the time of hire, within a reasonable range of compensation determined by competitive data, including that described above, and by experience. Our Compensation Committee reviews the base salaries of our named executive officers on an annual basis and determines if an increase is warranted based on its review of individual performance, compensation comparisons (with executives in comparable positions and comparisons among our other executives), consultation with our Chief Executive Officer and consideration of each named executive officer s experience and skills.

Our practice in 2010 was to take into consideration the base salaries of similarly situated executives at other companies to obtain a general understanding of current compensation practices when setting base salaries for our named executive officers, but we did not establish base salaries with reference to a specific percentile of base salaries earned by others inside or outside our company or otherwise benchmark salaries to those earned by others inside or outside our company. Internal compensation information and external compensation information were relevant factors in setting the base salaries for our named executive officers. The Compensation Committee has determined that the decision to benchmark at or near the median is necessary in order to offer compensation that is competitive with our peers in the industry in order to serve our recruitment and retention goals.

For 2010, the base salaries of Messrs. Fogarty, Bradley, Tremblay, Freund and Duffy were $575,000, $425,000, $375,000, $300,000 and $300,000, respectively. These included salary increases implemented in connection with our initial public offering in December 2009, which increases were determined to be appropriate in light of the increase in our named executive officers responsibilities and duties in connection with assuming an executive role at a public company and were based in part on recommendations by Hewitt Associates in establishing competitive pay for our executives. Effective January 1, 2011 and consistent with our election to benchmark at or near the median for our peer group, base salaries for Messrs. Fogarty and Freund were increased to $700,000 and $325,000, respectively.

Annual Cash Incentive Compensation. Our Compensation Committee intends for a significant portion of potential total cash compensation to be based on the performance of our company because the committee believes that performance-based compensation is best suited to aligning the interests of our named executive officers and our stockholders. Pursuant to their employment agreements, our named executive officers are

Table of Contents

eligible to receive potential annual cash incentive compensation at target levels equal to 100% of base salary for Mr. Fogarty, 75% of base salary for Mr. Bradley and 50% of base salary for each of Messrs. Tremblay, Freund and Duffy, with maximum bonuses of 200% of the target bonus amount. For eligible executives, including our named executive officers, this annual cash incentive compensation is earned and payable under the Polymer Holdings LLC Cash Incentive Plan.

Polymer Holdings LLC Cash Incentive Plan. The purposes of the Cash Incentive Plan are to promote the interests of our company and its stockholders by providing compensation opportunities that are competitive with other companies, and to provide performance-based cash bonus awards to those individuals who contribute to the long-term performance and growth of our company. Generally, our Compensation Committee will establish target bonuses for employees based on position and level of responsibility and grant awards based on the achievement of pre-established company and/or individual goals. Participants receive payments, if any, in cash following written certification by our Compensation Committee of the extent to which the applicable performance targets have been achieved, and in no event more than two and one half months following the end of the performance period to which such certification relates. The amount paid to a participant under the plan that relates (i) to a performance period of one year may not exceed $3,000,000 and (ii) to a performance period of more than one year may not exceed $9,000,000. This plan was adopted to take advantage of the performance-based compensation exception to Section 162(m) of the Internal Revenue Code. The plan contains additional limitations and requirements for awards to Covered Employees (as defined in Section 162(m) of the Code), including our named executive officers.

On March 8, 2010, our Compensation Committee approved the Performance Targets under the Cash Incentive Plan for the Kraton Leadership Team, which includes our named executive officers. For the bonus year that ended December 31, 2010, our Compensation Committee established the following Target Bonus amounts for our named executive officers:

Named Executive Officer	Target Bonus
Kevin M. Fogarty	1.0 x Base Salary
David A. Bradley	.75 x Base Salary
Stephen E. Tremblay	.50 x Base Salary
Lothar P. F. Freund	.50 x Base Salary
Stephen W. Duffy	.50 x Base Salary

As described more fully below, if the Business Performance Targets and the Personal Performance Targets had been achieved at the maximum, or stretch, levels, each named executive officer s actual bonus could have been be up to two times his Target Bonus.

The Compensation Committee established Business Performance Targets for the company and Personal Performance Targets for each named executive officer and assigned a percentage weighting to the achievement of each. The actual bonus earned has been calculated as the sum of

- the amount earned for achievement of Business Performance Targets times the seventy-five percent (75%) weighting assigned to the achievement of Business Performance Targets, and

- the Personal Performance Targets times the twenty-five percent (25%) weighting assigned to the achievement of Personal Performance Targets,

provided that if no bonus compensation was to have been payable for the achievement of Business Performance Targets, then no annual bonus compensation would have been payable to the participants, and provided, further, that, because we consider the achievement of workplace safety as a key component of overall performance, a safety multiplier from 0.9 to 1.1 is applied to the total based on the overall safety performance of our company, such that the bonus for any given named executive officer was calculated using the following formula:

Safety Multiplier x ((0.75 x Business Factor) + (0.25 x Personal Factor)) = <u>Total Annual Cash Incentive</u>

Table of Contents

The Business Performance Targets were comprised of three performance measures, each of which was assigned an individual weighting by our Compensation Committee: achievement of adjusted EBITDA (60%); achievement of operating cash flow (20%); and percentage of innovation sales (percentage of income generated from sales of products commercialized within the past five years) (20%). The Compensation Committee established threshold, target and stretch targets for each of these factors, which if achieved, would have provided a ratable bonus multiplier of from 0.5 to 2.0.

The Personal Performance Criteria were comprised of three or more performance measures within the executive s area of management or control, each of which was assigned an individual weighting. Examples of Personal Performance Criteria included: the achievement of specific goals (such as the successful commercialization of a specific product, execution of a particular capital spending project or the implementation of a new system or process) and the successful management of matters under the executive s control (such as safety performance, compliance, and process management and control). The Compensation Committee established threshold, target and stretch targets for each of these factors, which if achieved, would have provided a ratable bonus multiplier of from 0.5 to 2.0.

For 2010, our Business Performance Targets were as follows ($ in millions):

	Weighting	Threshold 0.5x	Target 1.0x	Stretch 2.0x
Adjusted EBITDA	60%	$ 117	$ 156	$ 180
Operating Cash Flow	20%	$ 63	$ 89	$ 115
Innovation %	20%	12%	14%	16%

And, our performance against these Business Performance Targets was as follows:

	Weighting	Threshold 0.5x	Target 1.0x	Stretch 2.0x	
Adjusted EBITDA[2]	60%			$ 195	1.20
Operating Cash Flow					

	Total	(Level 1)	Quoted Prices in Active Markets for Identical Assets (Level 2)	Significant Other Observable Inputs (Level 3)	Significant Unobservable Inputs
Assets:					
Money market funds (1)	$ 4,513	$ 4,513	$ —	$ —	
U.S. government securities(2)	13,233	—	13,233	—	
Total	$ 17,746	$ 4,513	$ 13,233	$ —	

(1) Included in cash and cash equivalents in the Company's condensed consolidated balance sheets

(2) Represents the portfolio of available for sale securities that is included in restricted investments and short-term investments in the Company's condensed consolidated balance sheets

Cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

The Company's available-for-sale securities consist of U.S. government securities with a minimum and weighted average credit rating of A-1+. The Company values these securities based on pricing from pricing vendors, who may use quoted prices in active markets for identical assets (Level 1 inputs) or inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs) in determining fair value. However, the Company classifies all of its fixed income available-for-sale securities as having Level 2 inputs. The valuation techniques used to measure the fair value of the Company's financial instruments having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or

pricing models, such as discounted cash flow techniques. The Company's procedures include controls to ensure that appropriate fair values are recorded by comparing prices obtained from a third party independent source.
As of March 31, 2017, the Company's available-for-sale securities had contractual maturities of six months and an average remaining term to maturity of three months. As of March 31, 2017, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses of the Company's short-term investments by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government securities	$ 11,978	$ 11,975	$ —	$ 3

The amortized cost basis, aggregate fair value and gross unrealized holding gains and losses for the Company's available-for-sale short-term investments, by major security type, were as follows as of December 31, 2016 (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government securities	$ 11,984	$ 11,983	$ —	$ 1

Market values were determined for each individual security in the investment portfolio. The Company reviews its investments on a regular basis to evaluate whether or not any have experienced an other-than-temporary decline in fair value.
3. Earnings Per Share:

The computation of diluted net loss per share does not include stock options, performance shares, and contingently issuable shares of 960,606 and 375,025 for the three months ended March 31, 2017 and 2016, respectively, because the effect of their inclusion would be anti-dilutive based on their respective exercise prices.
4. Stockholders' Equity and Employee Stock Option Plans:
On April 17, 2017, the Company's Board of Directors approved an amendment to the Tax Benefit Preservation Plan (the "Tax Plan"), dated as of April 22, 2016, by and between the Company and Computershare Inc., as rights agent (the "Rights Agent"), to extend the Final Expiration Date (as such term is defined in the Tax Plan) to April 25, 2019.

Table of Contents

Stock-based Compensation Expense

The following table summarizes stock-based compensation expense for the three months ended March 31, 2017 and 2016 and its allocation within the condensed consolidated statements of operations (in thousands):

	Three Months Ended March 31, 2017	2016
Cost of revenues	$29	$11
Product development	124	(1)
Sales and marketing	102	(121)
General and administrative	212	110
Total	$467	$(1)

The negative expense amounts reflected in the three months ended March 31, 2016, are primarily due to the reversal of previously recognized expense resulting from the forfeiture of equity awards for certain employees whose employment terminated during the respective periods.

Stock Award Activity

There were no options exercised during the three months ended March 31, 2017 and 2016.

The total fair value of RSUs vested and released during the three months ended March 31, 2017 was $49,000. The total fair value of RSUs vested and released during the three months ended March 31, 2016 was approximately $4,000. The fair value is calculated by multiplying the fair market value of the Company's common stock on the vesting date by the number of shares of common stock issued upon vesting.

5. Significant Customers:

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three months ended March 31, 2017 and 2016, the Company had two customers that accounted for a significant portion of its revenues: Avnet Europe Comm VA ("Avnet"), the Company's primary distributors of its IIoT products in Europe and Japan, and Enel Distribuzione Spa ("Enel"), an Italian utility company. For the three months ended March 31, 2017 and 2016, the percentage of the Company's revenues attributable to sales made to these customers was as follows:

	Three Months Ended March 31, 2017	2016
Avnet	29.6%	26.8%
Enel	— %	15.2%
Total	29.6%	42.0%

6. Commitments and Contingencies:

Legal Actions

From time to time, in the ordinary course of business, the Company may be subject to certain legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, or other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of March 31, 2017, the amounts of which were immaterial, it is possible that the Company's results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

Table of Contents

Line of Credit

As of March 31, 2017, the Company maintained an operating credit line of $1.0 million with its primary bank for company credit card purchases. This line of credit is secured by a collateral of the first priority on $1.3 million of the Company's investments (presented as restricted investments in the condensed consolidated balance sheets). The restricted investments are classified as current assets due to the contractual duration of the underlying credit agreement.

7. Accumulated Other Comprehensive Income (Loss), Net of Tax (Amounts in thousands):

	Foreign currency translation adjustment	Unrealized gain (loss) on available-for-sale securities	Accumulated Other Comprehensive Income (Loss)
Beginning balance at December 31, 2016	$ (2,435)	$ (2)	$ (2,437)
Change during January - March 2017	83	(1)	82
Balance at March 31, 2017	$ (2,352)	$ (3)	$ (2,355)

None of the above amounts have been reclassified in the condensed consolidated statement of operations.

8. Inventories:

Inventories are stated at the lower of cost (first in, first out) or market and include material, labor and manufacturing overhead. When required, provisions are made to reduce excess and obsolete inventories to their estimated net realizable value. Inventories consist of the following (in thousands):

	March 31, 2017	December 31, 2016
Purchased materials	$ 107	$ 148
Finished goods	2,409	2,422
	$ 2,516	$ 2,570

9. Accrued Liabilities:

Accrued liabilities consist of the following (in thousands):

	March 31, 2017	December 31, 2016
Accrued payroll and related costs	$ 814	$ 1,299
Warranty reserve	130	118
Restructuring charges	225	273
Other accrued liabilities	381	484
	$ 1,550	$ 2,174

10. Segment Disclosure:

ASC Topic 280, Segment Reporting, establishes standards for reporting information about operating segments, products and services, geographic areas of operations and major customers. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company’s chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports (CODM). The Company operates in one principal industry segment - the IIoT segment, which is its reportable segment.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa ("EMEA"); and Asia Pacific / Japan ("APJ"). Each geographic area provides products and services to the Company's customers located in the respective region. The Company's long-lived and other assets include property and equipment, acquired intangible assets, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are

13

located. As of March 31, 2017 and December 31, 2016, long-lived assets of approximately $2.1 million and $2.2 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the condensed consolidated financial statements.

In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations, value-added resellers, and local distributors, primarily in EMEA and APJ. Revenues are attributed to geographic areas based on the country where the products are shipped to or the services are delivered. Summary revenue information by geography for the three months ended March 31, 2017 and 2016 is as follows (in thousands):

	Three Months Ended March 31,	
	2017	2016
Americas	$3,170	$2,555
EMEA	2,875	4,672
APJ	1,754	1,420
Total	$7,799	$8,647

For information regarding the Company’s major customers, please refer to Note 5, Significant Customers.

11. Income Taxes:

The provision for (benefit from) income taxes for the three months ended March 31, 2017 and 2016 was $(6,000) and $6,000, respectively. The difference between the statutory rate and the Company’s effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

As of March 31, 2017 and December 31, 2016, the Company had gross unrecognized tax benefits of approximately $9.3 million and $9.2 million, respectively, of which $355,000 and $364,000, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The Company’s policy is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of March 31, 2017 and December 31, 2016, the Company had accrued $48,000 and $62,000, respectively, for interest and penalties. The $14,000 reduction in interest and penalties on gross unrecognized tax benefits during the three months ended March 31, 2017 was primarily attributable to the expiration of the statute of limitations in certain foreign jurisdictions.

12. Related Parties:

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 300,000 newly issued shares of its common stock for $130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To the Company’s knowledge, Enel has disposed of none of its 300,000 shares. Under the terms of the stock purchase agreement, Enel has the right to nominate one member of the Company’s board of directors. While a representative of Enel served on the board until March 14, 2012, no Enel representative is presently on the board.

In October 2006, the Company entered into a new development and supply agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from the Company. The development and supply agreement expired in March 2016.

For the three months ended March 31, 2017 and 2016, the Company recognized revenue from products sold to Enel and its designated manufacturers of approximately $0 and $1.3 million, respectively.

As of March 31, 2017 and December 31, 2016, none of the Company’s total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

13. Joint Venture:

On March 23, 2012, the Company entered into an agreement with Holley Metering Limited (“Holley Metering”), a designer and manufacturer of energy meters in China, to create a joint venture, Zhejiang Echelon-Holley Technology

Co., Ltd.

14

Table of Contents

(“Echelon-Holley”). The joint venture's intended focus was on the development and sales of smart energy products for China and rest-of-world markets. The Company has a 51.0% ownership interest in the joint venture and exercises controlling influence. Therefore, Echelon-Holley’s accounts are included in the Company’s condensed consolidated financial statements as of March 31, 2017 and 2016, and for the three months then ended. Holley Metering’s interests in Echelon-Holley’s net assets are reported in the non-controlling interest in subsidiary on the condensed consolidated balance sheet as of March 31, 2017. Net loss attributable to the non-controlling interest in Echelon-Holley was $0 and $0 during the three months ended March 31, 2017 and 2016, respectively.

As of March 31, 2017, Echelon and Holley Metering had contributed in cash a total of approximately $4.0 million in Share Capital, as defined in the joint venture agreement, to Echelon-Holley in proportion to their respective ownership interests.

In connection with the decision to sell the Grid business announced in the third quarter of 2014, the Company undertook a process to sell the remaining net assets of the joint venture and recorded the net assets and liabilities of the joint venture at the lower of their carrying amount or fair value less cost to sell, and classified them as held for sale on the accompanying balance sheet at December 31, 2014. The major classes of assets and liabilities that were classified as held for sale were inventory, deferred revenues and the related deferred costs of sales, and accrued liabilities.

During the quarter ended September 30, 2015, the Company concluded that it would no longer pursue a sale, but would instead work with Holley Metering to shut the joint venture down. The remaining net assets of the joint venture were immaterial as of September 30, 2015. As of March 31, 2017, the Company is continuing to work with Holley Metering to complete the shut-down.

14. Restructuring:

During the fourth quarter of 2016, the Company undertook restructuring actions affecting approximately 7 employees to be terminated between October 2016 and September 2017, as part of an overall plan to reshape the Company for the future. In connection with this restructuring, the Company recorded restructuring charges of approximately $286,000 related to termination benefits for these personnel during the year ended December 31, 2016.

The following table sets forth a summary of restructuring activities related to the Company's 2016 restructuring program (in thousands):

	December 31, 2016	Costs Incurred	Cash Payments	March 31, 2017
Termination benefits	$ 273	$ —	$ (48)	$ 225

15

Table of Contents

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as “we believe,” “expect,” “anticipate,” “intend,” “plan,” “goal,” “contin “may,” "target"," and similar expressions. Forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. In particular, these statements include statements such as: our plan to focus our product development spend in our foundational technology to broaden the applicability of our control networking platform into new markets; our predictions about the smart energy market, increased pricing pressures and worldwide macro-economic conditions; our projections of IIoT revenues; our expectations on shipments to Enel and revenues from Enel; our expectation that we will achieve a return on our investment of resources into our products; estimates of our future gross margins and factors affecting our gross margins; statements regarding reinvesting a portion of our earnings from foreign operations; plans to use our cash reserves to strategically acquire other companies, products, or technologies; our projections of our combined cash, cash equivalent and short term investment balance; the sufficiency of our cash reserves to meet cash requirements; our expectations that our IIoT revenues will not fluctuate significantly from foreign currency sales; estimates of our interest income and expense; our belief that we have adequately provided for legal contingencies; and our belief that we have made adequate provisions for tax exposure and legal matters. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the “Factors That May Affect Future Results of Operations” section. Therefore, our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to review or update publicly any forward-looking statements for any reason, except as required by law.

EXECUTIVE OVERVIEW

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We went public on the NASDAQ market under the symbol "ELON" in July 1998. We are based in Santa Clara, California, and maintain offices in several foreign countries throughout Europe and Asia. Our products enable "things" in commercial and industrial applications — such as air conditioners, lighting, manufacturing equipment, electricity meters, light switches, thermostats, and valves — to be made “smart” and inter-connected, part of an emerging market known as the Industrial Internet of Things ("IIoT").

Our widely deployed, open standard, multi-vendor energy control networking platform powers applications for smart cities, smart buildings, and smart campuses that help customers save on their energy usage; prevent failure or reduce failure duration; reduce carbon footprint; improve safety, comfort, and convenience; and more. Our solutions, which feature a programmable, distributed intelligence architecture that is designed for both high reliability and fast action, are implemented over the powerline or through wireless communication systems for flexibility in installation and operation.

We offer two product lines, the first of which is comprised of chips, modules, gateways, and design and management software that enables Original Equipment Manufacturers ("OEMs") to quickly design and bring to market interoperable smart systems for their commercial and industrial customers. These products are generally marketed under the LONWORKS and IzoT brand names. We refer to revenues from these products as "embedded systems" revenues.

Our second product line is a range of control networking solutions designed specifically for the lighting market within the IIoT. As this market continues its transition to solid state lighting, or LEDs, we have focused our initial offerings on outdoor lighting control solutions, as we believe that the incremental energy savings, maintenance benefits, and safety improvements resulting from the implementation of controls offers a compelling return on investment. In addition, due to the abundance of lighting fixtures in most locations, the lighting control system can host a variety of "smart" applications that can further improve safety and comfort on roadways, in parking lots and garages, on campuses, in tunnels, and more. Our lighting control solutions consist of wired and wireless control nodes placed at the lighting fixtures of a wide variety of manufacturers, “smart” gateways for interconnecting the control nodes, and a software-based Central Management System, or CMS, which is used for startup, commissioning, management, and monitoring of the lighting network. These solutions are sold to end users typically

16

through manufacturers' representatives, energy services companies, and distributors, and are generally marketed under the LumInsight and Lumewave by Echelon brand names. We refer to revenues from these products as "outdoor lighting" revenues.

The following tables provide an overview of key financial metrics for the three months ended March 31, 2017 and 2016 that our management team focuses on in evaluating our financial condition and operating performance (in thousands, except percentages).

	Three Months Ended March 31,			
	2017	2016	$ Change	% Change
Revenues	$7,799	$ 8,647	$(848)	(9.8)%
Gross margin	57.4 %	56.0 %	---	1.4 ppt
Operating expenses	$5,613	$ 5,506	$107	1.9 %
Net loss	$(1,199)	$ (875)	$(324)	37.0 %

	Balance as of			
	March 31, 2017	December 31, 2016	$ Change	% Change
Cash, cash equivalents, and short-term investments *	$21,552	$ 23,036	$(1,484)	(6.4)%

* As of March 31, 2017 and December 31, 2016, includes $1.3 million of restricted investments presented separately on condensed consolidated balance sheet

- Revenues: Our revenues decreased by 9.8% during the first quarter of 2017 as compared to the same period in 2016. The decrease in revenues between the two quarterly periods was mainly due to a decrease in sales of components sold to Enel. For further analysis please see the topic Revenues in the Results of Operations discussion later in this section.
- Gross margin: Our gross margins increased by 1.4 percentage points during the first quarter of 2017 as compared to the same period in 2016. These fluctuations were primarily due to a change in the mix of products sold. For further analysis please see the topic Gross Profit and Gross Margin in the Results of Operations discussion later in this section.
- Operating expenses: Our operating expenses increased by 1.9% during the three months ended March 31, 2017, respectively, as compared to the same period in 2016. The increase was primarily due to the fact that, during the first quarter of 2016, we recorded a $318,000 reduction in the accrual for contingent consideration we expected to owe the former Lumewave shareholders, which reduced our general and administrative expenses. Excluding that expense reduction, our operating expenses declined by approximately $211,000 during the first three months of 2017 as compared to the same period in 2016. This reduction was primarily the result of a decrease in fees paid to third party service providers. For further analysis please see the topic Operating Expenses in the Results of Operations discussion later in this section.
- Net loss: We generated a net loss of $1.2 million during the first quarter of 2017 compared to $875,000 during the same period in 2016. This increase in our net loss was mainly attributable to lower overall revenues and gross profits, and to a lesser extent, an increase in operating expenses.
- Cash, cash equivalents, and short-term investments: During the first three months of 2017, our cash, cash equivalents, and short-term investment balance decreased by 6.4%, from $23.0 million at December 31, 2016 to $21.6 million at March 31, 2017. This decrease was primarily the result of cash used in operations of $1.5 million (driven primarily by our net loss of $1.2 million).

Table of Contents

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. For further information on our significant accounting policies, see the Notes to our condensed consolidated financial statements included in Part 1 of this Report. Our critical accounting policies and estimates are also described in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 1, “Significant Accounting Policies” of Notes to consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016, which we filed with the Securities and Exchange Commission in March 2017. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, stock-based compensation, allowance for doubtful accounts, inventories, and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

During the three months ended March 31, 2017, there were no material changes to our critical accounting policies or in the matters for which we make critical accounting estimates in the preparation of our condensed consolidated financial statements as compared to those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2016.

RESULTS OF OPERATIONS

The following table reflects the percentage of total revenues represented by each item in our condensed consolidated statements of operations for the three months ended March 31, 2017 and 2016:

	Three Months Ended March 31,	
	2017	2016
Revenues	100.0 %	100.0 %
Cost of revenues	42.6	44.0
Gross profit	57.4	56.0
Operating expenses:		
Product development	28.6	25.4
Sales and marketing	18.7	15.1
General and administrative	24.7	23.2
Total operating expenses	72.0	63.7
Loss from operations	(14.6)	(7.7)
Interest and other income (expense), net	(0.8)	(2.3)
Loss before provision for income taxes	(15.5)	(10.0)
Income tax expense	(0.1)	0.1
Net loss	(15.4)%	(10.1)%

Revenues

Total revenues

	Three Months Ended			
(Dollars in thousands)	March 31, 2017	March 31, 2016	2017 over 2016 $	2017 over 2016 %

			Change	Change
Total revenues	$7,799	$8,647	$(848)	(9.8)%

Our revenues are primarily comprised of sales of our hardware products, and to a lesser extent, revenues we generate from sales of our software products and from our customer support and training offerings. Included in these totals are components we sell to Enel.

18

Excluding sales to Enel, a related party, which are discussed more fully below, our revenues increased during the three months ended March 31, 2017, as compared to the same period in 2016, by $464,000, or 6%. This increase was primarily due to increases in sales made to customers in the Americas and APJ regions, partially offset by a reduction in sales made to customers in the EMEA region. We have seen a loss in market share over the last several years due primarily to reduced investment in research and development and marketing, especially in our LONWORKS portfolio of products, which has caused a decrease in our embedded system revenues. In addition, the continued poor economic conditions in the EMEA region have also contributed to the year-over-year decline. Lastly, sales of components we make to our former Grid division also declined during the quarter ended March 31, 2017 as compared to the same period in 2016.

The portion of our revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 5.1% for the three months ended March 31, 2017 and 2.7% for the same period in 2016. Our revenues will continue to be subject to fluctuations in the exchange rates between the United States dollar and the foreign currencies in which we sell these products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from year to year. To date, we have not hedged any of these foreign currency risks. We do not currently expect that, during the remainder of 2017, the amount of our revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies were to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

Enel project revenues (included in total revenues)

	Three Months Ended			
(Dollars in thousands)	March 31, 2017	March 31, 2016	2017 over 2016 $ Change	2017 over 2016 % Change
Enel project revenues	$—	$1,312	$(1,312)	(100.0)%

In October 2006, we entered into a development and supply agreement with Enel. The development and supply agreement expired in March 2016. Under the development and supply agreement, Enel purchased metering kit products from us. Enel Project revenues recognized during the three months ended March 31, 2016 were driven primarily by shipments of metering kits under the development and supply agreement.

We sold our products to Enel and its designated manufacturers in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency risks. We do not currently expect that there will be any significant shipments to Enel in 2017. As such, we expect our revenues from Enel will decrease significantly in 2017 as compared to 2016.

Gross Profit and Gross Margin

	Three Months Ended			
(Dollars in thousands)	March 31, 2017	March 31, 2016	2017 over 2016 $ Change	2017 over 2016 % Change

Gross Profit	$4,473	$4,842	$ (369)	(7.6)%
Gross Margin	57.4%	56.0%	N/A	1.4

Gross profit is equal to revenues less cost of revenues. Cost of revenues associated with sales of our products includes direct costs associated with the purchase of components, sub-assemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to warranty and excess and obsolete inventory reserves. Cost of revenues associated with sales of our services includes employee-

related costs such as salaries and fringe benefits as well as other direct and indirect costs incurred in providing training and customer support. Gross margin is equal to gross profit divided by revenues.
Our gross margins increased by 1.4 percentage points for the three months ended March 31, 2017, as compared to the same periods in 2016. This increase is primarily due to a change in the mix of products sold.

Our future gross margins will continue to be affected by several factors, including, but not limited to: overall revenue levels, changes in the mix of products sold, changes in our distribution strategy and use of distributors, changes in the prices charged by our suppliers, periodic charges related to excess and obsolete inventories, warranty expenses, introductions of cost reduced versions of our products, changes in the average selling prices of the products we sell, purchase price variances, and fluctuations in the level of indirect overhead spending. In addition, the impact of foreign exchange rate fluctuations and labor rates may affect our gross margins in the future. We currently outsource the manufacturing of most of our products requiring assembly to CEMs located primarily in China. To the extent labor rates were to rise further, or to the extent the U.S. dollar were to weaken against the Chinese currency, or other currencies used by our CEMs, our costs for the products they manufacture could rise, which would negatively affect our gross margins.

Operating Expenses
Product Development

(Dollars in thousands)	Three Months Ended March 31, 2017	March 31, 2016	2017 over 2016 $ Change	2017 over 2016 % Change
Product Development	$2,227	$2,193	$ 34	1.6 %

Product development expenses consist primarily of payroll and related expenses for development personnel, facility costs, expensed material, fees paid to third party service providers, depreciation and amortization, and other costs associated with the development of new technologies and products.
Our product development expenses remained relatively unchanged during the three months ended March 31, 2017 as compared to the same period in 2016.
Sales and Marketing

(Dollars in thousands)	Three Months Ended March 31, 2017	March 31, 2016	2017 over 2016 $ Change	2017 over 2016 % Change
Sales and Marketing	$1,462	$1,302	$ 160	12.3 %

Sales and marketing expenses consist primarily of payroll, commissions, and related expenses for sales and marketing personnel, travel and entertainment, facilities costs, advertising and product promotion, and other costs associated with our sales and marketing activities.
Our sales and marketing expenses increased by 12% during the three months ended March 31, 2017, as compared to the same period in 2016. The primary cause of this increase was an increase in non-cash equity compensation charges for our sales and marketing personnel.
General and Administrative

(Dollars in thousands)	Three Months Ended March 31,	March 31,	2017 over	2017 over

	2017	2016	2016 $ Change	2016 % Change
General and Administrative	$1,924	$2,011	$ (87)	(4.3)%

20

Table of Contents

General and administrative expenses consist primarily of payroll and related expenses for executive, finance, and administrative personnel, professional fees for legal and accounting services rendered to the company, facility costs, insurance, and other general corporate expenses.

General and administrative expenses decreased modestly during the three months ended March 31, 2017, as compared to the same period in 2016. As mentioned earlier, included in our results for the quarter ended March 31, 2016 was a reduction of the contingent consideration we would owe to the former Lumewave shareholders. During the quarter ended March 31, 2016, we concluded that it was no longer probable that we would owe any further contingent consideration to the former Lumewave shareholders at the conclusion of the two-year period ending in August 2016. As a result, we reduced this accrual by the remaining $318,000 balance, which was recorded as a reduction to our general and administrative expenses. Excluding this reduction, our general and administrative expenses decreased by $405,000, which was driven in large part by a reduction of fees paid to third party service providers, including our registered independent accountants.

Interest and Other Income (Expense), Net

(Dollars in thousands)	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016	2017 over 2016 $ Change	2017 over 2016 % Change
Interest and Other Income (Expense), Net	$(65)	$(205)	$ 140	(68.3)%

Interest and other income (expense), net, primarily reflects interest earned by our company on cash and short-term investment balances as well as foreign exchange translation gains and losses related to short-term intercompany balances.

Interest and other expense, net, decreased by $140,000 during the three months ended March 31, 2017 as compared to the same period in 2016. This fluctuation was primarily attributable to the fact that, during the first quarter of 2017, we recognized approximately $88,000 of foreign currency translation losses, whereas in the first quarter of 2016, we recognized foreign currency translation losses of approximately $221,000. These fluctuations are primarily attributable to our foreign currency denominated short-term intercompany balances. We account for translation gains and losses associated with these balances by reflecting these amounts as either other income or loss in our condensed consolidated statements of operations. During periods when the U.S. dollar weakens in value against these foreign currencies, the associated translation losses negatively impact other income. Conversely, when the U.S. dollar strengthens, the resulting translation gains favorably impact other income.

We do not currently anticipate interest income on our investment portfolio will improve during 2017 as we expect interest rates to remain historically low. Future gains or losses associated with translating our foreign currency denominated short-term intercompany balances will depend on exchange rates in effect at the time of translation.

Income Tax Expense

(Dollars in thousands)	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016	2017 over 2016 $ Change	2017 over 2016 % Change
Income Tax Expense (Benefit)	$(6)	$ 6	$ (12)	200.0 %

The income tax expense (benefit) for the three months ended March 31, 2017 was $(6,000) compared to $6,000 for the same period in 2016. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related

to unrecognized tax benefits.
OFF-BALANCE-SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS
Off-Balance-Sheet Arrangements. We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose our company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.
Lease Commitments. In September 2015, we entered into a lease agreement for our corporate headquarters facility in Santa Clara, California. This lease commenced in November 2015 and will expire in July 2019. In addition, we lease facilities under

operating leases for our sales, marketing, and product development personnel located elsewhere within the United States and in several foreign countries throughout Europe and Asia. These operating leases expire on various dates through 2019, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.
Purchase Commitments. We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods up to twelve months, and in rare cases, up to eighteen months. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods up to twelve months.

We also utilize purchase orders when procuring capital equipment, supplies, and services necessary for our day-to-day operations. These purchase orders generally cover periods ranging up to twelve months, but in some instances cover a longer duration.

Indemnifications. In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that would enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

Royalties. We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded as cost of revenues in our condensed consolidated statements of operations, was approximately $80,000 for the three months ended March 31, 2017, and $56,000 for the same period in 2016.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

Taxes. We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon's operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of March 31, 2017, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

Legal Actions. From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of March 31, 2017, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during 2012 and certain earlier years, we were also able to finance our operations through operating cash flows.

The following table presents selected financial information as of March 31, 2017, and for each of the last three fiscal years (dollars in thousands):

	March 31,	December 31,		
	2017	2016	2015	2014
Cash, cash equivalents, and short-term investments*	$21,552	$23,036	$26,070	$43,570
Trade accounts receivable, net	3,035	3,015	4,030	3,948
Working capital	22,527	23,083	26,713	40,310
Stockholders' equity	24,010	24,678	28,921	43,177

* As of March 31, 2017 and December 31, 2016, includes $1.3 million of restricted investments presented separately on condensed consolidated balance sheet

As of March 31, 2017, we had $21.6 million in cash, cash equivalents, restricted cash and short-term investments, a decrease of $1.5 million as compared to December 31, 2016. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options by our employees and directors, and the exercise of warrants. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase programs.

Cash flows from operating activities. Cash flows from operating activities have historically been driven by net income (loss) levels; adjustments for non-cash charges such as stock-based compensation, depreciation, and amortization; changes in accrued investment income; and fluctuations in operating asset and liability balances. Net cash used in operating activities was $1.5 million for the three months ended March 31, 2017, a decrease in cash outflows of approximately $919,000 as compared to the same period in 2016. During the three months ended March 31, 2017, net cash used in operating activities was primarily the result of our net loss of $1.2 million, and changes in our operating assets and liabilities of $851,000; partially offset by stock-based compensation expenses of $467,000, and depreciation and amortization expense of $110,000. The primary components of the $851,000 net change in our operating assets and liabilities were a $545,000 decrease in accrued liabilities, a $125,000 increase in deferred cost of revenues, and a $124,000 increase in other current assets. Accrued liabilities decreased primarily due to the payment of bonuses that were accrued as of December 31, 2016. Deferred cost of revenues increased due to the mix of products for which revenue was deferred at March 31, 2017. Other current assets increased primarily as a result of an increase in prepaid expenses.

During the three months ended March 31, 2016, net cash used in operating activities was primarily the result of our net loss of $875,000, decreases in operating assets and liabilities of $1.4 million, and a reduction in the expected amount of contingent consideration we expect to owe the former Lumewave shareholders of $318,000; partially offset by depreciation and amortization expense of $144,000. The primary components of the $1.4 million net decrease in our operating assets and liabilities were a $904,000 decrease in accrued liabilities, a $433,000 increase in inventories, a $189,000 increase in accounts receivable, and a $131,000 decrease in deferred revenues; partially offset by a $113,000 increase in accounts payable. Accrued liabilities decreased primarily to the payment of bonuses that were accrued as of December 31, 2015. Inventories increased due to the timing of the purchase and sale of inventory during the quarter. Accounts receivable increased primarily as a result of the timing of shipments to and the corresponding collections from our customers in the first three months of 2016. Deferred revenues decreased in accordance with the overall activity with distributors in all regions. Accounts payable increased due to the timing of receipt and payment

of invoices we received from our vendors during the quarter.
Cash flows from investing activities. Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions and divestitures. Net cash provided by investing activities was $16,000 for the three months ended March 31, 2017, an increase in cash inflows of $13,000 from the same period in 2016. During the three months ended March 31, 2017, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $6.0 million, partially offset by purchases of available-for-sale short-term investments of $6.0 million, and capital expenditures of $16,000.

23

Table of Contents

During the three months ended March 31, 2016, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $4.0 million, partially offset by purchases of available-for-sale short-term investments of $4.0 million, and capital expenditures of $5,000.

Cash flows from financing activities. Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs and principal payments on our lease financing obligations. Net cash used in financing activities was $17,000 for the three months ended March 31, 2017, a increase in cash outflows of $16,000 as compared to the same period in 2016.

During the three months ended March 31, 2017, net cash used in financing activities was primarily the result of $17,000 worth of shares repurchased from employees for payment of employee taxes on vesting of performance shares.

During the three months ended March 31, 2016, net cash used in financing activities was primarily the result of $1,000 worth of shares repurchased from employees for payment of employee taxes on vesting of performance shares.

As noted above, our cash and investments totaled $21.6 million as of March 31, 2017. Of this amount, approximately 5% was held by our foreign subsidiaries. Our intent is to permanently reinvest a significant portion of our earnings from foreign operations, and current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed to fund operations in the United States and if U.S. tax has not already been previously provided, we would provide for and pay any additional U.S. taxes due in connection with repatriating these funds.

We use well-regarded investment managers to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated U.S. government securities, and to a lesser extent, money market funds. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our Board of Directors.

We maintain an operating credit line of $1.0 million with our primary bank for company credit card purchases. This line of credit continues to be secured by a collateral of the first priority on $1.3 million of our investments (presented as restricted investments in the condensed consolidated balance sheets).

In the future, our cash reserves may be used to strategically acquire or invest in other companies, products, or technologies that are complementary to our business. In addition, our combined cash, cash equivalents, and short-term investments balances could be negatively affected by various risks and uncertainties, including, but not limited to, the risks detailed in this Quarterly Report in the section titled “Factors That May Affect Future Results of Operations.” For example, any continued weakening of economic conditions or changes in our planned cash outlay could negatively affect our existing cash reserves.

Based on our current business plan and revenue prospects, we believe that our existing cash reserves will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. However, we currently expect that our combined cash, cash equivalent, and short-term investment balance will decline during the remainder of 2017. In the event that we require additional financing, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

RELATED PARTY TRANSACTIONS

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 300,000 newly issued shares of our common stock for $130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 300,000 shares. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. A representative of Enel served on our board until March 14, 2012; no Enel representative is presently serving on our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the “R&D Agreement”). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel’s remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the

Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel.

Table of Contents

Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provided software enhancements to Enel for use in its Contatore Elettronico system. The software enhancement was assigned to S&T as part of the sale of our Grid division in September 2014. The development and supply agreement expired in March 2016.

For the three months ended March 31, 2017 and 2016, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $0 and $1.3 million, respectively. As of March 31, 2017 and December 31, 2016, none of the Company's total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

RECENTLY ISSUED ACCOUNTING STANDARDS

During the three months ended March 31, 2017, there have been no new recent accounting pronouncements or changes in accounting pronouncements, other than those noted in Note 1 in the Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report, that are of significance, or potential significance, to our company.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the condensed consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q.

There can be no guarantee that the IIoT market in general, and the lighting market segment in particular, will develop as expected, or that we will be successful in pursuing these market opportunities.

We have devoted and will continue to devote significant effort and resources to leverage our technology and develop and launch our platform to customers within the IIoT market. However, to date, the market for our products has not developed as quickly as anticipated, and our efforts to capitalize on these opportunities have not produced the results we anticipated. Our efforts to capitalize on these opportunities may not be successful in the near term, or at all. Furthermore, for the last several years, revenues from our legacy embedded systems products have been declining, and we anticipate that this trend will continue for the foreseeable future.

We have decided to focus predominantly on lighting controls within the IIoT as our targeted market. As we have a limited operating history in this market segment, we are subject to a number of risks and uncertainties that may impact our ability to gain market acceptance for our lighting control products.

In recent years, we have invested substantial resources in the development and commercialization of control networking solutions for the lighting market. However, we have a limited operating history in this market segment, and we may not recognize a meaningful amount of revenues from these efforts in the near future, or at all. Our efforts to gain market acceptance for our lighting control products and solutions are subject to considerable risk and uncertainty, including:

- the risk of competition and emerging technologies (see "If we do not develop and maintain adequate distribution channels, our revenues will be harmed" for additional information on the risks associated with competing for market share);
- the risk that we will not be able to develop adequate sales channels for these new products and services (see "Our IIoT revenues may not meet expectations, which could cause volatility in the price of our stock" for additional information on the risks associated with establishing new sales channels);
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the risk that we misjudge the market and fail to develop solutions that meet the requirements of our existing or potential customers;

- the risk that our solutions will suffer security breaches or unintended releases of private data;
- the risk that our products will not perform adequately due to defect or misuse by customers (see "Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses" for additional information on the risks associated with defective or misused products);
- the risk that our supply chain for components is unable to meet our demand (see "Because we depend on a limited number of key suppliers and in certain cases, a sole supplier, the failure of any key supplier to produce timely and compliant

products could result in a failure to ship products, or could subject us to higher prices, which would harm our results of operations and financial position" for additional information on the risks associated with manufacturing).

We have changed our business model significantly in recent years, which makes it difficult to evaluate our prospects and forecast our future operating results.

Although we commenced our business in 1988, we have made significant changes to our business model in recent years. Historically, we derived all of our revenues from our embedded systems and Grid businesses. However, in 2014, we sold our Grid business, and over the last several years, we have experienced a decline in revenues from our legacy embedded systems products and services, including a cessation in our shipments to Enel.

In recent years, we have shifted our focus to networking solutions for the outdoor lighting market. Unlike our legacy embedded systems products, which are typically sold to OEMs for incorporation into their products, which are then sold to their commercial and industrial customers, our lighting solutions products are more project based, being sold through energy services companies and distributors to municipalities, enterprise and educational campuses, retailers, and other end users. In addition, our outdoor lighting solutions typically generate lower overall gross margins than do our embedded systems products.

As we have a limited operating history with our lighting solutions, our ability to forecast our future operating results and effectively assess our future prospects is subject to a number of uncertainties that may impact our ability to plan for and model future growth. Our historical revenue growth should not be considered indicative of our future performance. Further, in future periods, our revenues could decline for a number of reasons, including the failure to offset the expected decline in revenues from our embedded systems products by an increase in sales of our lighting solutions, changes in our pricing structure, increased competition in the IIoT market generally or in the lighting market in particular, or our failure, for any reason, to capitalize on growth opportunities. We have encountered and will continue to encounter risks and uncertainties frequently experienced by companies in rapidly changing industries. If our assumptions regarding these risks and uncertainties, which we use to plan our business, are incorrect or change, or if we do not address these risks successfully, our operating and financial results could differ materially from our expectations, and our business could suffer.

Our revenues may not meet expectations, and our operating expenses may be higher than we anticipate, which could cause volatility in the price of our stock.

As we attempt to grow our IIoT business, we will commit significant resources developing new products in emerging markets. In addition, our IIoT business operates in nascent markets, such as outdoor lighting and controls, in which we have yet to build a reliable customer base. As a result, sales of our products are unpredictable and yet to be proven, and sales and marketing costs related to our products may be significant. These factors could have a negative impact on our revenues and make it difficult to project our financial results, which could cause declines and volatility in our stock price. Additionally, because we are operating in an emerging market, risks that we are not currently able to identify are likely to materialize and could negatively impact our operations and financial condition.

Emerging markets are particularly dynamic and highly competitive, and we may lose sales to our competitors, which would harm our revenues and results of operations.

Competition in the IIoT market is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, industry consolidations, effective management of distribution channels, rapid changes in customer or regulatory requirements, and localized market requirements. In each of our existing and target markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses. The future of our IIoT business depends significantly on our ability to react to changing customer needs by enhancing our existing products and developing new products. There can be no guarantee, however, that new products and product enhancements will be accepted by businesses and consumers. If we make investments in technologies that do not gain market acceptance, our business may not grow as anticipated. In addition, future product offerings by our competitors can render our products obsolete. Any failure to evolve with emerging technologies and our competitors could cause a loss of market share and result in declining revenues.

The principal competitive factors that affect the markets for our products include the following:

- our ability to anticipate changes in customer or regulatory requirements and to develop, or improve, our products to meet these requirements in a timely manner;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our product reputation, quality, performance, and conformance with established industry standards;

26

- our ability to expand our product line to address our customers' requirements;
- our ability to effectively manage and expand our distribution channels to address new markets for current and future products;
- our ability to meet a customer's required delivery schedules;
- a customer's willingness to do business with us because of our size and perceived concerns regarding our liquidity and financial strength relative to our competitors;
- the risk of industry consolidation, which is particularly high in emerging markets such as the IIoT;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

Competitors for our IIoT products include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Cimcon Lighting, Inc., Cree Inc., Digi International, General Electric, LED Roadway Lighting, Maxim Integrated Products, Philips, Siemens, Silver Spring Networks, STMicroelectronics, Telensa, Texas Instruments, and Tridium. Key industry standard and trade group competitors include BACnet, DALI, DeviceNet, HART, Konnex, Profibus, ZigBee, and the ZWave Alliance in the IIoT market. Each of these standards and/or alliances is backed by one or more competitors. For example, the ZigBee alliance includes over 300 member companies with promoter members, such as Ember, Emerson, Freescale, Kroger, Landis+Gyr (a subsidiary of Toshiba), Philips, Reliant Energy, Schneider Electric, STMicroelectronics, Tendril, and Texas Instruments. Additionally, because we are operating in an emerging market, it is likely that additional competitors could surface and rapidly gain market share.

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings, all of which may impact the willingness of customers and potential customers to do business with us. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

The sales cycle for our products is often lengthy and unpredictable.

The sales cycle between initial customer contact and execution of a contract or license agreement with a customer or purchaser of our products can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products.

If we are successful in this effort for our embedded systems products, OEMs will typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM's product development, system integration, and product introduction periods have been completed. In addition, changes in our customers' budgets, or the priority they assign to control network development, could also affect the sales cycle.

For our outdoor lighting controls products, the sales cycle can also be extended. As a nascent market, many of our sales channel partners, as well as end use customers, are not aware of the benefits our controls technology can bring to their lighting systems. This requires extensive educational efforts on our part, which, if successful, can lead to one or more projects that deploy our lighting control solution. For larger projects, this typically commences with a trial deployment of relatively low value to us. If the trial is successful, the end use customer may commence a full scale deployment that could take months or years to complete.

In addition, potential customers for our products, both embedded systems and outdoor lighting controls, include local, state and federal government authorities. For several reasons, sales to government authorities can be extended and unpredictable. Government authorities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending, and their spending is likely to be adversely impacted by economic conditions. In addition, in many instances, sales to government authorities may require field trials and may be delayed by the time it takes for government officials to evaluate multiple competing bids, negotiate terms, and award contracts. We further face the risk of cancellation during development and production due to regulatory, government and geopolitical changes, and delays in installing, operating, and evaluating the results of any field trials before full implementation of our products.

For these reasons, the sales cycle associated with our IIoT products is subject to a number of significant risks that are beyond our control. Consequently, if our forecasted customer orders are not realized, our revenues could be materially adversely affected. In addition, the extended sales cycle may result in our inability to recognize revenue from existing or new projects until the end of several fiscal quarters. This may also make it difficult to predict our financial results and increase the volatility of our stock price.

Table of Contents

If we are not able to develop or enhance our products in a timely manner, our revenues will suffer.
Due to the nature of development efforts in general, we can experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. In addition, such delays could cause us to incur penalties if our deliveries are delayed, could otherwise impair our relationship with any of our customers that were relying on the timely delivery of our products in order to complete their own products or projects, or could cause the customer to cancel orders or to seek alternate sources of supply or other remedies. Any delay in the introduction of new products could impact future revenue targets or forecasts.
We are sometimes required to modify our products to meet local rules and regulations. We may not be able to increase the price of such products to reflect the costs of such modifications, given competitive markets. In addition, given the long-term nature of development activities, we may be required to undertake such modifications prior to receiving firm commitments or orders from our customers. In either of these or other similar scenarios, we may not be able to recover our costs attributable to required product modifications.
We intend to continue investing resources in our development activities, which will expose us to risks, such as protection of intellectual property, investment risk, and labor costs and other matters. We could also be adversely affected by delays or cost increases experienced by third parties that are developing products on our behalf.
If we do not develop and maintain adequate distribution channels, our revenues will be harmed.
The market for our products is new and unproven, and we cannot rely solely on our existing distributors to sell our products. Therefore, we are focused on expanding our distribution channel to include new distributors in order to generate revenue from product sales. We expect that the distribution channel for our products will be dispersed and it is difficult to predict how long it will take and how costly it will be to develop. We may not be successful in developing and maintaining adequate distribution channels within our expected timeframe and cost expectations, if at all. In addition, if any of our new or existing distributor partners fail to dedicate sufficient resources to market and sell our products, our revenues would suffer. Furthermore, if our existing distributor partners were to significantly reduce their inventory levels for our products, we could expect a decrease in service levels to our end-use customers.
Sales of our products may fail to meet our financial targets, which would negatively impact our results of operations and expected return on investment in the IIoT market.
We have invested and intend to continue to invest significant resources in the development and sales of products in the emerging IIoT market, particularly in the outdoor lighting market segment. If we are unable to receive orders for, ship, and recognize revenue for our products in a timely manner, and in the quantities and at prices in line with our targets, our financial results will be harmed. Our long-term financial goals include expectations for a return on these investments, but we may or may not ever realize any return whatsoever on this investment of resources.
Our market share in our existing embedded systems business has declined due to increased competition, reduced levels of investment in our LONWORKS product line, and pricing pressures faced around the world. Moreover, recent revenues generated from our embedded systems business have failed to meet our expectations. We expect this trend to continue for the foreseeable future, which could cause our operating results to suffer to the extent we are not able to generate offsetting revenues and gross profit through the sale of our control networking solutions for the outdoor lighting market. If this market share loss were to accelerate, our ability to continue funding our entry into the outdoor lighting segment could be harmed.

In order to achieve our financial targets, we believe that we must meet the following objectives:

- Achieve acceptance of our products in the IIoT market, particularly the outdoor lighting market, in order to increase our revenues;
- Manage our operating expenses to a reasonable percentage of revenues; and
- Manage our cash resources prudently.

Even if we meet these objectives, there can be no assurance that we will meet our overall financial targets and objectives.

A significant portion of our operating expenses are fixed. Therefore, if we cannot achieve our revenue targets, our use of cash balances would increase, our losses would increase, and/or we would be required to take additional actions necessary to reduce

28

expenses. We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals and, if we fail to achieve our goals, our results of operations are likely to be harmed.

In our legacy embedded systems business, we may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.

LONWORKS and IzoT technology are open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our IIoT customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers, in particular, could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our IIoT competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market; and Echonet, ZigBee, and Z-Wave in the home control markets.

The ability of our IIoT products to interoperate with multiple standards is important to our success. Our technologies, protocols, or standards may not be successful or we may decide not to invest our resources at the levels required in order to compete with new or enhanced products or standards introduced by our IIoT product line competitors, which would have a material adverse effect on our revenues, results of operations, and financial condition.

We are increasingly dependent on third-party developers.

We are increasingly reliant on various third parties for the development of software used in our products. There is a risk that the software provided by these third parties could contain errors or defects that could adversely impact the quality of our products. In addition, these third parties may use open source or other code that contains security flaws, which may cause our products to be more prone to hacking or other security attacks. We may also be negatively impacted by employee turnover or other challenges that these third-party developers face in their own businesses. The materialization of any of these risks would impact our ability to deliver quality products on a timely basis, which could adversely impact our reputation and brand and harm our business and operating results.

In addition, many of these third-party developers are located in markets that are subject to political risk, intellectual property misappropriation, corruption, infrastructure problems and natural disasters in addition to country specific privacy and data security risks, given current legal and regulatory environments. The failure of these third parties to meet their obligations and adequately deploy business continuity plans in the event of a crisis and/or the development of significant disagreements, natural or man-made disasters or other factors that materially disrupt our ongoing relationship with these developers could negatively affect our operations.

Because we depend on a limited number of key suppliers and, in certain cases, a sole supplier, the failure of any key supplier to produce timely and compliant products could result in a failure to ship products, or could subject us to higher prices, which would harm our results of operations and financial position.

Our future success will depend significantly on our ability to timely manufacture our products cost effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally Bel-Fuse. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, finished products, and manufacturing yields. For example, an extended delay in the supply of a key component could disrupt the manufacturing of our products. Any such interruption in the supply of key components could therefore have a material adverse effect on our customer relationships and revenues. As a result of these and other risks, our CEMs could demand price increases for manufacturing our products. The Bel-Fuse factories, where our products are manufactured, are located in China. The Chinese government maintains programs, whereby labor rates for the manufacture of our products will increase over time. In addition, our agreements with our CEMs make us responsible for components and subassemblies purchased by the CEMs when based on our forecasts or purchase orders. Accordingly, we will be at risk for any excess and obsolete inventory purchased by our CEMs. Lastly, CEMs can experience turnover, instability, and lapses in manufacturing or component quality, exposing us to additional risks as well as missed commitments to our customers.

Table of Contents

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products. Cypress Semiconductor is the sole licensee, manufacturer and distributor for the Cypress Neuron, which is an important part of the LONWORKS portfolio. As a result, we or our customers may experience longer lead times and higher pricing for these parts, which could result in reduced orders for our products from these same customers. In addition, Cypress Semiconductor could decide to reduce or cease production of the Neuron chip in the future, at any time, with or without advance notice to us.

The FT 5000 free topology transceiver and the Neuron 5000 are sole sourced from the Taiwan Semiconductor Manufacturing Company (TSMC) foundry through our aggregator Open Silicon. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms. Any sole source relationship could make us vulnerable to price increases, particularly where we do not maintain long-term supply agreements with the supplier, or to supply disruptions that would result if the supplier issued an end of life notice with respect to a key product.

We are continuing to review the impact that economic factors are having on our suppliers. Some of these suppliers are large, well-capitalized companies, while others are smaller and more highly leveraged. In order to mitigate these risks, we may take actions such as increasing our inventory levels and/or adding additional sources of supply. Such actions may increase our costs and increase the risk of excess and obsolete inventories. Even if we undertake such actions, there can be no assurance that we will be able to prevent any disruption in the supply of goods and services we receive from these suppliers.

We may also elect to change any of these key suppliers. As part of such a transition, we may be required to purchase certain raw material and in-process inventory from the existing supplier and resell it to the new source. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a replacement. Also, as our business grows, we will be required to expand our business with our key suppliers or find additional sources of supply. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

- moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;
- reestablishing acceptable manufacturing processes with a new work force; and
- exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could result in our failure to ship products in a timely manner or at all, which would adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position. Any such failures could also have a negative impact on our ability to project our financial results, which could result in volatility in our stock price.

Our business depends on the Internet and its continued access and development.

The Internet is crucial to the operations of many of our IIoT products and is a key component of the IIoT market as a whole. Our reliance on the Internet exposes us to a number of risks and uncertainties that are beyond our control, including risks related to privacy and data security. It is difficult to quantify the impact that any future security or performance problems associated with the Internet may have on our products and revenues.

In addition, state, federal and foreign regulators could adopt laws and regulations that impose additional burdens on companies that conduct business over the Internet. The growth and development of the market for online services may prompt calls for more stringent consumer protection laws or laws that may inhibit the use of Internet-based communications or the information contained in these communications. The adoption of any additional laws or regulations may impact the growth of the IIoT market. Any new legislation or regulations, application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or application of existing laws and regulations to the IIoT and other related services could increase our costs and harm our growth. In particular, there is increasing focus on privacy and data security regulations applicable to the IoT. For example, the Federal Trade

Commission released a report on January 27, 2015 with recommendations for privacy and data security recommendations applicable to connected devices, objects and sensors. In addition, the EU intends to adopt new, stricter standards around privacy and data security. We may be required to re-engineer our products and incur additional costs to comply with new regulations, any of which would negatively impact our business.

If our IIoT solutions become subject to cyber-attacks, or if public perception is that they are vulnerable to cyber-attacks, our reputation and business would suffer.

We have designed our IIoT products, including our outdoor lighting solutions products, to interoperate with other third-party products and systems. Although we attempt to safeguard our products and solutions from cybersecurity threats, the potential for cyber security attacks continues to evolve in scope and frequency.

Advances in and expanding availability of technical tools to enable cybersecurity attacks, and increasing sophistication of the threats, deepen the risk of potential security failures. This risk expands as new protocols and devices are implemented into our products and systems, and as customer requirements evolve. Should our products, or the combination of our products into third party systems, fail to prevent or be unable to withstand any such threats or cyber-attacks, or if our partners or customers fail to safeguard the technologies, products or the systems with adequate security policies or otherwise, our business and reputation may be harmed.

We have attempted to design certain of our products to prevent and monitor unauthorized access, misuse, modification or other activities related to those products and the systems into which the products are intended to be placed. Despite our security measures, our products or systems may be subject to unauthorized break ins, viruses, disruptions, high-jacking, cyber terrorism, misuse, or other unauthorized tampering or modification. Should our products fail to perform, or be unable to withstand a cyber-attack, we could face legal liability, and encounter material adverse financial and reputational harm.

In addition, we believe that there could be incidents of security breaches in the future which could receive a high degree of publicity and visibility, regardless of whether or not the problem is due or related to the performance of our particular products or systems. Any such publicity could have a negative effect on public confidence, or cause a perception that our solutions are or could be subject to similar attacks or breaches, and our business, operating results and financial condition may be materially adversely affected. Such an event could also result in a material adverse effect on the market price of our common stock, independent of the direct effects on our business.

Furthermore, because some of the information collected by some of our solutions, is or could be considered confidential consumer information in some jurisdictions, a cyber-attack could cause a violation of applicable privacy, consumer or security laws, which could cause our company to face financial or legal liability, should a security breach occur, which could have a material adverse effect on the Company.

We are dependent on technology systems and third-party content that are beyond our control.

Our success in the IIoT market will depend in part on the availability of online services and Internet connections to facilitate data transmission. In most instances, these services will be provided by third parties and will be outside of our control. Even when we are not responsible for connectivity or other problems, users of our products may attribute the problem to us. For example, many of our customers rely on the capacity, reliability and security of wireless networks owned and controlled by third parties to use our IIoT products. However, the price of access and operational integrity of online services, wireless networks and Internet connections are beyond our control. As a result, it may be difficult to identify the source of problems if they occur. This could diminish our brand and harm our business, divert the attention of our technical personnel from our product development efforts or cause significant customer relations problems.

Information Technology system security failures, cyber-attacks, and other technological breaches could cause harms to our business.

We also rely on the security of our third party providers to protect our proprietary information and information of our customers. Information technology system failures, including a breach of our or our third party providers' data security, could disrupt our ability to function in the normal course of business by potentially causing, among other things, an unintentional disclosure of customer information. Despite our implementation of security measures or those of our third party providers, information systems may be vulnerable to threats such as computer hacking, cyber-terrorism or other unauthorized attempts by third parties to access, modify or delete our or our customers' data or otherwise disrupt our systems.   Any such breach could have a material adverse effect on our business, operating results and our reputation as a provider of data collection, and secure and reliable device connection, collaboration and communications solutions, including legal claims for damages or injunctive relief under state, federal and foreign laws, reputational damage, and decreased revenues.

We have designed our IIoT products and solutions products to interoperate with other third party products and systems. Although we attempt to safeguard our products and solutions from cybersecurity threats, the potential for cyber security attacks continues to evolve in scope and frequency.

Table of Contents

Because our products use components or materials that may be subject to price fluctuations, shortages, interruptions of supply, or discontinuation, we may be unable to ship our products in a timely fashion, which would adversely affect our revenues, harm our reputation and negatively impact our results of operations.

We may be vulnerable to price increases for products, components, or materials, such as silver, copper, and cobalt. We generally do not enter into forward contracts or other methods of hedging against supply risk for these items. In addition, we have in the past and may in the future experience shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which can cause us to delay shipments beyond targeted or announced dates. We have also recently reduced our inventory levels, which could impact our ability to supply our customers with products in a timely manner if there was an unexpected increase in demand. Such shortages or interruptions could result from events outside our control, as was the case with the earthquake and tsunami in Japan in March 2011. To help address these issues, we may decide from time to time to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results. In addition, if a component or other product goes out of production, we may be required to requalify substitute components or products, or even redesign our products to incorporate an alternative component or product. If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

We face operational and other risks associated with our international operations.

Risks inherent in our international business activities include, but are not limited to, the following:

- timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
- that the nature and composition of our products may subject us to any number of additional legal requirements, which might include, but are not limited to, data privacy regulations, import/export regulations and other similar requirements;
- inherent challenges in managing international operations;
- the burdens of complying with a wide variety of foreign laws and any related implementation costs; the applicability of foreign laws that could affect our business or revenues, such as laws that purport to require that we return payments that we received from insolvent customers in certain circumstances; and unexpected changes in regulatory requirements, tariffs, and other trade barriers;
- inherent cultural differences that could make it more difficult to sell our products or could result in allegations that sales activities have violated the U.S. Foreign Corrupt Practices Act or similar laws that prohibit improper payments in connection with efforts to obtain business;
- the imposition of tariffs or other trade barriers on the importation of our products;
- potentially adverse tax consequences, including restrictions on repatriation of earnings;
- economic and political conditions in the countries where we do business;
- differing vacation and holiday patterns in other countries, particularly in Europe;
- increased costs of labor, particularly in China;
- labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products; and
- international terrorism.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our business or operating results.

Our business can be affected by a number of factors that are beyond our control, such as general geopolitical, economic, and business conditions. In addition, political uncertainty in the countries where we seek to do business may impact the timing, as well as our ultimate ability, of obtaining new customers and implementing new systems.

In addition, there could be a number of follow-on effects from the credit crisis on our business, such as the insolvency of certain of our key customers, which could impair our distribution channels or result in the inability of our customers to obtain credit to finance purchases of our products.

Table of Contents

This uncertainty about future economic and political conditions continues to make it difficult for us to forecast operating results and to make decisions about future investments. We continue to see the effects of the tentative economy on our IIoT revenues.

If economic activity in the U.S. and other countries' economies remains weak, many customers may continue to delay, reduce, or even eliminate their purchases of networking technology products. This could result in reductions in sales of our products, longer sales cycles, slower adoption of our technologies, increased price competition, and increased exposure to excess and obsolete inventory. For example, distributors could decide to reduce inventories of our products. If conditions in the global economy, U.S. economy or other key vertical or geographic markets we serve remain uncertain or continue to be weak, we would experience material negative impacts on our business, financial condition, results of operations, cash flow, capital resources, and liquidity.

Our executive officers and technical personnel are critical to our business.

Our success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer and other executive officers, as well as our technical personnel. Our future success will depend on our ability to attract, integrate, motivate and retain qualified executive, managerial, technical, sales, and operations personnel, particularly given the overall economic climate and the emphasis on reducing expenses at our company.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to retain qualified executive officers and key personnel and attract new officers and personnel when necessary. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

If we are unable to obtain additional funds when needed, our business could suffer.

For the last several years, our combined cash, cash equivalent, and short-term investment balance has declined. As we continue to implement our long-term strategic focus on the IIoT business, including the outdoor lighting controls market, this trend may continue.

As our cash balances decline, customers or potential customers may become less interested in doing business with us, or we may not satisfy the financial criteria they have established for their suppliers. In addition, from time to time we may also decide to use a portion of our cash balances to settle alleged warranty issues that may arise with our customers or¸ as noted under the heading "Legal Proceedings," in connection with litigation. We may do so even if we do not believe we have liability to our customers or in connection with such litigation, in order to limit our risk, reduce outlays to third party providers, and for administrative convenience. In the future, to the extent that our revenues grow or as we may determine necessary to maintain adequate supply levels, we may experience higher levels of inventory and accounts receivable, which will also use our cash balances. In addition, to the extent we plan to make alternate uses of our facilities, we may incur additional cash expenditures. We may also use our cash reserves to strategically acquire or invest in other companies, products, or technologies that are complementary to our business. Lastly, our combined cash, cash equivalents, and short-term investment balances could be negatively affected by the various risks and uncertainties that we face, especially in light of our focus on the nascent and emerging IIoT things market, and any changes in our planned cash outlay could negatively affect our existing cash reserves.

There can be no assurance that we will be able to obtain financing in the future, including, but not limited to, being able to draw on funds under our existing credit facilities or being able to incur indebtedness or sell equity if that became necessary or desirable. In addition, if we do not meet our revenue targets, our use of our cash balances would increase due to the fact that a significant portion of our operating expenses are fixed. If we were not able to obtain additional financing when needed, or on acceptable terms, our ability to invest in additional research and development resources and sales and marketing resources could be adversely affected, which could hinder our ability to sell competitive products into our markets on a timely basis and harm our business.

Our current stock price and corresponding market valuation could give rise to stockholder activism or hostile takeover attempts, which could be harmful to our business.

Table of Contents

Because the current trading price of our common stock and aggregate market capitalization are low, there is a risk that we could face stockholder activism or hostile takeover attempts, which could divert management's attention from its strategic plan to build stockholder value through the expansion of our lighting solutions business. If the IIoT market in general, and the outdoor lighting market segment in particular, do not materialize as anticipated, if our control networking solutions and other product offerings are not accepted and utilized, or if we are subject to a hostile takeover at a depressed valuation, we may have to devote a significant amount of time and resources without any return on our investment. This could cause us to suffer significant financial losses and could also have a negative impact on our reputation and results of operations, any of which would likely cause our stock price to decline.

Voluntary and/or industry standards and governmental regulatory actions in our markets could limit our ability to sell our products.

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary and/or industry standards organizations around the world in order to help prevent the adoption of exclusionary standards as well as to promote standards for our products. However, we do not have the resources to participate in all standards processes that may affect our markets, and our efforts to influence the direction of those standards bodies in which we do participate may not be successful. Many of our competitors have significantly more resources focused on standards activities and may influence those standards in a way that would be disadvantageous to our products and thereby make it difficult for us to achieve our business and financial objectives.

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation. In addition, the markets for our IIoT products may experience a movement towards standards based protocols driven by governmental action, such as those being considered in the U.S. by NIST. To the extent that we do not adopt such protocols or do not succeed in achieving adoption of our own protocols as standards or de facto standards, sales of our IIoT products may be adversely affected. Moreover, even if our own protocols are adopted as standards, we run the risk that we could lose business to competing implementations.

The adoption of voluntary and/or industry standards or the passage of governmental regulations, for example by state utility commissions or national regulatory bodies such as FERC in the United States and PTB or BSI in Germany, that are incompatible with our products or technology could limit the market opportunity for our products or result in increased costs, which could harm our revenues, results of operations, and financial condition.

We are subject to numerous governmental regulations concerning the manufacturing and use of our products. We must stay in compliance with all such regulations and any future regulations. Any failure to comply with such regulations, and the unanticipated costs of complying with future regulations, may adversely affect our business, financial condition, and results of operations.

We manufacture and sell products incorporating electronic components that may contain materials that are subject to government regulation in the locations in which our products are manufactured and assembled, as well as the locations where we sell our products. Since we operate on a global basis, maintaining compliance with regulations concerning the materials used in our products is a complex process that requires continual monitoring of regulations and ongoing compliance procedures. For example, in 2012 the European Union issued recast regulations regarding the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment ("RoHS"), and in 2014, the SEC rules requiring companies to publicly disclose their use of "conflict minerals" that originated in the Democratic Republic of the Congo (DRC) or an adjoining country also become effective. The adoption of any unanticipated new regulations that significantly impact the various components we use or require that we use more expensive components would have a material adverse impact on our business, financial condition and results of operations.

Our reliance on third-party manufacturers exposes us to the risk that conflict minerals that are contained in our products have originated in the DRC or an adjoining country. We have incurred and expect to incur additional costs to comply with the disclosure requirements. Moreover, the implementation of these requirements could adversely affect the sourcing, availability and pricing of materials used in the manufacture of our products to the extent that there may be only a limited number of suppliers offering "conflict free" minerals that can be used in our products. There can be no assurance that we will be able to obtain such minerals in sufficient quantities or at competitive prices. We may also encounter customers who require that all of the components of our products be certified as conflict free. If we are not able to meet customer requirements, such customers may choose to not purchase our products, which could impact our sales.

Our manufacturing processes, including the processes used by our suppliers, are also subject to numerous governmental regulations that cover both the use of various materials as well as environmental concerns. Since we and our suppliers operate on a global basis, maintaining compliance with regulations concerning our production processes is also a complex process that requires continual monitoring of regulations and ongoing compliance procedures. For example, environmental issues such as pollution and climate change have seen significant legislative and regulatory interest on a global basis. Changes in these areas could directly increase the cost of energy, which may have an impact on the way we or our suppliers manufacture products or use energy to produce our products. In addition, any new regulations or laws in the environmental area might increase the cost of raw materials we use in our products. We are currently unable to predict how any such changes will impact us and if any such impact could be material to our business. Any new law or regulation that significantly increases our costs of manufacturing or causes us or our suppliers to significantly alter the way that our products are manufactured would have a material adverse effect on our business, financial condition and results of operations.

Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.

Our products are manufactured with highly complex electronic components and may, as a result, contain or may be alleged to contain errors or failures, including those relating to actual or potential security breaches. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our IIoT products, LONWORKS technology could be used in a manner for which it was not intended.

Even if we determine that an alleged error or failure in our products does not exist, we may incur significant expense and shipments and revenues may be delayed while we analyze the alleged error or failure. If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all, and our reputation may suffer. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. For example, we could decide to replace defective products at a cost that is significantly higher than the value of the original products. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. However, our customer contracts may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. For example, our outdoor lighting control products operate in a variety of settings under diverse conditions that may present the risk of product failure, which could subject us to liability. For instance, a failure of our automated smart lighting product used by a customer to enhance security could subject us to liability in the event of unlawful activity by third parties. Moreover, our IIoT products may present risks beyond our control such as operational misuse that could ultimately subject us to liability. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.

We may be unable to realize the benefits of our net operating loss carry-forwards (“NOLs”).

NOLs may be carried forward to offset federal and state taxable income in future years and eliminate income taxes otherwise payable on such taxable income, subject to certain adjustments. Based on current federal and state corporate income tax rates, our NOLs and other carry-forwards could provide a benefit to us, if fully utilized, of significant future tax savings. However, our ability to use these tax benefits in future years will depend upon the amount of our otherwise federal and state taxable income. If we do not have sufficient federal and state taxable income in future years to use the tax benefits before they expire, we will lose the benefit of these NOLs permanently. Consequently, in addition to dependence on the generation of future business profits, our ability to use the tax benefits associated with our substantial NOLs will depend significantly on our success in identifying suitable acquisition or investment candidates, and once identified, successfully consummating an acquisition of or investment in these candidates.

Table of Contents

Additionally, federal NOLs are subject to annual limitations under the change of ownership rules within Section 382 of the Internal Revenue Code. In general, an ownership change occurs when the percentage of stock held by one or more 5-percent shareholders increases by more than 50 percentage points over the lowest stock ownership held by such shareholders at any time within a prescribed period, usually three years. If an ownership change were to occur, we may be unable to use a significant portion of our NOLs to offset taxable income. As discussed in Note 7 to our consolidated financial statements included in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission in March 2017, on April 22, 2016, the Company's Board of Directors adopted a Tax Benefit Preservation Plan ("Tax Plan") intended to reduce the likelihood that changes in the Company's investor base have the unintended effect of limiting the Company's use of its tax benefits. The Tax Plan is intended to require any person acquiring shares of the Company's securities equal to or exceeding 4.99% of the Company's outstanding shares to obtain the approval of the Board of Directors. This would protect the tax benefits because changes in ownership by a person owning less than 4.99% of the Company's stock are considered and included in one or more public groups in the calculation of "ownership change" for purposes of Section 382 of the Code. However, there can be no assurance that the Tax Plan would be effective under all circumstances. Moreover, the Tax Plan, as amended on April 17, 2017, will expire on April 25, 2019, unless renewed by our Board of Directors.

The amount of NOLs that we have claimed has not been audited or otherwise validated by the U.S. Internal Revenue Service ("IRS"). The IRS could challenge our calculation of the amount of our NOLs or our determinations as to when a prior change in ownership occurred, and other provisions of the Internal Revenue Code may limit our ability to carry forward our NOLs to offset taxable income in future years. If the IRS was successful with respect to any such challenge, the potential tax benefit of the NOLs to us could be substantially reduced.

We have limited ability to protect our intellectual property rights.

Our success depends significantly upon our intellectual property rights, which can vary significantly from jurisdiction to jurisdiction. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection, particularly in those countries that lack robust or accessible enforcement mechanisms. For example, we have in the past and may in the future form joint ventures with foreign companies, including those in China, where intellectual property mechanisms are generally less stringent than those found in the U.S. We have also outsourced certain development activities to third parties. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology. In addition, our trade secrets or other intellectual property that we license to third parties could be used improperly or otherwise in violation of the license terms.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks, or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights, trade secrets, or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States, and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

Table of Contents

Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others, or if we are unable to secure rights to use the intellectual property rights of others on reasonable terms.

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party's intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources, and cause us to incur significant expenses. We do not insure against infringement of a third party's intellectual property rights.

As the result of such a claim, we may elect or be required to redesign our products that are alleged to infringe the third party's patents or other intellectual property rights, which could cause those product offerings to be delayed. Or we could be required to cease distributing those products altogether. In the alternative, we could seek a license to the third party's intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

In some cases, even though no infringement has been alleged, we may attempt to secure rights to use the intellectual property rights of others that would be useful to us. We cannot guarantee that we would be able to secure such rights on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

Any of the foregoing risks could have a material adverse effect on our revenues, results of operations, and financial condition.

We face currency risks associated with our international operations.

We have operations located in seven countries and our products are sold in many more countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 68.2%, 71.3% and 72.4%, of our total revenues for the years ended December 31, 2016, 2015, and 2014, respectively. We expect that international sales will continue to constitute a significant portion of our total revenues. Given our high dependency on sales of our products into Europe, the ongoing financial crisis in that region, which may be adversely impacted by the "Brexit" vote in the United Kingdom, could adversely affect our financial results.

Changes in the value of currencies in which we conduct our business relative to the U.S. dollar have caused and could continue to cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

In general, we sell our products to foreign customers primarily in U.S. dollars. As such, fluctuations in exchange rates have had, and could continue to have, an impact on revenues. If the value of the dollar rises, our products will become more expensive to our foreign customers, which could result in their decision to postpone or cancel a planned purchase.

With respect to the relatively minimal amount of our revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, we will face increased exposure to foreign currency risk if, in the future, our foreign customers require us to price our products in a local currency.

In addition, for our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these companies are presently denominated in U.S. dollars, in the future they may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. In addition, increases in labor costs in the markets where our products are manufactured could also result in higher costs to procure our products. For example, China has recently experienced overall wage increases, which our CEMs have generally passed along to us.

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

Table of Contents

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.
Fluctuations in our operating results may cause our stock price to decline.

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet market expectations. Moreover, we have a history of losses and negative cash flow and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

- orders may be cancelled;
- the mix of products and services that we sell may change to a less profitable mix;
- shipment, payment schedules, and product acceptance may be delayed;
- our products may not be purchased by OEMs, systems integrators, service providers and end-users at the levels we project;
- our ability to develop products that comply with future regulations and trade association guidelines;
- the revenue recognition rules relating to certain of our products could require us to defer some or all of the revenue associated with product shipments until certain conditions, such as delivery and acceptance criteria for our software and/or hardware products, are met in a future period;
- our CEMs may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- downturns in any customer’s or potential customer’s business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;
- we may incur costs associated with any future business acquisitions; and
- any future impairment charges related to our intangible assets that are required to be recorded under generally accepted accounting principles in the United States may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.
We may be unable to anticipate or fail to adequately mitigate against increasingly sophisticated methods to engage in illegal or fraudulent activities against us.

Despite any defensive measures we take to manage threats to our business, our risk and exposure to these matters remain heightened because of, among other things, the evolving nature of such threats in light of advances in computer capabilities, new discoveries in the field of cryptography, new and sophisticated methods used by criminals including phishing, social engineering or other illicit acts, or other events or developments that we may be unable to anticipate or fail to adequately mitigate. If such efforts against us were to be successful, it could have a material adverse effect on our results of operations and financial condition.
Future acquisitions, strategic investments, partnerships or alliances could be difficult to identify and integrate, divert the attention of management, disrupt our business, dilute stockholder value and adversely affect our operating results and financial condition.

As opportunities present themselves, we may from time to time evaluate and enter into strategic partnerships or transactions involving acquisitions of or investments in other businesses, products or technologies that we believe could complement or expand our services, enhance our technical capabilities or otherwise offer growth opportunities. The pursuit of potential transactions may divert the attention of management and cause us to incur various expenses in identifying, investigating and pursuing suitable opportunities, whether or not transactions are ultimately completed. If we acquire businesses, we may not be able to integrate successfully the acquired personnel, operations and technologies, or effectively manage the combined business following the acquisition. We may not be able to find and identify desirable opportunities or be successful in entering into an agreement with respect to the opportunities that we do identify. Acquisitions and other transactions could also result in dilutive issuances of equity securities, use of our existing cash reserves or the incurrence of debt, which could adversely affect our operating results. In addition, if a transaction fails to meet our expectations, our operating results, business and financial condition may suffer.

Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.

Table of Contents

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, limiting our ability or our partners' or customers' ability to sell or use our products, affecting our third party developer's ability to complete developments on schedule or at all, or affecting our suppliers' ability to provide us with components or products. For example, the 2011 earthquake and tsunami in Japan adversely impacted our revenues from customers located in Japan and/or our ability to source parts from companies located in Japan. Shortly after the earthquake, we received notice from Toshiba (one of two manufacturers of the Neuron Chip - an important component that we and our customers use in control network devices), that they would no longer be able to manufacture Neuron Chips due to earthquake damage suffered at the semiconductor manufacturing facility that produced the Neuron Chips. However, the abrupt termination of Toshiba's Neuron Chip manufacturing capability caused a disruption in supply and an increase in prices from the remaining supplier, Cypress Semiconductor. We do not insure against several natural disasters, including earthquakes.

Any outbreak of a widespread communicable disease pandemic, such as the outbreak of the H1N1 influenza virus in 2009, could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K for the year ended December 31, 2016.

Market Risk Disclosures. The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

Interest Rate Sensitivity. We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10% from levels at March 31, 2017 and December 31, 2016, the fair value of the portfolio would decline by an immaterial amount. We currently intend to hold our fixed income investments until maturity, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. However, if necessary, we may sell short-term investments prior to maturity to meet the liquidity needs of the company.

Foreign Currency Exchange Risk. We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. If foreign exchange rates were to fluctuate by 10% from rates at March 31, 2017, and December 31, 2016, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

In addition, for our cost of goods sold, our products are generally assembled by CEMs in China, although our transactions with these vendors have historically been denominated in U.S. dollars. These vendors may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Effectiveness of Disclosure Controls and Procedures

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this

Table of Contents

evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of March 31, 2017.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended March 31, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION
ITEM 1. LEGAL PROCEEDINGS

For a discussion regarding our legal proceedings and matters, please refer to the “Legal Actions” section of Note 6, Commitments and Contingencies, to our condensed consolidated financial statements included under Item 1 of Part I, Financial Information, which information is incorporated herein by reference.
ITEM 1A. RISK FACTORS

A restated description of the risk factors associated with our business is included under “Factors That May Affect Future Results of Operations” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contained in Item 2 of Part I of this report. This description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Item 1A of our 2016 Annual Report on Form 10-K and is incorporated herein by reference.
ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
The following table provides information about the repurchase of our common stock during the quarter ended March 31, 2017:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
January 1 - January 31	820	$ 4.83	—	—
February 1 - February 28	653	$ 4.93	—	—
March 1 - March 31	1,640	$ 6.00	—	—
Total	3,113	$ 5.47	—	—

(1) Shares purchased represent those shares surrendered to us by employees in order to satisfy stock-for-stock option exercises, also commonly referred to as "net exercises", and/or withholding tax obligations related to stock-based compensation.

41

Table of Contents

ITEM 6. EXHIBITS

Exhibit No.	Description of Document
31.1 #	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 #	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32 **	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.
101.INS+	XBRL Instance Document
101.SCH+	XBRL Taxonomy Extension Schema
101.CAL+	XBRL Taxonomy Extension Calculation Linkbase
101.DEF+	XBRL Taxonomy Extension Definition Linkbase
101.LAB+	XBRL Taxonomy Extension Label Linkbase
101.PRE+	XBRL Taxonomy Extension Presentation Linkbase

Filed herewith

** The information in this exhibit is furnished and deemed not filed with the Securities and Exchange Commission for purposes of section 18 of the Exchange Act of 1934, as amended (the "Exchange Act"), and is not to be incorporated by reference into any filing of Echelon Corporation under the Securities Act of 1933, as amended (the "Securities Act"), or the Exchange Act, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

+ The financial information contained in these XBRL documents is unaudited and is furnished, not filed with the Securities and Exchange Commission.

42

Table of Contents

SIGNATURE

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

			ECHELON CORPORATION
Date:	May 11, 2017	By:	/s/ C. Michael Marszewski
			C. Michael Marszewski Vice President and Chief Financial Officer (Duly Authorized Officer and Principal Financial Officer)

43

Table of Contents

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31.1 #	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 #	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32 **	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.
101.INS+	XBRL Instance Document
101.SCH+	XBRL Taxonomy Extension Schema
101.CAL+	XBRL Taxonomy Extension Calculation Linkbase
101.DEF+	XBRL Taxonomy Extension Definition Linkbase
101.LAB+	XBRL Taxonomy Extension Label Linkbase
101.PRE+	XBRL Taxonomy Extension Presentation Linkbase

Filed herewith

** The information in this exhibit is furnished and deemed not filed with the Securities and Exchange Commission for purposes of section 18 of the Exchange Act of 1934, as amended (the “Exchange Act”), and is not to be incorporated by reference into any filing of Echelon Corporation under the Securities Act of 1933, as amended (the “Securities Act”), or the Exchange Act, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

+ The financial information contained in these XBRL documents is unaudited and is furnished, not filed with the Securities and Exchange Commission.

44