CAVIUM, INC.
Form 10-Q
August 03, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

OR

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

For the transition period from to

Commission file number: 001-33435

CAVIUM, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE	**77-0558625**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
2315 N. First Street	
San Jose, California	**95131**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (408) 943-7100

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

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

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

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

The number of shares of the Registrant s Common Stock, $0.001 par value, outstanding as of July 30, 2012 was: 49,801,191

Table of Contents

CAVIUM, INC.

QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

CAVIUM, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(unaudited)

	June 30, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 61,352	$ 63,225
Accounts receivable, net of allowances of $1,387 and $694, respectively	37,804	37,839
Inventories	42,096	41,719
Prepaid expenses and other current assets	4,211	3,177
Deferred income taxes	5,604	5,604
Total current assets	151,067	151,564
Property and equipment, net	19,583	17,027
Intangible assets, net	76,249	54,215
Goodwill	101,402	101,402
Deferred income taxes	38,382	34,490
Other assets	1,388	1,559
Total assets	$ 388,071	$ 360,257
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 18,702	$ 13,528
Accrued expenses and other current liabilities	7,321	9,022
Deferred revenue	15,630	11,202
Capital lease and technology license obligations, current portion	11,159	6,385
Total current liabilities	52,812	40,137
Capital lease and technology license obligations, net of current portion	18,656	719
Deferred tax liability	5,946	5,946
Other non-current liabilities	2,664	2,762
Total liabilities	80,078	49,564
Commitments and contingencies (Note 11)		
Stockholders equity		
Common stock, par value $0.001:		
200,000,000 shares authorized; 49,780,946 and 49,103,352 shares issued and outstanding as of June 30, 2012 and December 31, 2011, respectively	50	49
Additional paid-in capital	375,071	352,104
Accumulated deficit	(67,128)	(41,460)

Total stockholders equity	307,993	310,693
Total liabilities and stockholders equity	$ 388,071	$ 360,257

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

3

Table of Contents

CAVIUM, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net revenue	$ 55,287	$ 71,615	$ 108,030	$ 135,185
Cost of revenue	24,749	28,698	52,757	53,523
Gross profit	30,538	42,917	55,273	81,662
Operating expenses:				
Research and development	26,123	23,660	53,181	44,382
Sales, general and administrative	18,489	17,554	30,973	34,457
Total operating expenses	44,612	41,214	84,154	78,839
Income (loss) from operations	(14,074)	1,703	(28,881)	2,823
Other expense, net:				
Interest expense	(22)	(63)	(54)	(136)
Other, net	(14)	49	(108)	11
Total other expense, net	(36)	(14)	(162)	(125)
Income (loss) before income taxes	(14,110)	1,689	(29,043)	2,698
Benefit from income taxes	(2,271)	(233)	(3,375)	(716)
Net income (loss)	$ (11,839)	$ 1,922	$ (25,668)	$ 3,414
Net income (loss) per common share, basic	$ (0.24)	$ 0.04	$ (0.52)	$ 0.07
Shares used in computing basic net income (loss) per common share	49,664	48,381	49,494	47,740
Net income (loss) per common share, diluted	$ (0.24)	$ 0.04	$ (0.52)	$ 0.07
Shares used in computing diluted net income (loss) per common share	49,664	51,104	49,494	50,540

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

Table of Contents

CAVIUM, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Cash flows from operating activities:		
Net income (loss)	$ (25,668)	$ 3,414
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Stock-based compensation expense	19,800	14,293
Depreciation and amortization	14,667	10,916
Deferred income taxes	(3,893)	(1,138)
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	34	(16,276)
Inventories	(424)	7,097
Prepaid expenses and other current assets	(65)	(1,339)
Other assets	172	(202)
Accounts payable	811	(3,311)
Deferred revenue	4,427	(434)
Accrued expenses and other current and non-current liabilities	(1,231)	994
Net cash provided by operating activities	8,630	14,014
Cash flows from investing activities:		
Purchases of property and equipment	(4,685)	(5,547)
Convertible notes receivable	(968)	
Acquisition of businesses, net of cash acquired		(30,780)
Purchases of intangible assets	(2,735)	(2,781)
Net cash used in investing activities	(8,388)	(39,108)
Cash flows from financing activities:		
Proceeds from issuance of common stock upon exercise of options	2,650	10,297
Principal payment of capital lease and technology license obligations	(4,765)	(6,643)
Net cash provided by (used in) financing activities	(2,115)	3,654
Net decrease in cash and cash equivalents	(1,873)	(21,440)
Cash and cash equivalents, beginning of period	63,225	90,673
Cash and cash equivalents, end of period	$ 61,352	$ 69,233
Supplemental disclosure of cash flow from investing activities		
Property and equipment and intangible assets acquired included in accounts payable	$ 4,740	$
Property and equipment and intangible assets acquired included in capital lease and technology license obligations	$ 27,381	$ 5,649

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

5

Table of Contents

CAVIUM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Organization and Significant Accounting Policies

Organization

Cavium, Inc., (the Company), was incorporated in the state of California on November 21, 2000 and was reincorporated in the state of Delaware effective February 6, 2007. Effective June 17, 2011, the Company changed its corporate name from Cavium Networks, Inc. to Cavium, Inc. The Company designs, develops and markets semiconductor processors for intelligent and secure networks.

The Company completed the acquisition of substantially all of the assets of Wavesat Inc. (Wavesat) on January 25, 2011 and Celestial Semiconductor, Ltd. (Celestial Semiconductor) on March 4, 2011. For a complete discussion of the Company s acquisition of Wavesat and Celestial Semiconductor, see Note 5.

Summary of Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements include the accounts of Cavium, Inc. and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or US GAAP, and pursuant to the rules and regulations of the Securities and Exchange Commission or SEC. Accordingly, they do not include all of the information and footnotes required by US GAAP for annual financial statements. For further information, these financial statements should be read in conjunction with the Company s Annual Report on Form 10-K (File No. 001-33435) on file with the SEC for the year ended December 31, 2011.

The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly the Company s condensed consolidated financial position at June 30, 2012, and the condensed consolidated results of its operations for the three and six months ended June 30, 2012 and 2011, and condensed consolidated statements of cash flows for the six months ended June 30, 2012 and 2011. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at December 31, 2011 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP.

During the six months ended June 30, 2012, there were no significant changes to the significant accounting policies and estimates discussed in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, except for the adoption of the new standard on goodwill impairment effective January 1, 2012 as discussed below.

Goodwill Impairment

The Company performs a qualitative analysis at the end of each reporting period to determine if any events have occurred or circumstances exist that would indicate that it is more likely than not that a goodwill impairment exists. The qualitative factors the Company reviews include, but are not limited to: (a) macroeconomic conditions; (b) industry and market considerations ; (c) overall financial performance; (d) a significant adverse change in legal factors or in the business climate; (e) an adverse action or assessment by a regulator; (f) relevant entity-specific events including changes in management, strategy or customers; (g) a more-likely-than-not expectation of sale or disposal of a reporting unit or a significant portion thereof; or (h) sustained decrease in share price.

Table of Contents

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in its condensed consolidated financial statements and accompanying notes. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis of making judgments about the carrying values of assets and liabilities. Actual results could differ from those estimates.

Concentration of Risk

The Company s products are currently manufactured, assembled and tested by third-party contractors in Asia. There are no long-term agreements with any of these contractors. A significant disruption in the operations of one or more of these contractors would impact the production of the Company s products for a substantial period of time, which could have a material adverse effect on the Company s business, financial condition and results of operations.

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and accounts receivable. The Company deposits cash with credit worthy financial institutions primarily located in the United States. The Company has not experienced any losses on its deposits of cash. Management believes that the financial institutions are reputable and, accordingly, minimal credit risk exists. The Company follows an established investment policy and set of guidelines to monitor, manage and limit the Company s exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits the Company s exposure to any one issuer, as well as the maximum exposure to various asset classes.

The Company performs ongoing credit evaluations of its customers financial condition and, generally, requires no collateral from its customers. The Company provides an allowance for doubtful accounts based upon the expected collectability of accounts receivable.

Summarized below are individual customers whose accounts receivable balances were 10% or higher of the consolidated gross accounts receivable:

	As of June 30, 2012
Percentage of gross accounts receivable	
Flextronics	11%
Honhai	11%

The end customer representing greater than 10% of the consolidated net revenue for each of the periods presented was:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Percentage of total net revenue				
Cisco	29%	27%	29%	24%

2. Net Income (Loss) Per Common Share

The Company calculates basic net income (loss) per common share by dividing net income (loss) by the weighted average number of common shares outstanding during the reporting period (excluding shares subject to repurchase). Diluted net income (loss) per common share is computed by dividing net income (loss) by the weighted-average number of common and potentially dilutive common shares outstanding during the reporting period. Potentially dilutive securities are composed of incremental common shares issuable upon the exercise of stock options and restricted stock units. The dilutive effect of outstanding shares is reflected in diluted earnings per share by application of the treasury stock method. This method includes consideration of the amounts to be paid by the employees if the instrument was exercised and the amount of unrecognized stock-based compensation related to future services. No potential dilutive common shares are included in the computation of any diluted per share amount when a net loss is reported.

Table of Contents

The following table sets forth the computation of net income (loss) per share:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
	(in thousands, except per share data)			
Net income (loss)	$ (11,839)	$ 1,922	$ (25,668)	$ 3,414
Weighted average common shares outstanding - basic	49,664	48,381	49,494	47,740
Dilutive effect of employee stock plans		2,723		2,800
Weighted average common shares outstanding - diluted	49,664	51,104	49,494	50,540
Basic net income (loss) per share	$ (0.24)	$ 0.04	$ (0.52)	$ 0.07
Diluted net income (loss) per share	$ (0.24)	$ 0.04	$ (0.52)	$ 0.07

The following outstanding options and restricted stock units were excluded from the computation of diluted net income per common share for the periods presented because including them would have had an anti-dilutive effect:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
	(in thousands)			
Options to purchase common stock	4,647		4,647	
Restricted stock units	2,260		2,260	

3. Fair Value Measurements

At June 30, 2012 and December 31, 2011, all of the Company s investments were classified as cash equivalents and are comprised of an investment in a money market fund. In accordance with the guidance provided under fair value measurements and disclosures, the Company determined the fair value hierarchy of its money market fund as Level 1 (Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access), which approximated $42.7 million and $47.7 million as of June 30, 2012 and December 31, 2011, respectively.

4. Balance Sheet Components

Inventories are comprised of the following:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
Work-in-process	$ 32,777	$ 31,419
Finished goods	9,319	10,300
	$ 42,096	$ 41,719

Table of Contents

Property and equipment, net, consist of the following:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
Mask costs and test equipment	$ 29,713	$ 24,204
Software, computer and other equipment	29,043	25,789
Furniture, office equipment and leasehold improvements	957	784
	59,713	50,777
Less: accumulated depreciation and amortization	(40,130)	(33,750)
	$ 19,583	$ 17,027

Depreciation and amortization expense was $3.0 million and $3.0 million for the three months ended June 30, 2012 and 2011, respectively, and $6.5 million and $5.5 million for the six months ended June 30, 2012 and 2011, respectively.

The Company leases certain design tools under time-based capital lease arrangements which are included in property and equipment, net, which total cost amounted to $14.1 and $13.2 million at June 30, 2012 and December 31, 2011, respectively. Amortization expense related to assets recorded under capital leasing agreements was $1.1 million and $1.0 million for the three months ended June 30, 2012 and 2011, respectively, and $2.1 million and $2.0 million for the six months ended June 30, 2012 and 2011, respectively.

Accrued expenses and other current liabilities consist of the following:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
Accrued compensation and related benefits	$ 4,213	$ 4,451
Professional fees	864	1,011
Restructuring related payables	687	1,140
Deferred compensation		568
Income tax payable	437	760
Other	1,120	1,092
	$ 7,321	$ 9,022

Warranty Accrual

The following table presents a reconciliation of the warranty liability, which is included within other in the accrued expenses and other current liabilities above:

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
	(in thousands)			
Beginning balance	$ 410	$ 285	$ 412	$ 234
Accruals	59	151	278	347
Settlements and adjustments made	(46)	(82)	(267)	(227)
Ending balance	$ 423	$ 354	$ 423	$ 354

9

Table of Contents

Deferred revenue consists of the following:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
Services / Support and Maintenance	$ 8,588	$ 4,176
Software License / Subscription	4,716	4,683
Distributors	2,326	2,343
	$ 15,630	$ 11,202

Other non-current liabilities consist of the following:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
Accrued rent	$ 671	$ 750
Restructuring related payables	158	920
Income tax payable	953	248
Other	882	844
	$ 2,664	$ 2,762

5. Business Combination

Wavesat Inc.

On January 25, 2011, the Company completed the acquisition of substantially all of the assets of Wavesat Inc. (Wavesat) for a total purchase price consisting of cash consideration of $10.0 million and loan advances made prior to the closing of acquisition amounting to $500,000. The acquisition has been accounted for using the purchase method of accounting in accordance with the business combination standards. Under the purchase accounting method, the total estimated purchase consideration of the acquisition was allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their relative fair values. The excess of the purchase consideration over the net tangible and identifiable intangible assets acquired and liabilities assumed was recorded as goodwill. The Company expensed the related transaction costs amounting to $1.2 million incurred during the six months ended June 30, 2011 associated with the acquisition and recorded the costs in the sales, general and administrative expenses in the condensed consolidated statements of operations. No such transaction costs were incurred during the six months ended June 30, 2012.

The purchase price allocation was as follows:

	Amount (in thousands)
Net tangible liabilities	$ (1,912)
In-process research and development	800
Other identifiable intangible assets	3,700
Goodwill	7,912
Total purchase price	$ 10,500

Table of Contents

The following represents details of the purchased other identifiable intangible assets as part of the acquisition:

	Estimated useful life (in years)	Amount (in thousands)
Existing technology	6.0	$ 2,500
Core technology	6.0	900
Trademarks	6.0	300
Total		$ 3,700

The fair value of the acquired in-process research and development (IPR&D) was determined based on an income approach using the discounted cash flow method and was initially recognized and classified as indefinite-lived assets until it was abandoned during the fourth quarter of 2011. Accordingly, the initially recognized fair value of the IPR&D amounting to $800,000 was charged to selling and general administrative expense within total operating expenses.

The fair value of the existing technology was determined based on an income approach using the discounted cash flow method its remaining useful life was based on historical product development cycles, the projected rate of technology attrition, and the pattern of projected economic benefit of the asset. The fair value of core technology and trademark were determined using a variation of income approach known as profit allocation method and its estimated useful life was determined based on the future economic benefit expected to be received from the assets. During the fourth quarter of 2011, the Company determined to write-down the carrying value of the existing technology, core technology and trademarks as a result of the assessment of the recoverability and future benefit from the assets. The write-down of $2.4 million was charged to selling and general administrative expense within total operating expenses. The remaining carrying value of the existing and core technology will be amortized over the estimated useful life of 3 years.

This acquisition added multicore wireless digital system processing to the Company s embedded processor product line. This factor contributed to a purchase price resulting in the recognition of goodwill. This acquisition is related to the Company s semiconductor products reportable segment. Of the total acquired goodwill from Wavesat, approximately $4.2 million is expected to be deductible for tax purposes in future periods.

Celestial Semiconductor, Ltd.

On March 4, 2011, the Company completed the acquisition of substantially all of the assets and assumed certain liabilities of Celestial Semiconductor, Ltd. (Celestial Semiconductor) for an aggregate purchase price consisting of a mix of cash and shares of the Company s common stock. In addition, the Company agreed to pay an additional earn-out consideration determined based on a certain percentage of the qualified earn-out revenue for the 12 months following the close of the acquisition as specified in the asset purchase agreement. The acquisition has been accounted for using the purchase method of accounting in accordance with the business combination standards. Under the purchase accounting method, the total estimated purchase consideration of the acquisition was allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their relative fair values. The excess of the purchase consideration over the net tangible and identifiable intangible assets acquired and liabilities assumed was recorded as goodwill. The Company expensed the related transaction costs amounting to $914,000 incurred during the six months ended June 30, 2011 associated with the acquisition and recorded the costs in the sales, general and administrative expense in the condensed consolidated statements of operations. No such transaction costs were incurred during the six months ended June 30, 2012.

Following summarizes the total purchase price consideration:

	Amount (in thousands)
Cash consideration	$ 20,606
Common stock (758,265 shares at $43.86 per share)	33,258
Estimated fair value of the contingent earn-out consideration to other selling shareholders	3,432

Total	$	57,296

Table of Contents

In February 2012, the Company filed an indemnity notice and escrow claim against Celestial Semiconductor for the escrow fund amounting to $4.4 million. The claim alleged Celestial Semiconductor breached certain representations made in the asset purchase agreement. The claim was settled on March 21, 2012 and the full amount of the escrow was released to the Company. Since the related settlement claim does not establish a clear and direct link to the acquisition price, the Company reflected the receipt of the settlement proceeds in the statement of operations in the first quarter of 2012 as a credit to sales, general and administrative expenses within total operating expenses.

The total common stock issued to Celestial Semiconductor was determined by dividing the purchase price consideration of $35.0 million as per the asset purchase agreement with the Company s average stock price of $43.41, or total equivalent common stock of 806,265 shares. The average stock price was determined based on the average closing price reported on NASDAQ for the 15 trading days ending five trading days prior to March 1, 2011. The Company, Celestial Semiconductor and a former executive of Celestial Semiconductor, who became an employee of the Company, entered into a holdback share agreement to hold 48,000 shares issued to such executive in an escrow account. Such holdback shares would vest and would be released to such executive over two years following the acquisition date subject to the terms and conditions of continued employment with the Company. Accordingly, the fair value of such shares at the closing date, approximately $2.1 million, was not included in the purchase price and would be accounted for as liability-classified stock-based compensation and recognized ratably over the vesting period of two years. The vested shares are marked-to-market at each reporting period and the related compensation liability is recorded as deferred compensation in accrued expenses and other current liabilities and reclassified to stockholders equity upon release of the vested shares. During the first quarter of 2012, the Company released 4,733 vested shares in accordance with the vesting term per the holdback share agreement. In April 2012, the Company and such executive signed an employment separation agreement wherein as part of the employment separation package, the Company agreed to release the remaining holdback shares to such executive at the separation date. Accordingly, the Company recognized the stock-based compensation expense related to the accelerated vesting of such remaining holdback shares at the separation date. Total stock-based compensation expense recorded as sales, general and administrative expenses related to such holdback shares for three and six months ended June 30, 2012 amounted to $517,000 and $753,000, respectively.

The contingent earn-out provision of up to $10.0 million was expected to be allocated approximately $5.0 million to certain employees of Celestial Semiconductor who became employees of the Company (affected employees) and approximately $5.0 million to other selling shareholders who did not become employees of the Company (other selling shareholders). The contingent earn-out is determined based on a certain percentage of the qualified earn-out revenue for the 12 months following the close of the acquisition as specified in the asset purchase agreement. The estimated initial fair value of the earn-out liability was determined using the weighted probabilities of the achievement of the qualified earn-out revenue discounted using the estimated cost of debt.

The initial fair value of the earn-out liability expected to be distributed to other selling shareholders amounted to $3.4 million and was accounted for as part of the purchase price and was recorded as acquisition related payables in accrued expense and other current liabilities. The initial fair value of the earn-out liability to be distributed to the affected employees amounted to $3.4 million and was not considered to be a component of the purchase price. Instead, considering the terms of employment, compensation expense was recognized ratably over a one year period beginning on the acquisition date. As of the second quarter of 2011, the Company recorded $1.1 million as accrued compensation and related benefits in accrued expense and other current liabilities. In accordance with the business combination guidance, any changes in the fair value of the contingent earn-out consideration subsequent to the acquisition date, including changes from events after the acquisition date, are recognized in earnings in the period the estimated fair value changes. During the third quarter of 2011, management determined that the qualifying earn-out revenue would likely not be achieved due to a delay in the customers product roll-out. As such, management assessed that the initial contingent earn-out liability totaling $4.6 million would likely not be paid out, and thus, the related liability was reversed within sales, general and administrative expenses within total operating expenses. The qualifying earn-out was not achieved within the earn-out period which expired on March 4, 2012, the first year anniversary of the acquisition.

The purchase price allocation was as follows:

	Amount (in thousands)
Net tangible assets	$ 436
In-process research and development	600
Other identifiable intangible assets	20,000
Goodwill	36,260
Total purchase price	$ 57,296

12

The following table represents details of the purchased other identifiable intangible assets as part of the acquisition:

	Estimated useful life (in years)	Amount (in thousands)
Existing technology	4.0	$ 11,300
Core technology	4.0	3,000
Customer contracts and relationships	7.0	4,600
Trademarks	4.0	1,000
Order backlog	1.0	100
Total		$ 20,000

The fair value of the IPR&D assets was determined based on an income approach using the discounted cash flow method and was initially recognized at and classified as indefinite-lived assets until the successful completion and abandonment of the associated research and development projects. During the fourth quarter of 2011, the Company determined to abandon one of the two IPR&D projects. As such, the related initial fair value of such IPR&D project amounting to $305,000 was charged to selling, general and administrative expense within total operating expenses. The other IPR&D project with an initial fair value of $295,000 was completed in the fourth quarter of 2011, thus was classified as part of finite-lived intangible assets, and is amortized over the estimated useful life of five years.

The fair value of the existing technology and customer contracts and relationships were determined based on an income approach using the discounted cash flow method. The remaining useful life for the existing technology was based on historical product development cycles, the projected rate of technology attrition, and the pattern of projected economic benefit of the asset. The remaining useful life of customer contracts and relationships was estimated based on customer attrition, new customer acquisition and future economic benefit of the asset. The fair value of core technology and trademark were determined using a variation of income approach known as profit allocation method. The fair value of the order backlog was determined using a cost approach where the fair value was based on estimated sales and marketing expenses expected that would have to be incurred to regenerate the order backlog. The estimated useful lives for both assets were determined based on the future economic benefit expected to be received from the asset.

With the acquisition of Celestial Semiconductor, the Company added a processor family targeted for the market of digital media players. This factor contributed to a purchase price resulting in the recognition of goodwill, which was allocated to the Company s semiconductor products reportable segment. Of the total acquired goodwill from Celestial Semiconductor, approximately $17.5 million is expected to be deductible for tax purposes in future periods. The change in the deductible goodwill amount from December 31, 2011 was due to the release of escrow to the Company in the first quarter of 2012 .

Pro forma financial information

The unaudited pro forma financial information in the table below summarizes the combined results of operations of the Company, Wavesat and Celestial Semiconductor, as though the acquisition of the companies had occurred as of the beginning of the comparable prior annual reporting period. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of the comparable prior annual reporting period as presented (in thousands).

	Net Revenue	Net Loss
	(in thousands)	
Actual from acquisition dates to June 30, 2011	$ 2,011	$ (8,712)
Supplemental pro forma from January 1, 2011 to June 30, 2011	135,505	(1,033)

The supplemental pro forma net loss from January 1, 2011 to June 30, 2011 was adjusted to exclude $5.4 million of acquisition related costs incurred during the six months ended June 30, 2011 and include $826,000 intangible amortization calculated from January 1, 2011 to the respective acquisition dates.

Table of Contents

6. Goodwill and Intangible Assets, Net

Goodwill

The following table presents the changes in the carrying amount of goodwill:

	Semiconductor Products	Software and Services (in thousands)	Total
Balance at December 31, 2011	$ 56,389	$ 45,013	$ 101,402
Additions			
Adjustments			
Balance at June 30, 2012	$ 56,389	$ 45,013	$ 101,402

The result of the annual impairment test performed by the Company during the fourth quarter of 2011 showed that the estimated fair value of the semiconductor reporting unit exceeded its carrying value with significant headroom while for software and services reporting unit, the estimated fair value exceeded its carrying value by approximately 33%. The Company continues to monitor the impact of recent market and economic events to determine if impairment indicators exist. No such triggering event occurred during the first or second quarter of 2012 to cause the Company to perform an interim impairment test.

Intangible assets, net consisted of the following:

	As of June 30, 2012			
	Gross	Accumulated Amortization (in thousands)	Net	Weighted average remaining amortization period (years)
Existing and core technology - product	$ 48,052	$ (27,531)	$ 20,521	3.17
Technology licenses	65,832	(16,596)	49,236	8.08
Customer contracts and relationships	8,991	(3,615)	5,376	4.95
Trade name	2,296	(1,180)	1,116	2.60
Order backlog	640	(640)		0.00
Total amortizable intangible assets	$ 125,811	$ (49,562)	$ 76,249	6.46

	As of December 31, 2011			
	Gross	Accumulated Amortization (in thousands)	Net	Weighted average remaining amortization period (years)
Existing and core technology - product	$ 48,052	$ (23,386)	$ 24,666	3.61
Technology licenses	35,630	(13,390)	22,240	6.97
Customer contracts and relationships	8,991	(3,031)	5,960	5.41
Trade name	2,296	(964)	1,332	3.10
Order backlog	640	(623)	17	0.17
Total amortizable intangible assets	$ 95,609	$ (41,394)	$ 54,215	5.18

Intangible assets include among others, technology licenses, core technology, customer contracts and relationships acquired either as a result of business acquisitions or licensing from third party vendors. Significant additions to the intangible assets during the six months ended June 30, 2012 relates to licensed technologies which include an architecture license, patent licenses and other technology licenses.

14

Amortization expense was $4.1 million and $3.3 million for the three months ended June 30, 2012 and 2011, respectively, and $8.2 million and $5.4 million for the six months ended June 30, 2012 and 2011, respectively. The estimated future amortization expense from amortizable intangible assets is as follows (in thousands):

Remainder of 2012	$ 9,442
2013	18,339
2014	15,238
2015	7,712
2016	5,819
2017 and thereafter	19,699
	$ 76,249

7. Restructuring Accrual

In connection with the acquisition of MontaVista in 2009, the Company assumed a restructuring related liability of $1.3 million. The liability is related to the operating lease facility for the portion of the facility that MontaVista no longer occupied. In December 2011, the MontaVista operation was moved to the Company s principal office in San Jose, California. As such, the remaining portion of the leased facility of MontaVista is no longer occupied. The Company recorded an additional restructuring accrual of $918,000 in 2011 for such remaining portion of the leased facility. During the first quarter of 2012, the Company entered into a lease settlement agreement for the entire facility to buy out the remaining lease term for $925,000, which was settled during the three months ended June 30, 2012.

In the first quarter of 2012, the Company recorded an additional restructuring accrual amounting to $420,000 related to the leased facility of Wavesat in Canada which will no longer be occupied. The Company expects the Wavesat obligation to be settled by March 2014.

In connection with a workforce reduction during the three months ended June 30, 2012, the Company incurred $1.2 million in expense primarily related to severance and other related benefits. These charges were recorded as sale, general and administrative expense in the operating expenses. The remaining severance and other related benefits liability is expected to be paid in the third quarter of 2012.

A summary of the accrued restructuring liabilities, net of related activities during the six months ended June 30, 2012 is as follows (in thousands):

	Excess facility related costs	Severance and other benefits (in thousands)	Total
Accrued restructuring - December 31, 2011	$ 1,388	$	$ 1,388
Additions	420	1,245	1,665
Cash payments and other non-cash adjustments	(1,440)	(768)	(2,208)
Accrued restructuring - June 30, 2012	368	477	845
Less: current portion	210	477	687
Long-term portion	$ 158	$	$ 158

8. Stockholders Equity

Equity Incentive Plans

The description of the key features of the Company s 2007 Equity Incentive Plan and 2001 Stock Incentive Plan may be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

Table of Contents

The following table summarizes the details related to stock options granted and outstanding under the 2007 Equity Incentive Plan and 2001 Stock Incentive Plan for the six months ended June 30, 2012:

	Number of Shares Outstanding	Weighted Average Exercise Price
Balance as of December 31, 2011	4,651,720	$ 15.25
Options granted	333,750	34.10
Options exercised	(205,878)	12.87
Options cancelled and forfeited	(132,823)	24.40
Balance as of June 30, 2012	4,646,769	$ 16.44

The fair value of each employee option grant for the three and six months ended June 30, 2012 and 2011 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Three months ended June 30, 2012		Six months ended June 30, 2012	
	2012	2011	2012	2011
Risk-free interest rate	0.57%	1.22%	0.57% to 0.83%	1.22% - 1.64%
Expected life	4.08 years	4.53 years	4.08 - 4.53 years	4.53 years
Dividend yield	0%	0%	0%	0%
Volatility	51.3%	54.0%	51.3% - 53.6%	54.0% - 54.5%

For options granted prior to 2012, the expected volatility of common stock at the date of grant was based on reported market value data of a group of publicly traded companies, which were selected from certain market indices, that the Company believed was relatively comparable after consideration of their size, stage of life cycle, profitability, growth, and risk and return of investments. Further, the expected term was estimated using the simplified method as permitted by the provisions on stock-based compensation. The implied volatility and simplified method to estimate the expected term were determined considering that the Company had a limited trading history. Since the Company s stock has been publicly traded beginning May 2007, it deemed that it has sufficient trading history to use the historical volatility for option grants beginning in the first quarter of 2012.

The estimated weighted-average grant date fair value of options granted were $10.46 and $18.90 per share for the three months ended June 30, 2012 and 2011, respectively, and $14.90 and $17.31 per share for the six months ended June 30, 2012 and 2011, respectively.

As of June 30, 2012, there was $13.7 million of unrecognized compensation costs, net of estimated forfeitures, related to stock options granted under the Company s 2007 Equity Incentive Plan and 2001 Stock Incentive Plan. The unrecognized compensation cost is expected to be recognized over a weighted average period of 1.99 years.

The following table summarizes the details related to restricted stock units, or RSUs, granted and outstanding under the 2007 Equity Incentive Plan for the six months ended June 30, 2012:

	Number of Shares	Weighted-Average Grant Date Fair Value Per Share
Balance as of December 31, 2011	1,952,605	$ 30.33
Granted	992,372	35.22
Issued and released	(471,715)	28.98
Cancelled and forfeited	(213,457)	30.60
Balance as of June 30, 2012	2,259,805	$ 32.73

For restricted stock units, or RSUs, stock-based compensation expense is calculated based on the market price of the Company s common stock on the date of grant, multiplied by the number of RSUs granted. The grant date fair value of RSUs, less estimated forfeitures, is recorded on a straight-line basis, over the vesting period.

As of June 30, 2012, there was $64.7 million of unrecognized compensation costs, net of estimated forfeitures related to RSUs granted under the Company s 2007 Equity Incentive Plan. The unrecognized compensation cost is expected to be recognized over a weighted average period of 2.72 years.

Table of Contents

Stock-Based Compensation

The Company recognizes stock-based compensation for options and RSUs granted to employees in accordance with the fair value recognition provisions authoritative guidance as provided under stock-based compensation. In addition, the Company also recognized stock-based compensation for holdback shares issued related to the Celestial Semiconductor acquisition (See Note 5). The following table presents the detail of stock-based compensation expense amounts included in the condensed consolidated statement of operations for each of the periods presented:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
	(in thousands)			
Cost of revenue	$ 551	$ 438	$ 1,068	$ 805
Research and development	4,436	3,674	8,502	6,382
Sales, general and administrative	5,800	4,195	10,230	7,106
	$ 10,787	$ 8,307	$ 19,800	$ 14,293

The total stock-based compensation cost capitalized as part of inventory as of June 30, 2012 and December 31, 2011 were not significant.

9. Income Taxes

The quarterly tax provision for (benefit from) income taxes was based on the estimated annual effective tax rate, plus any discrete items. The Company updates its estimate of its annual effective tax rate at the end of each quarterly period. The estimate takes into account estimations of annual pre-tax income, the geographic mix of pre-tax income and interpretations of tax laws and the possible outcomes of current and future audits.

The following table presents the provision for (benefit from) income taxes and the effective tax rates for the three and six months ended June 30, 2012 and 2011:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
	(in thousands)			
Income (loss) before income taxes	$ (14,110)	$ 1,689	$ (29,043)	$ 2,698
Benefit from income taxes	(2,271)	(233)	(3,375)	(716)
Effective tax rate	16.1%	-13.8%	11.6%	-26.5%

The benefit from income taxes for the three and six months ended June 30, 2012 was primarily related to the year-to-date pre-tax losses and the release of uncertain tax position reserves. The benefit from income taxes for the three and six months ended June 30, 2011 was mainly attributable to a tax provision for federal, state and foreign income taxes reduced by a discrete tax benefit. The discrete benefit in the three and six months ended June 30, 2011 was solely related to increased federal research and development credits that resulted from the exercise of compensatory stock options. The federal research and development credits expired at the end of 2011 and the related tax benefit was not included in the 2012 tax analysis.

The difference between the provision for (benefit from) income taxes that would be derived by applying the statutory rate to the Company s loss before tax and the benefit from income taxes actually recorded for the three and six months ended June 30, 2012 was primarily attributable to the impact of the difference in foreign tax rates, non-deductible stock-based compensation charges and other non-deductible items. The difference between the provision for (benefit from) income taxes that would be derived by applying the statutory rate to the Company s net income before tax and the benefit from income taxes actually recorded for the three and six months ended June 30, 2011 was primarily attributable to the impact of the differential in foreign tax rates, non-deductible stock-based compensation charges, and the federal research and development credit benefits.

The Company s net deferred tax assets relate predominantly to its United States tax jurisdiction. The valuation allowance is determined in accordance with the provisions of income taxes which require an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction-by-jurisdiction basis. During the year ended December 31, 2010, the Company released its valuation allowance against its United States federal deferred tax assets because the Company believed that sufficient positive evidence existed from historical operations and future projections to conclude that it was more-likely-than-not to fully realize its federal deferred tax assets. In

Table of Contents

making this determination, the Company considered all available evidence, both positive and negative. Such evidence include, among others, the Company s history of losses and profitability, jurisdictional income recognition trends, taxable income adjusted for certain extraordinary and other items, the impact of acquisitions, and forecasted income by jurisdiction. As of December 31, 2011 and June 30, 2012, the Company believes that it is more-likely-than-not that a valuation allowance is not required against its United States federal deferred tax assets. The Company continues to maintain a full valuation allowance against its California and Massachusetts deferred tax assets of $12.8 million because the likelihood of the realization of those assets have not become more-likely-than-not.

The Company continues to monitor the likelihood that it will be able to recover its deferred tax assets. If recovery is not likely, the Company must increase its provision for taxes by recording a valuation allowance against the deferred tax assets that it estimates will not be ultimately recoverable. Recovery is dependent on generating sufficient taxable income in the future. Although recovery is not assured, the Company believes that it is more-likely-than-not that it will ultimately recover the $34.1 million of deferred tax assets recorded on its consolidated balance sheets as of December 31, 2011 (other than that for California and Massachusetts), even in light of the losses in recent quarters due to the expectation of returning to profitability in the immediately succeeding years. However, should there be a change in the Company s ability to recover its deferred tax assets, the tax provision would increase in the period in which it determined that the likelihood of recovery was less than more-likely-than-not.

As of June 30, 2012 and December 31, 2011, the Company had unrecognized tax benefits for income taxes associated with uncertain tax positions of $11.2 million, each respectively. If all of these unrecognized tax benefits were recognized, $10.1 million would reduce the Company s effective tax rate. The Company is not anticipating any significant changes in unrecognized tax benefits in the next 12 months.

The major jurisdictions in which the Company is subject to income tax reporting requirements are the U.S. federal, the states of California and Massachusetts, Japan, India, China and Singapore. The Company believes it is compliant with all income tax return filing and payment requirements in the major jurisdictions. As of June 30, 2012, the Company was not aware of any on-going tax audits in the major jurisdictions.

10. Segment and Geographic Information

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or CODM, in deciding how to allocate resources and in assessing performance. The Company has determined that it operates in two reportable segments, namely: (1) semiconductor products; and (2) software and services.

The two reportable segments are based upon the Company s internal organizational structure, the manner in which the operations are managed, the criteria used by the CODM to evaluate segment performance and the availability of separate financial information. The accounting policies for the segment reporting are the same as for the Company as a whole. The financial information used by the Company s CODM to evaluate segments results are net revenue and income from segment operations.

Selected segment financial information for the Company s reportable segments was as follows:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
	(in thousands)			
Net revenue:				
Semiconductor products	$ 49,102	$ 61,300	$ 93,965	$ 110,935
Software and services	6,185	10,315	14,065	24,250
Total consolidated net revenue	$ 55,287	$ 71,615	$ 108,030	$ 135,185
Segment income:				
Semiconductor products	$ 4,857	$ 18,587	$ 7,383	$ 31,582
Software and services	(116)	2,195	305	8,242
Total segment income from operations	$ 4,741	$ 20,782	$ 7,688	$ 39,824

18

Table of Contents

The following is a reconciliation of the total segment income from reportable segments to the total consolidated income (loss) before income taxes:

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
	(in thousands)			
Segment income from reportable segments	$ 4,741	$ 20,782	$ 7,688	$ 39,824
Unallocated stock compensation and related taxes	(11,120)	(8,898)	(20,695)	(15,783)
Amortization of acquired intangible assets	(2,472)	(2,656)	(4,961)	(4,496)
Acquisition and restructuring related expenses	(1,716)	(4,897)	(8,813)	(11,184)
Proceeds received from settlement of an escrow claim			4,414	
Unallocated corporate, general and administrative expenses	(3,507)	(2,628)	(6,514)	(5,538)
Total consolidated income (loss) from operations	(14,074)	1,703	(28,881)	2,823
Other (expense) income, net	(36)	(14)	(162)	(125)
Total consolidated income (loss) before income taxes	$ (14,110)	$ 1,689	$ (29,043)	$ 2,698

The following table is based on the geographic location of the original equipment manufacturers, the contract manufacturers or the distributors who purchased the Company s products. For sales to the distributors, their geographic location may be different from the geographic locations of the ultimate end customers. Sales by geography for the periods indicated were as follows:

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
	(in thousands)			
United States	$ 13,360	$ 21,348	$ 32,998	$ 43,117
China	17,902	20,757	31,589	36,356
Taiwan	6,769	11,947	12,322	18,334
Japan	2,211	3,002	4,983	9,009
Malaysia	3,678	4,492	8,164	8,265
Korea	3,278	3,061	6,001	5,777
Other countries	8,089	7,008	11,973	14,327
Total	$ 55,287	$ 71,615	$ 108,030	$ 135,185

The following table sets forth long lived assets, which consist primarily of property and equipment, net by geographic regions:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
United States	$ 14,864	$ 13,941
All other countries	4,719	3,086
Total	$ 19,583	$ 17,027

11. Commitments and Contingencies

The Company is not currently a party to any legal proceedings that the outcome of which, if determined adversely to the Company, would have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

The Company leases its facilities under non-cancelable operating leases, which contain renewal options and escalation clauses, and expire on various dates ending in February 2019. The Company also acquires certain assets under capital leases.

Table of Contents

Minimum commitments under non-cancelable operating and capital lease agreements, excluding accrued restructuring liability (See Note 7) as of June 30, 2012 were as follows:

	Capital lease and technology license obligations	Operating leases	Total
		(in thousands)	
Remainder of 2012	$ 9,392	$ 1,933	$ 11,325
2013	7,034	3,590	10,624
2014	5,175	2,639	7,814
2015	5,150	2,637	7,787
2016	5,150	2,716	7,866
2017 thereafter		6,167	6,167
	$ 31,901	$ 19,682	$ 51,583
Less: Interest component (3.75% to 5.5% annual rate)	(2,086)		
Present value of minimum lease payment	29,815		
Less: current portion	(11,159)		
Long-term portion of obligations	$ 18,656		

On March 16, 2011, the Company entered into a lease agreement with a landlord to lease approximately 113,400 sq. ft. in a building located in San Jose, California. The lease term is 7.75 years beginning on June 1, 2011 and ending on February 28, 2019. This leased facility is currently held as the Company s principal executive office, which accommodates the principal software engineering, sales and marketing, operations and finance and administrative activities.

Rent expense incurred under operating leases was $1.3 million and $1.3 million for the three months ended June 30, 2012 and 2011 and $2.8 million and $2.3 million for the six months ended June 30, 2012 and 2011, respectively.

The capital lease and technology license obligations include future cash payments payable primarily for license agreements with various outside vendors. For license agreements which qualify under capital lease and where installment payments extend beyond one year, the present value of the future installment payments are capitalized and included as part of intangible assets or property and equipment which is amortized over the estimated useful lives of the related licenses.

As of June 30, 2012, the Company had a funding commitment of $1.0 million for a convertible note receivable which was funded in July 2012.

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

The following discussion should be read in conjunction with the Consolidated Condensed Financial Statements and the related notes that appear elsewhere in this document.

The information in this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act), which are subject to the safe harbor created by those sections. Forward-looking statements are based on our management s beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, estimate, project, predict, potential, continue, strategy, believe, anticipate, plan, expect, intend and similar expression intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. We discuss many of these risks, uncertainties and other factors in this Quarterly Report on Form 10-Q in greater detail under the heading Risk Factors. Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this Quarterly Report on Form 10-Q completely and with the understanding that our actual future results may be materially different from what we expect. We *hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.*

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Overview

We are a provider of highly integrated semiconductor processors that enable intelligent processing for networking, communications, storage, wireless, security, video and connected home and office applications. Our products allow our customers to develop networking, wireless, storage and electronic equipment that is application-aware and content-aware and securely processes voice, video and data traffic at high speeds. Our products are systems on a chip, or SoCs, which incorporate single or multiple processor cores, a highly integrated architecture and customizable software that is based on a broad range of standard operating systems. We focus our resources on the design, sales and marketing of our products, and outsource the manufacturing of our products.

From our incorporation in 2000 through 2003, we were primarily engaged in the design and development of our first processor family, NITROX, which we began shipping commercially in 2003. In 2004, we introduced and commenced commercial shipments of NITROX Soho. In 2006, we commenced our first commercial shipments of our OCTEON family of multi-core MIPS64® processors. We introduced a number of new products within all three of these product families in 2006. In 2007 we introduced our new line of OCTEON based storage services processors designed to address the specific needs in the storage market, as well as other new products in the OCTEON and NITROX families. In 2008, we expanded our OCTEON and NITROX product families with new products including wireless services processors to address the needs for wireless infrastructure equipment. In 2009, we announced the OCTEON II Internet Application Processor (IAP) family multi-core MIPS64® processors, with one to 32 cores to address next generation networking applications support converged voice, video, data mobile traffic and services. In 2010, we announced the next generation NITROX III, a processor family with 16 to 64-cores that delivers security and compression processors for application delivery, cloud computing and wide area network optimization. In 2011, we introduced NEURON, a new search processor product family that targets a wide range of high performance, L2-L4 network search applications in enterprise and service provider infrastructure equipment. In 2011, we also introduced another new product family, the OCTEON Fusion, a single chip SoCs with up to 6x MIPS64 cores and up to 8x LTE/3G baseband DSP cores which enable macro base station class features for small cell base stations. In 2012, we introduced OCTEON III, Cavium s 48-core 2.5GHz multi-core processor family that can deliver up to 100Gbps of application processing, up to 120GHz of 64-bit compute processing per chip and can be connected in multi-chip configurations.

In August 2008, we acquired Star Communications, Inc. With the acquisition of Star, we added the Star ARM-based processors to our portfolio to address connected home and office applications and have since introduced our ECONA line of dual-core ARM processors that address a large variety of connected home and office applications.

In December 2008, we acquired W&W Communications, Inc. This acquisition launched us into the video processor market with our PureVu product line. These products address the need for video processing in wireless displays, teleconferencing, gaming and other applications.

In December 2009, we acquired MontaVista Software, Inc. This acquisition complements our broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market.

In October 2010, we acquired Celestial Systems, Inc. With the acquisition of Celestial Systems, we gained additional professional services such as Automotive Infotainment Systems, Digital Media product development and Android commercialization and support.

In January 2011, we acquired Wavesat Inc. This acquisition added multicore wireless digital system processing to our embedded processor product line.

In March 2011, we acquired Celestial Semiconductor, Ltd. With the acquisition of Celestial Semiconductor, we added a processor family targeted for the market of digital media players.

For a complete discussion on our recent acquisitions, see Note 5 of Unaudited Condensed Consolidated Financial Statements.

Since inception, we have invested heavily in new product development and our net revenue has grown from $7.4 million in 2004 to $259.2 million in 2011 driven primarily by demand in the enterprise network, data center and access and service provider markets and increased demand in the broadband and consumer markets. For the six months ended June 30, 2012, our net revenue was $108.0 million. We expect sales of our products for use in the enterprise network, data center and access and service provider markets to continue to represent a significant portion of our revenue in the foreseeable future, however, we do expect growth in the broadband and consumer markets.

Table of Contents

We primarily sell our products to OEMs, either directly or through their contract manufacturers. Contract manufacturers purchase our products only when an OEM incorporates our product into the OEM s product, not as commercial off-the-shelf products. Our customers products are complex and require significant time to define, design and ramp to volume production. Accordingly, our sales cycle is long. This cycle begins with our technical marketing, sales and field application engineers engaging with our customers system designers and management, which is typically a multi-month process. If we are successful, a customer will decide to incorporate our product in its product, which we refer to as a design win. Because the sales cycles for our products are long, we incur expenses to develop and sell our products, regardless of whether we achieve the design win and well in advance of generating revenue, if any, from those expenditures. We do not have long-term purchase commitments from any of our customers, as sales of our products are generally made under individual purchase orders. However, once one of our products is incorporated into a customer s design, it is likely to remain designed in for the life cycle of the product. We believe this to be the case because a redesign would generally be time consuming and expensive. We have experienced revenue growth due to an increase in the number of our products, an expansion of our customer base, an increase in the number of average design wins within any one customer and an increase in the average revenue per design win.

Our revenue from MontaVista is mainly from sale of software subscriptions of embedded Linux operating system, related development tools, support and professional services. The net revenue for our software and services are primarily derived from the sale of time-based software licenses, software maintenance and support, and from professional services arrangements and training.

Key Business Metrics for Semiconductor Products

Design Wins. We closely monitor design wins by customer and end market on a periodic basis. We consider design wins to be a key ingredient in our future success, although the revenue generated by each design win can vary significantly. Our long-term sales expectations are based on internal forecasts from specific customer design wins based upon the expected time to market for end customer products deploying our products and associated revenue potential.

Pricing and Margins. Pricing and margins depend on the features of the products we provide to our customers. In general, products with more complex configurations and higher performance tend to be priced higher and have higher gross margins. These configurations tend to be used in high performance applications that are focused on the enterprise network, data center, and access and service provider markets. We tend to experience price decreases over the life cycle of our products, which can vary by market and application. In general, we experience less pricing volatility with customers that sell to the enterprise and data center markets.

Sales Volume. A typical design win can generate a wide range of sales volumes for our products, depending on the end market demand for our customers products. This can depend on several factors, including the reputation, market penetration, the size of the end market that the product addresses, and the marketing and sales effectiveness of our customer. In general, our customers with greater market penetration and better branding tend to develop products that generate larger volumes over the product life cycle. In addition, some markets generate large volumes if the end market product is adopted by the mass market.

Customer Product Life Cycle. We typically commence commercial shipments from nine months to three years following a design win. Once our product is in production, revenue from a particular customer may continue for several years. We estimate our customers product life cycles based on the customer, type of product and end market. In general, products that go into the enterprise network and data center take longer to reach volume production but tend to have longer lives. Products for other markets, such as broadband and consumer, tend to ramp relatively quickly, but generally have shorter life cycles. We estimate these life cycles based on our management s experience with providers of networking equipment and the semiconductor market as a whole.

Table of Contents

Results of Operations

Three and six months ended June 30, 2012 and 2011

Our net revenue, cost of revenue, gross profit and gross margin for the periods presented were:

	Three months ended June 30,				Six months ended June 30,			
	2012	2011	change	%	2012	2011	change	%
	(in thousands)				(in thousands)			
Net revenue	$ 55,287	$ 71,615	$ (16,328)	-22.8%	$ 108,030	$ 135,185	$ (27,155)	-20.1%
Cost of revenue	24,749	28,698	(3,949)	-13.8%	52,757	53,523	(766)	-1.4%
Gross Profit	$ 30,538	$ 42,917	$ (12,379)	-28.8%	$ 55,273	$ 81,662	$ (26,389)	-32.3%
Gross Margin	55.2%	59.9%	-4.7%		51.2%	60.4%	-9.2%	

Net Revenue. Our net revenue consists primarily of sales of our semiconductor products to providers of networking equipment and their contract manufacturers and distributors. Initial sales of our products for a new design are usually made directly to providers of networking equipment as they design and develop their product. Once their design enters production, they often outsource their manufacturing to contract manufacturers that purchase our products directly from us or from our distributors. We price our products based on market and competitive conditions and periodically reduce the price of our products, as market and competitive conditions change, and as manufacturing costs are reduced. We do not experience different margins on direct sales to providers of networking equipment and indirect sales through contract manufacturers because in all cases we negotiate product pricing directly with the providers of networking equipment. To date, most of our revenue has been denominated in U.S. dollars.

Our sole end customer representing greater than 10% of net revenue for the three and six months ended June 30, 2012 and 2011 was Cisco. Cisco accounted for 29% and 27% of the net revenue for the three months ended June 30, 2012 and 2011, respectively, and 29% and 24% for the six months ended June 30, 2012 and 2011, respectively.

Revenue and costs relating to sales to distributors are deferred if we grant more than limited rights of returns and price credits or if we cannot reasonably estimate the level of returns and credits issuable. We have an existing agreement with a certain distributor to distribute our products primarily in the United States. Given the terms of the distribution agreement, for sales to this distributor, revenue and costs are deferred until products are sold to its end customers. For the three months ended June 30, 2012 and 2011, 5.7% and 5.9%, respectively, and for the six months ended June 30, 2012 and 2011, 5.7% and 5.3%, respectively, of our net revenues were from products sold by this distributor. Revenue recognition depends on notification from this distributor that product has been sold to its end customers.

Our distributors, other than the distributor discussed above, are used primarily to support international sale logistics in Asia, including importation and credit management. Total net revenue through these distributors was $18.6 million and $21.7 million for the three months ended June 30, 2012 and 2011, respectively, which accounted for 33.7% and 30.3% of net revenue, respectively, and $36.3 million and $39.1 million for the six months ended June 30, 2012 and 2011, respectively, which accounted for 33.6% and 28.9% of net revenue, respectively. The inventory at these distributors at the end of the period may fluctuate from time to time mainly due to the OEM production ramps and new customer demands. While we have purchase agreements with our distributors, the distributors do not have long-term contracts with any of the equipment providers. Our distributor agreements limit the distributor s ability to return product up to a portion of purchases in the preceding quarter. Given our experience, along with our distributors limited contractual return rights, we believe we can reasonably estimate expected returns from our distributors. Accordingly, we recognize sales through distributors at the time of shipment, reduced by our estimate of expected returns.

Revenue derived from licensing software and providing software maintenance, support and training amounted to $3.5 million and $4.7 million for the three months ended June 30, 2012 and 2011, respectively and $8.1 million and $11.0 million for the six months ended June 30, 2012 and 2011, respectively. Revenue from professional service arrangements amounted to $2.7 million and $5.7 million for the three months ended June 30, 2012 and 2011, respectively, and $6.0 million and $13.2 million for the six months ended June 30, 2012 and 2011, respectively.

Our net revenue decreased by $16.3 million or 22.8% and $27.2 million or 20.1% in the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011. The decrease in net revenue was attributable to the decrease in sales of $8.1 million and $14.1 million for the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011, from our enterprise network; data center; and access and service provider markets, combined, and the decrease of $4.1 million and $8.7 million in net revenue for the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011 from our software and services. The decrease in sales in our enterprise networks; data center; and access and service provider markets was mainly due to the decline in demand for our products from our top 20 customers which was generally impacted by the timing of these customers volume production of our design wins. The decrease in net revenue from our software and services was mainly driven by the timing of completion of existing large professional service agreements as well as a decrease in the rate of execution of new professional service contracts. In addition, net revenue in broadband and consumer markets decreased by $4.1 million and $4.4 million for the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011 due mainly to lower customers demand.

Table of Contents

The following table is based on the geographic location of our customers including the original equipment manufacturers, contract manufacturers or the distributors who purchased our products and services. For sales to our distributors, their geographic location may be different from the geographic locations of the ultimate end customers. Sales by geography for the periods presented were:

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
	(in thousands)			
United States	$ 13,360	$ 21,348	$ 32,998	$ 43,117
China	17,902	20,757	31,589	36,356
Taiwan	6,769	11,947	12,322	18,334
Japan	2,211	3,002	4,983	9,009
Malaysia	3,678	4,492	8,164	8,265
Korea	3,278	3,061	6,001	5,777
Other countries	8,089	7,008	11,973	14,327
Total	$ 55,287	$ 71,615	$ 108,030	$ 135,185

Cost of Revenue and Gross Margin. We outsource wafer fabrication, assembly and test functions of our products. A significant portion of our cost of revenue consists of payments for the purchase of wafers and for assembly and test services, amortization of acquired intangibles and amortization related to capitalized mask costs. To a lesser extent, cost of revenue includes expenses relating to our internal operations that manage our contractors, stock-based compensation, the cost of shipping and logistics, royalties, inventory valuation expenses for excess and obsolete inventories, warranty costs and changes in product cost due to changes in sort, assembly and test yields. In general, our cost of revenue associated with a particular product declines over time as a result of yield improvements, primarily associated with design and test enhancements.

We use third-party foundries and assembly and test contractors, which are primarily located in Asia, to manufacture, assemble and test our semiconductor products. We purchase processed wafers on a per wafer basis from our fabrication suppliers, which are currently Taiwan Semiconductor Manufacturing Company, or TSMC, with the remaining manufacturing outsourced to Samsung Electronics, or Samsung, Fujitsu Microelectronics, or Fujitsu and United Microelectronics Corporation, or UMC. We also outsource the sort, assembly, final testing and other processing of our product to third-party contractors, primarily ASE Electronics in Taiwan, Malaysia and Singapore, as well as ISE Labs, Inc, in the United States. We negotiate wafer fabrication on a purchase order basis and do not have long-term agreements with any of our third-party contractors.

Our gross margin has been and will continue to be affected by a variety of factors, including the product mix, average sales prices of our products, the amortization expense associated with the acquired intangible assets, the timing of cost reductions for fabricated wafers and assembly and test service costs, inventory valuation charges, the cost of fabrication masks that are capitalized and amortized, and the timing and changes in sort, assembly and test yields. Overall gross margin is impacted by the mix between higher performance, higher margin products and services and lower performance, lower margin products and services. In addition, we typically experience lower yields and higher associated costs on new products, which improve as production volumes increase.

Gross margin decreased from 59.9% in the three months ended June 30, 2011 to 55.2% in the three months ended June 30, 2012, a decrease of 4.7% and a decrease from 60.4% in the six months ended June 30, 2011 to 51.2% in the six months ended June 30, 2012, a decrease of 9.2%. The decrease in the overall gross margin percentage for the three months ended June 30, 2012 compared to the same period in 2011 was mainly due to overall decrease in revenue and shift of product sales mix of our semiconductor product as we sold more of our lower performance products, which yields lower gross margins compared to our higher performance products. The decreased in overall gross margin for the six months ended June 30, 2012 compared to the same period in 2011 was primarily due to the overall decrease in revenue and increase in cost of sales due to write-downs of Celestial product inventories of approximately $4.8 million during the first quarter of 2012. In addition, the overall product sales mix contributed, to a lesser extent, to the decrease in the overall gross margin.

Research and Development Expenses

Research and development expenses primarily include personnel costs, engineering design development software and hardware tools, allocated facilities expenses and depreciation of equipment used in research and development, and stock-based compensation.

Table of Contents

Total research and development expenses for the periods presented were:

	Three months ended June 30,				Six months ended June 30,			
	2012	2011	change	%	2012	2011	change	%
	(in thousands)				(in thousands)			
Research and development expenses	$ 26,123	$ 23,660	$ 2,463	10.4%	$ 53,181	$ 44,382	$ 8,799	19.8%
Percent of total net revenue	47.2%	33.0%	14.2%		49.2%	32.8%	16.4%	

Research and development expenses increased by $2.5 million or 10.4% in the three months ended June 30, 2012 and increased by $8.8 million or 19.8% in the six months ended June 30, 2012 compared to the same periods in 2011. The increase was primarily due to higher salaries and benefit expenses of $664,000 and $3.4 million in the three and six months ended June 30, 2012, respectively, and stock-based compensation expense and related taxes of $664,000 and $1.8 million in the three and six months ended June 30, 2012, respectively compared to the same periods in 2011 as a result of increased headcount, severance and other related benefits to certain employees affected by a work-force reduction during the second quarter of 2012 and additional expense associated with the options and restricted stock unit grants. In addition, depreciation and amortization expense increased by $958,000 and $2.4 million in the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011 mainly due to higher amortization expense from acquired technology licenses used for research and development projects. The remaining increase was due to higher facilities expenses, software maintenance costs and other miscellaneous research and development costs which resulted from increased research and development activities to support the development of our new products. Research and development headcount increased to 558 at June 30, 2012 compared to 520 at June 30, 2011.

Sales, General and Administrative Expenses

Sales, general and administrative expenses primarily include personnel costs, accounting and legal fees, information systems, sales commissions, trade shows, marketing programs, depreciation, allocated facilities expenses and stock-based compensation.

Total sales, general and administrative costs for the periods presented were:

	Three months ended June 30,				Six months ended June 30,			
	2012	2011	change	%	2012	2011	change	%
	(in thousands)				(in thousands)			
Sales, general and administrative	$ 18,489	$ 17,554	$ 935	5.3%	$ 30,973	$ 34,457	$ (3,484)	-10.1%
Percent of total net revenue	33.4%	24.5%	8.9%		28.7%	25.5%	3.2%	

Sales, general and administrative expenses increased by $935,000 or 5.3% in the three months ended June 30, 2012, and decreased by $3.5 million or 10.1% in the six months ended June 30, 2012, compared to the same periods in 2011. Excluding the one-time credit of $4.4 million due to the receipt of proceeds from an escrow claim related to Celestial Semiconductor acquisition in the first quarter of 2012, total sales, general and administrative expenses for the six months ended June 30, 2012 increased by $930,000 or 2.7% compared to the same period in 2011. The increase was mainly due to the higher stock-based compensation and related taxes of $1.5 million and $2.8 million for the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011 as a result of additional expense associated with the options and restricted unit grants and vesting acceleration related to a workforce reduction during the second quarter of 2012. Outside services, which includes legal, audit and consulting fees remained flat for the three months ended June 30, 2012 and decreased for the six months ended June 30, 2012 by $2.2 million compared to the same periods in 2011 mainly as a result of the timing of when the costs were incurred generally for acquisition related services. Salaries and employee benefits decreased by $732,000 for the three months ended June 30, 2012 but remained flat for the six months ended June 30, 2012 compared to the same periods in 2011 mainly due to decreased headcount and lower cost incurred for retention and certain bonuses related to acquisition, which was partially or fully offset by severance and other related benefit cost to certain employees affected by a work-force reduction during the second quarter of 2012. Sales, general and administrative headcount decreased to 173 at June 30, 2012 from 185 at June 30, 2011.

Table of Contents

Other income (expense), net. Other income (expense), net primarily includes interest expense associated with the installment payment of capital leases, foreign currency gains and losses, financing expenses and interest income on cash and cash equivalents.

	Three months ended June 30,				Six months ended June 30,			
	2012	2011	change	%	2012	2011	change	%
	(in thousands)				(in thousands)			
Interest expense	$ (22)	$ (63)	$ 41	-65.1%	$ (54)	$ (136)	$ 82	-60.3%
Other, net	(14)	49	(63)	-128.6%	(108)	11	(119)	-1081.8%
Total other expense, net	$ (36)	$ (14)	$ (22)	157.1%	$ (162)	$ (125)	$ (37)	29.6%

Other expense, net increased in the three and six months ended June 30, 2012 compared to the same periods in 2011 mainly due to higher foreign exchange loss resulting from balance sheet remeasurement, which was partially offset by lower interest expense associated with installment payment of capitalized leases.

Benefit from Income Taxes. For the three and six months ended June 30, 2012 and 2011, the tax benefit from income taxes was based on our estimated annual effective tax rate, plus any discrete items, in compliance with applicable guidance. We update our estimate of our annual effective tax rate at the end of each quarterly period. Our estimate takes into account estimations of annual pre-tax income, the geographic mix of pre-tax income and our interpretations of tax laws and the possible outcomes of current and future audits.

The following table presents the benefit from income taxes and the effective tax rates for the respective periods presented:

	Three months ended June 30,				Six months ended June 30,			
	2012	2011	change	%	2012	2011	change	%
	(in thousands)				(in thousands)			
Income (loss) before income taxes	$ (14,110)	$ 1,689	$ (15,799)	-935.4%	$ (29,043)	$ 2,698	$ (31,741)	-1176.5%
Benefit from income taxes	(2,271)	(233)	(2,038)	874.7%	(3,375)	(716)	(2,659)	371.4%
Effective tax rate	16.1%	-13.8%	29.9%		11.6%	-26.5%	38.1%	

The benefit from income taxes for the three and six months ended June 30, 2012 was primarily related to the year-to-date pre-tax losses and release of uncertain position reserves. The benefit from income taxes for the three and six months ended June 30, 2012 was mainly attributable to a tax provision for federal, state and foreign income taxes reduced by a discrete tax benefit. The discrete benefit in the three and six months end June 30, 2011 was solely related to increased federal research and development credits that resulted from the exercise of compensatory stock options. The federal research and development credits expired at the end of 2011 and the related tax benefit was not included in the 2012 tax analysis.

The difference between the provision for (benefit from) income taxes that would be derived by applying the statutory rate to our loss before tax and the benefit from income taxes actually recorded for the three and six months ended June 30, 2012 was primarily attributable to the impact of the difference in foreign tax rates, non-deductible stock-based compensation charges and other non-deductible items. The difference between the provision for (benefit from) income taxes that would have been derived by applying the statutory rate our net income before tax and the benefit from income taxes actually recorded for the three and six months ended June 30, 2011 was primarily attributable to the impact of the differential in foreign tax rates, non-deductible stock-based compensation charges and the federal research and development credit benefits.

Our net deferred tax assets relate predominantly to the United States tax jurisdiction. The valuation allowance is determined in accordance with the provisions of income taxes which require an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction-by-jurisdiction basis. During the year ended December 31, 2010, we released our valuation allowance against the United States federal deferred tax assets because we believed that sufficient positive evidence existed from historical operations and future projections to conclude that it was more-likely-than-not to fully realize our federal deferred tax assets. In making this determination,

26

Table of Contents

we considered all available evidence, both positive and negative. Such evidence include, among others, our history of losses and profitability, jurisdictional income recognition trends, taxable income adjusted for certain extraordinary and other items, the impact of acquisitions, and forecasted income by jurisdiction. As of December 31, 2011 and June 30, 2012, we believe that it is more-likely-than-not that a valuation allowance is not required against our United States federal deferred tax assets. We continue to maintain a full valuation allowance against our California and Massachusetts deferred tax assets of $12.8 million because the likelihood of the realization of those assets have not become more-likely-than-not.

We continue to monitor the likelihood that we will be able to recover our deferred tax assets. If recovery is not likely, we must increase our provision for taxes by recording a valuation allowance against the deferred tax assets that our estimate will not be ultimately recoverable. Recovery is dependent on generating sufficient taxable income in the future. Although recovery is not assured, we believe that it is more-likely-than-not that we will ultimately recover the $34.1 million of deferred tax assets recorded on our consolidated balance sheets as of December 31, 2011 (other than that for California and Massachusetts), even in light of the losses in recent quarters due to the expectation of returning to profitability in the immediately succeeding years. However, should there be a change in our ability to recover its deferred tax assets, the tax provision would increase in the period in which we determined that the likelihood of recovery was less than more-likely-than-not.

As of June 30, 2012 and December 31, 2011, we had unrecognized tax benefits for income taxes associated with uncertain tax positions of $11.2 million, each respectively. If all of these unrecognized tax benefits were recognized, $10.1 million would reduce our effective tax rate. We are not anticipating any significant changes in unrecognized tax benefits in the next 12 months.

Our major jurisdictions in which we are subject to income tax reporting requirements are the U.S. federal, the states of California and Massachusetts, Japan, India, China and Singapore. We believe we are compliant with all income tax return filing and payment requirements in the major jurisdictions. As of June 30, 2012, we were not aware of any on-going tax audits in the major jurisdictions.

Liquidity and Capital Resources

Following is a summary of our working capital and cash and cash equivalents as of June 30, 2012 and December 31, 2011:

	As of June 30, 2012	As of December 31, 2011
	(in thousands)	
Working capital	$ 98,255	$ 111,427
Cash and cash equivalents	$ 61,352	$ 63,225

Following is a summary of our cash flows from operating activities, investing activities and financing activities for the periods presented:

	Six months ended June 30, 2012	2011
	(in thousands)	
Net cash provided by operating activities	$ 8,630	$ 14,014
Net cash used in investing activities	$ (8,388)	$ (39,108)
Net cash provided by (used in) financing activities	$ (2,115)	$ 3,654

Cash Flows from Operating Activities

Net cash flows from operating activities decreased by $5.4 million from $14.0 million in the six months ended June 30, 2011 compared to $8.6 million in the six months ended June 30, 2012. Net loss after adjustments of non-cash operating items was $4.9 million cash inflow in the six months ended June 30, 2012 compared to net income after adjustments of non-cash operating items of $27.5 million cash inflow in the six months ended June 30, 2011. The decrease resulted mainly from lower net revenue which generated lower income from operations. Changes in assets and liabilities generated net cash inflow of $3.7 million for the six months ended June 30, 2012 compared to a net cash outflow of $13.5 million for the six months ended June 30, 2011. The significant changes in assets and liabilities for the six months ended June 30, 2012 were mainly due to higher accounts payable due to the timing of payments to vendors and higher deferred revenue due to the timing of the receipt of subscription licenses and professional services billings from the customers. Inventory was slightly up mainly due to the timing of inventory build-up in

Table of Contents

anticipation for the expected future customer demands. Accounts receivable remained flat resulted from lower net revenue and timing of collection. The significant changes in assets and liabilities for the six months ended June 30, 2011 were mainly due to higher accounts receivable as a result of higher net revenue and the timing of collection and lower accounts payable, net of assumed liabilities from acquisitions as a result of timing of payments to vendors. This was partially offset by the decrease in inventory as a result of higher shipments to customers and timing of inventory build-up.

Cash Flows from Investing Activities

Net cash used in investing activities for the six months ended June 30, 2012 was $8.4 million resulted mainly from the payments made to purchase property and equipment of $4.7 million, purchase of intangible assets of $2.7 million and cash advances for a convertible notes receivable of $1.0 million. Net cash used in investing activities for the six months ended June 30, 2011 was $39.1 million resulted mainly from cash payments made for business acquisitions of $30.8 million, purchases of property and equipment of $5.5 million and intangible assets of $2.8 million.

Cash Flows from Financing Activities

Net cash used in financing activities for the six months ended June 30, 2012 was $2.1 million which resulted mainly from principal payment of capital lease and technology license obligations of $4.8 million, partially offset by the proceeds from issuance of common stock upon exercise of options of $2.7 million. Net cash provided by financing activities for the six months ended June 30, 2011 was $3.7 million which resulted mainly from the issuance of common stock upon exercise of options of $10.3 million, partially offset by the principal payment of capital lease and technology license obligations of $6.6 million.

Capital Resources

Cash equivalents consist primarily of an investment in a money market fund. As of June 30, 2012, we have not experienced any impairment charges due to such concentration of credit risk. We believe that our $61.4 million of cash and cash equivalents at June 30, 2012 and expected cash flows from operations will be sufficient to fund our projected operating requirements for at least twelve months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our engineering, sales and marketing activities, the timing and extent of our expansion into new territories, the timing of introductions of new products and enhancements to existing products and the continuing market acceptance of our products. Although we currently are not a party to any agreement with respect to potential material investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Indemnities

In the ordinary course of business, we have entered into agreements with customers that include indemnity provisions. Based on historical experience and information known as of June 30, 2012, we believe our exposure related to the above indemnities at June 30, 2012 is not material. We also enter into indemnification agreements with our officers and directors and our certificate of incorporation and bylaws include similar indemnification obligations to our officers and directors. It is not possible to determine the amount of our liability related to these indemnification agreements and obligations to our officers and directors due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

Off-Balance Sheet Arrangements

During the periods presented, we did not have, nor do we currently have, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Table of Contents

Contractual Obligations

The following table describes our commitments to settle contractual obligations in cash as of June 30, 2012:

	Total	Payments Due By Period Remainder of 2012	1 to 3 Years	4 to 5 Years	More Than 5 Years
	(in thousands)				
Operating lease obligations	$ 22,480	$ 1,933	$ 8,866	$ 5,514	$ 6,167
Capital lease and technology license obligations	31,901	9,392	17,359	5,150	
Total	$ 54,381	$ 11,325	$ 26,225	$ 10,664	$ 6,167

As of June 30, 2012, the liability for uncertain tax positions was $943,000. The timing of any payments which could result from these unrecognized tax benefits will depend upon a number of factors. Accordingly, the timing of payment cannot be estimated.

As of June 30, 2012, we had a funding commitment of $1.0 million for a convertible note receivable which was funded in July 2012.

In addition, we have other obligations for goods and services entered into in the normal course of business. These obligations, however, are either not enforceable or legally binding or are subject to change based on our business decisions.

Critical Accounting Policies and Estimates

The preparation of our financial statements and accompanying disclosures in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and the accompanying notes. The SEC has defined a company s critical accounting policies as policies that are most important to the portrayal of a company s financial condition and results of operations, and which require a company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have identified our most critical accounting policies and estimates to be as follows: (1) revenue recognition; (2) stock-based compensation; (3) inventory valuation; (4) accounting for income taxes; (5) mask costs; (6) business combinations and (7) goodwill and purchased intangible assets. Although we believe that our estimates, assumptions and judgments are reasonable, they are based upon information not presently available. Actual results may differ significantly from these estimates if the assumptions, judgments and conditions upon which they are based turn out to be inaccurate. Management believes that there have been no significant changes to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations, in our Annual Report on Form 10-K for the year ended December 31, 2011 filed on February 27, 2012, except for the adoption of the new standard on goodwill impairment effective January 1, 2012, as discussed in Note 1 of Unaudited Condensed Consolidated Financial Statements.

Recent Accounting Pronouncements

Please refer to the recent accounting pronouncements listed in Note 1 of Unaudited Condensed Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

During the six months ended June 30, 2012, there were no material changes to our quantitative and qualitative disclosures about market risk related to our investment activities as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011 as filed with the SEC on February 27, 2012.

Item 4. *Controls and Procedures*

Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer evaluated, with the participation of our management, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of

June 30, 2012. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2012 that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1A. ***Risk Factors***

The following risks and uncertainties may have a material adverse effect on our business, financial condition or results of operations. Investors should carefully consider the risks described below before making an investment decision. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also significantly impair our business operations. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks, and investors may lose all or part of their investment.

We have marked with an asterisk (*) those risks described below that reflect substantive changes from the risks described under Item 1A. Risk Factors included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 27, 2012.

Risks Related to Our Business and Industry

We have a limited history of profitability, and we may not achieve or sustain profitability in the future, on a quarterly or annual basis.

We were established in 2000. Our first quarter of profitability since then was the quarter ended September 30, 2007 and we remained profitable through the quarter ended September 30, 2008. We incurred a net loss for the year ended December 31, 2009 and became profitable from the quarter ended June 30, 2010 through the quarter ended September 30, 2011. We incurred a net loss for the quarter ended December 31, 2011, for the quarter ended March 31, 2012 and for the quarter ended June 30, 2012. As of June 30, 2012, our accumulated deficit was $67.1 million. We expect to make significant expenditures related to the development of our products and expansion of our business, including research and development and sales and administrative expenses. Additionally, we may encounter unforeseen difficulties, complications, product delays and other unknown factors that require additional expenditures. As a result of these increased expenditures, we may have to generate and sustain substantially increased revenue to achieve profitability. Our revenue growth trends in prior periods may not be sustainable. Accordingly, we may not be able to achieve or maintain profitability and we may continue to incur losses in the future.

We expect our operating results to fluctuate.

We expect our revenues and expense levels to vary in the future, making it difficult to predict our future operating results. In particular, we experience variability in demand for our products as our customers manage their product introduction dates and their inventories. Given the current global economic uncertainty, the demand for our products may be more varied and difficult to ascertain in a timely and efficient manner.

Additional factors that could cause our results to fluctuate include, among other things:

- fluctuations in demand, sales cycles, product mix and prices for our products;
- The variability in lead time between the time when a customer begins to design in one of our products and the time when the customer s end system goes into production and they begin purchasing our products;
- the forecasting, scheduling, rescheduling or cancellation of orders by our customers;
- the timing of our new product introductions;
- our dependence on a few significant customers;

our ability to retain, recruit and hire key executives, technical personnel and other employees in the positions and numbers, and with the experience and capabilities that we need;

our ability to successfully define, design and release new products in a timely manner that meet our customers needs;

- changes in manufacturing costs, including wafer, test and assembly costs, mask costs, manufacturing yields and product quality and reliability;
- the timing and availability of adequate manufacturing capacity from our manufacturing suppliers;
- the timing of announcements by our competitors or us;
- future accounting pronouncements and changes in accounting policies;
- volatility in our stock price, which may lead to higher stock compensation expenses;
- general economic and political conditions in the countries where we operate or our products are sold or used;
- costs associated with litigation, especially related to intellectual property; and
- productivity and growth of our sales and marketing force.

Unfavorable changes in any of the above factors, most of which are beyond our control, could significantly harm our business and results of operations.

We have a limited operating history, and we may have difficulty accurately predicting our future revenues for the purpose of appropriately budgeting and adjusting our expenses.

We were established in 2000. Since we have had only ten quarters of operating profitability, we do not have an extended history from which to predict and manage profitability. Our limited operating experience, a dynamic and rapidly evolving market in which we sell our products, our dependence on a limited number of customers, as well as numerous other factors beyond our control, including general market conditions, impede our ability to forecast quarterly and annual revenues accurately. As a result, we could experience budgeting and cash flow management problems, unexpected fluctuations in our results of operations and other difficulties, any of which could make it difficult for us to attain and maintain profitability and could increase the volatility of the market price of our common stock.

We face intense competition and expect competition to increase in the future, which could reduce our revenue and customer base.

The market for our products is highly competitive and we expect competition to intensify in the future. This competition could make it more difficult for us to sell our products, and result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses and failure to increase, or the loss of, market share or expected market share, any of which would likely seriously harm our business, operating results and financial condition. For instance, semiconductor products have a history of declining prices as the cost of production is reduced. However, if market prices decrease faster than product costs, gross and operating margins can be adversely affected. Currently, we face competition from a number of established companies, including Broadcom Corporation, Freescale Semiconductor, Inc., Intel Corporation, Marvell Technology Group Ltd., and PMC-Sierra, Inc. In addition, in the video capture, process and display market segments we consider our competition to be companies that provide video encode and decode solutions, including Broadcom, Marvell and Wondermedia Technologies, Inc.

A few of our current competitors operate their own fabrication facilities and have, and some of our potential competitors could have, longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we have. Potential customers may prefer to purchase from their existing suppliers rather than a new supplier regardless of product performance or features.

We expect increased competition from other established and emerging companies both domestically and internationally. Our current and potential competitors may also establish cooperative relationships among themselves or with third parties. If so, new competitors or alliances that include our competitors may emerge that could acquire significant market share. We expect these trends to continue as companies attempt to strengthen or maintain their market positions in an evolving industry. In the future, further development by our competitors could cause our products to become obsolete. We expect continued competition from incumbents as well as from new entrants into the markets we serve. Our ability to compete depends on a number of factors, including:

our success in identifying new and emerging markets, applications and technologies and developing products for these markets;

our products performance and cost effectiveness relative to that of our competitors products;

Table of Contents

- our ability to deliver products in large volume on a timely basis at a competitive price;
- our success in utilizing new and proprietary technologies to offer products and features previously not available in the marketplace;
- our ability to recruit design and application engineers and sales and marketing personnel; and
- our ability to protect our intellectual property.

In addition, we cannot assure you that existing customers or potential customers will not develop their own products, purchase competitive products or acquire companies that use alternative methods to enable networking, communication or security applications to facilitate network-aware processing in their systems. Any of these competitive threats, alone or in combination with others, could seriously harm our business, operating results and financial condition.

Our customers may cancel their orders, change production quantities or delay production, and if we fail to forecast demand for our products accurately, we may incur product shortages, delays in product shipments or excess or insufficient product inventory.

We generally do not obtain firm, long-term purchase commitments from our customers. Because production lead times often exceed the amount of time required to fulfill orders, we often must build in advance of orders, relying on an imperfect demand forecast to project volumes and product mix. Our demand forecast accuracy can be adversely affected by a number of factors, including inaccurate forecasting by our customers, changes in market conditions, adverse changes in our product order mix and demand for our customers products. Even after an order is received, our customers may cancel these orders or request a decrease in production quantities. Any such cancellation or decrease subjects us to a number of risks, most notably that our projected sales will not materialize on schedule or at all, leading to unanticipated revenue shortfalls and excess or obsolete inventory which we may be unable to sell to other customers. Alternatively, if we are unable to project customer requirements accurately, we may not build enough products, which could lead to delays in product shipments and lost sales opportunities in the near term, as well as force our customers to identify alternative sources, which could affect our ongoing relationships with these customers. We have in the past had customers dramatically increase their requested production quantities with little or no advance notice. If we do not timely fulfill customer demands, our customers may cancel their orders. Either underestimating or overestimating demand could lead to insufficient, excess or obsolete inventory, which could harm our operating results, cash flow and financial condition, as well as our relationships with our customers.

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

As our business has grown to both customers located in the United States as well as customers located outside of the United States, we have become increasingly subject to the risks arising from adverse changes in both the domestic and global economic and political conditions. For example, the direction and relative strength of the U.S. and international economies remains uncertain due to softness in the housing markets, difficulties in the financial services sector and credit markets and continuing geopolitical uncertainties. If economic growth in the United States and other countries economies continues to slow, the demand for our customer s products could decline, which would then decrease demand for our products. Furthermore, if economic conditions in the countries into which our customers sell their products continue to deteriorate, some of our customers may decide to postpone or delay certain development programs, which would then delay their need to purchase our products. This could result in a reduction in sales of our products or in a reduction in the growth of our product sales. Any of these events would likely harm investors view of our business, and our results of operations and financial condition.

****We receive a substantial portion of our revenues from a limited number of customers, and the loss of, or a significant reduction in, orders from one or a few of our major customers would adversely affect our operations and financial condition.***

We receive a substantial portion of our revenues from a limited number of customers. We received an aggregate of approximately 48.5% and 44.9% of our net revenues from our top five customers for the six months ended June 30, 2012 and 2011, respectively. We received approximately 29% and 24% of our net revenue from Cisco for the six months ended June 30, 2012 and 2011 respectively. We anticipate that we will continue to be dependent on a limited number of customers for a significant portion of our revenues in the immediate future and in some cases the portion of our revenues attributable to certain customers may increase in the future. However, we may not be able to maintain or increase sales to certain of our top customers for a variety of reasons, including the following:

our agreements with our customers do not require them to purchase a minimum quantity of our products;

- some of our customers can stop incorporating our products into their own products with limited notice to us and suffer little or no penalty; and

- many of our customers have pre-existing or concurrent relationships with our current or potential competitors that may affect the customers decisions to purchase our products.

In the past, we have relied in significant part on our strategic relationships with customers that are technology leaders in our target markets. We intend to continue expanding such relationships and forming new strategic relationships but we cannot assure you that we will be able to do so. These relationships often require us to develop new products that may involve significant technological challenges. Our customers frequently place considerable pressure on us to meet their tight development schedules. Accordingly, we may have to devote a substantial amount of our resources to our strategic relationships, which could detract from or delay our completion of other important development projects. Delays in development could impair our relationships with our other strategic customers and negatively impact sales of the products under development. Moreover, it is possible that our customers may develop their own product or adopt a competitor s solution for products that they currently buy from us. If that happens, our sales would decline and our business, financial condition and results of operations could be materially and adversely affected.

In addition, our relationships with some customers may also deter other potential customers who compete with these customers from buying our products. To attract new customers or retain existing customers, we may offer certain customers favorable prices on our products. In that event, our average selling prices and gross margins would decline. The loss of a key customer, a reduction in sales to any key customer or our inability to attract new significant customers could seriously impact our revenue and materially and adversely affect our results of operations.

If we do not manage the risks associated with our large professional service contracts properly our revenue and customer base could be adversely affected.

The pricing and other terms of some of our larger professional services agreements require us to make estimates and assumptions at the time we enter into these contracts that could differ from actual results. Any increased or unexpected costs or unanticipated delays in connection with the performance of these engagements, including delays caused by factors outside our control, could make these agreements less profitable or unprofitable, which would have an adverse effect on the profit margin of our software and services business segment and adversely affect our operating results. In addition, changes in costs or a delay in connection with the performance of our large professional service agreements may harm our relationships with these customers.

We may not sustain our growth rate, and we may not be able to manage any future growth effectively.

We have experienced significant growth in a short period of time. Our net revenues increased from approximately $7.4 million in 2004 to $259.2 million in 2011. For the six months ended June 30, 2012, our net revenue was $108.0 million. We may not achieve similar growth rates in future periods. You should not rely on our operating results for any prior quarterly or annual periods as an indication of our future operating performance. If we are unable to maintain adequate revenue growth, our financial results could suffer and our stock price could decline.

To manage our growth successfully and to continue handling the responsibilities of being a public company, we believe we must effectively, among other things:

- recruit, hire, train and manage additional qualified engineers for our research and development activities, especially in the positions of design engineering, product and test engineering, and applications engineering;

- enhance our information technology support for enterprise resource planning and design engineering by adapting and expanding our systems and tool capabilities, and properly training new hires as to their use;

- expand our administrative, financial and operational systems, procedures and controls; and

- add additional sales personnel and expand sales offices.

If we are unable to manage our growth effectively, we may not be able to take advantage of market opportunities or develop new products and we may fail to satisfy customer requirements, maintain product quality, execute our business plan or respond to competitive pressures.

Table of Contents

The average selling prices of products in our markets have historically decreased over time and will likely do so in the future, which could harm our revenues and gross profits.

Average selling prices of semiconductor products in the markets we serve have historically decreased over time. Our gross profits and financial results will suffer if we are unable to offset any reductions in our average selling prices by reducing our costs, developing new or enhanced products on a timely basis with higher selling prices or gross profits, or increasing our sales volumes. Additionally, because we do not operate our own manufacturing, assembly or testing facilities, we may not be able to reduce our costs as rapidly as companies that operate their own facilities, and our costs may even increase, which could also reduce our margins.

We may be unsuccessful in developing and selling new products or in penetrating new markets.

We operate in a dynamic environment characterized by rapidly changing technologies and industry standards and technological obsolescence. Our competitiveness and future success depend on our ability to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost effective basis. A fundamental shift in technologies in any of our product markets could harm our competitive position within these markets. Our failure to anticipate these shifts, to develop new technologies or to react to changes in existing technologies could materially delay our development of new products, which could result in product obsolescence, decreased revenues and a loss of design wins to our competitors. The success of a new product depends on accurate forecasts of long-term market demand and future technological developments, as well as a variety of specific implementation factors, including:

- timely and efficient completion of process design and transfer to manufacturing, assembly and test processes;
- the quality, performance and reliability of the product; and
- effective marketing, sales and service.

If we fail to introduce new products that meet the demand of our customers or penetrate new markets that we target our resources on, our revenues will likely decrease over time and our financial condition could suffer. Additionally, if we concentrate resources on a new market that does not prove profitable or sustainable, our financial condition could decline.

****Fluctuations in the mix of products sold may adversely affect our financial results.***

Because of the wide price differences among our processors, the mix and types of performance capabilities of processors sold affect the average selling price of our products and have a substantial impact on our revenue. Generally, sales of higher performance products have higher gross margins than sales of lower performance products. We currently offer both higher and lower performance products in our NITROX, OCTEON, ECONA, NEURON, Celestial and PureVu product families. During 2008 and in the first two quarters of 2009, we experienced a sales mix shift towards increased sales of lower performance, lower margin products, which negatively affected our overall gross margins. In the third and fourth quarters of 2009, the product mix moved towards higher performance and higher margin products and the product mix was at about the same level throughout 2010 and 2011. In the first and second quarter of 2012, the product mix shifted slightly as we sold more of our lower performance products. If the sales mix shifts back to lower performance, lower margin products, our overall gross margins will be negatively affected. Fluctuations in the mix and types of our products may also affect the extent to which we are able to recover our fixed costs and investments that are associated with a particular product, and as a result can negatively impact our financial results.

The semiconductor and communications industries have historically experienced significant fluctuations with prolonged downturns, which could impact our operating results, financial condition and cash flows

The semiconductor industry has historically exhibited cyclical behavior, which at various times has included significant downturns in customer demand, including in late 2008 through 2009. Because a significant portion of our expenses is fixed in the near term or is incurred in advance of anticipated sales, we may not be able to decrease our expenses rapidly enough to offset any unanticipated shortfall in revenues. If this situation were to occur, it could adversely affect our operating results, cash flow and financial condition. Furthermore, the semiconductor industry has periodically experienced periods of increased demand and production constraints. If this happens in the future, we may not be able to produce sufficient quantities of our products to meet the increased demand. We may also have difficulty in obtaining sufficient wafer, assembly and test resources from our subcontract manufacturers. Any factor adversely affecting the semiconductor industry in general, or the particular segments of the industry that our products target, may adversely affect our ability to generate revenue and could negatively impact our operating results.

The communications industry has, in the past, experienced pronounced downturns, and these cycles may continue in the future. To respond to a downturn, many networking equipment providers may slow their research and development activities, cancel or delay new product development, reduce their inventories and take a cautious approach to acquiring our products, which would have a significant negative impact on our business. If this situation were to occur, it could adversely affect our operating results, cash flow and financial condition. In the future, any of these trends may also cause our operating results to fluctuate significantly from year to year, which may increase the volatility of the price of our stock.

Our products must meet exact specifications, and defects and failures may occur, which may cause customers to return or stop buying our products.

Our customers generally establish demanding specifications for quality, performance and reliability that our products must meet. However, our products are highly complex and may contain defects and failures when they are first introduced or as new versions are released. If defects and failures occur in our products during or after the design phase, we could experience lost revenues, increased costs, including warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments, product returns or discounts, diversion of management resources or damage to our reputation and brand equity, and in some cases consequential damages, any of which would harm our operating results. In addition, delays in our ability to fill product orders as a result of quality control issues may negatively impact our relationship with our customers. We cannot assure you that we will have sufficient resources, including any available insurance, to satisfy any asserted claims.

We may have difficulty selling our products if our customers do not design our products into their systems, and the nature of the design process requires us to incur expenses prior to recognizing revenues associated with those expenses which may adversely affect our financial results.

One of our primary focuses is on winning competitive bid selection processes, known as design wins, to develop products for use in our customers products. We devote significant time and resources in working with our customers system designers to understand their future needs and to provide products that we believe will meet those needs and these bid selection processes can be lengthy. If a customer s system designer initially chooses a competitor s product, it becomes significantly more difficult for us to sell our products for use in that system because changing suppliers can involve significant cost, time, effort and risk for our customers. Thus, our failure to win a competitive bid can result in our foregoing revenues from a given customer s product line for the life of that product. In addition, design opportunities may be infrequent or may be delayed. Our ability to compete in the future will depend, in large part, on our ability to design products to ensure compliance with our customers and potential customers specifications. We expect to invest significant time and resources and to incur significant expenses to design our products to ensure compliance with relevant specifications.

We often incur significant expenditures in the development of a new product without any assurance that our customers system designers will select our product for use in their applications. We often are required to anticipate which product designs will generate demand in advance of our customers expressly indicating a need for that particular design. Even if our customers system designers select our products, a substantial period of time will elapse before we generate revenues related to the significant expenses we have incurred.

The reasons for this delay generally include the following elements of our product sales and development cycle timeline and related influences:

- our customers usually require a comprehensive technical evaluation of our products before they incorporate them into their designs;

- it can take from nine months to three years from the time our products are selected to commence commercial shipments; and

- our customers may experience changed market conditions or product development issues.

The resources devoted to product development and sales and marketing may not generate material revenue for us, and from time to time, we may need to write off excess and obsolete inventory if we have produced product in anticipation of expected demand. We may spend resources on the development of products that our customers may not adopt. If we incur significant expenses and investments in inventory in the future that we are not able to recover, and we are not able to compensate for those expenses, our operating results could be adversely affected. In addition, if we sell our products at reduced prices in anticipation of cost reductions but still hold higher cost products in inventory, our operating results would be harmed.

Additionally, even if system designers use our products in their systems, we cannot assure you that these systems will be commercially successful or that we will receive significant revenue from the sales of processors for those systems. As a result, we may be unable to accurately forecast the volume and timing of our orders and revenues associated with any new product introductions.

Because a significant portion of our software and licenses revenues is derived from subscription-based software licenses, we are dependent upon the ability of our customers to develop and penetrate new markets successfully, and to develop new products for existing markets.

Our subscription-based license revenues depend both upon our ability to successfully negotiate such license agreements with our customers and, in turn, upon our customers successful commercialization of their underlying products. As our open source business grows, we may not be able to rely on receiving per unit fees from our customers. For our open source business, we may instead need to rely on other fees to compensate for the subscription-based license fees that we have traditionally received for our proprietary products. Also, we derive significant revenues from customers that develop products in highly competitive and technologically complex markets such as the internet infrastructure, server and storage, digital consumer, aerospace and defense, industrial control, medical equipment, gaming, office automation and automotive markets. If these customers sell fewer products or otherwise face significant economic difficulties, particularly in the current global economic recession, our revenues may decline.

In the event we terminate one of our distributor arrangements, it could lead to a loss of revenues and possible product returns.

A portion of our sales is made through third-party distribution agreements. Termination of a distributor relationship, either by us or by the distributor, could result in a temporary or permanent loss of revenues, until a replacement distributor can be established to service the affected end-user customers. We may not be successful in finding suitable alternative distributors on satisfactory terms or at all and this could adversely affect our ability to sell in certain locations or to certain end-user customers. Additionally, if we terminate our relationship with a distributor, we may be obligated to repurchase unsold products. We record a reserve for estimated returns and price credits. If actual returns and credits exceed our estimates, our operating results could be harmed.

We rely on our ecosystem partners to enhance our product offerings and our inability to continue to develop or maintain such relationships in the future would harm our ability to remain competitive.

We have developed relationships with third parties, which we refer to as ecosystem partners, which provide operating systems, tool support, reference designs and other services designed for specific uses with our SoCs. We believe that these relationships enhance our customers ability to get their products to market quickly. If we are unable to continue to develop or maintain these relationships, we might not be able to enhance our customers ability to commercialize their products in a timely fashion and our ability to remain competitive would be harmed, which could negatively impact our ability to generate revenue and our operating results

The loss of any of our key personnel could seriously harm our business, and our failure to attract or retain specialized technical, management or sales and marketing talent could impair our ability to grow our business.

We believe our future success will depend in large part upon our ability to attract, retain and motivate highly skilled managerial, engineering, sales and marketing personnel. The loss of any key employees or the inability to attract, retain or motivate qualified personnel, including engineers and sales and marketing personnel could delay the development and introduction of and harm our ability to sell our products. We believe that our future success is highly dependent on the contributions of Syed Ali, our co-founder, President and Chief Executive Officer, and others. None of our employees have fixed-term employment contracts; they are all at-will employees. The loss of the services of Mr. Ali, other executive officers or certain other key personnel could materially and adversely affect our business, financial condition and results of operations. For instance, if any of these individuals were to leave our company unexpectedly, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity during the search for and while any such successor is integrated into our business and operations.

There is currently a shortage of qualified technical personnel with significant experience in the design, development, manufacturing, marketing and sales of integrated circuits. In particular, there is a shortage of engineers who are familiar with the intricacies of the design and manufacture of multi-core networking processors, and competition for these engineers is intense. Our key technical personnel represent a significant asset and serve as the source of our technological and product innovations. We may not be successful in attracting, retaining and motivating sufficient numbers of technical personnel to support our anticipated growth.

To date, we have relied primarily on our direct marketing and sales force to drive new customer design wins and to sell our products. Because we are looking to expand our customer base and grow our sales to existing customers, we will need to hire additional qualified sales personnel in the near term and beyond if we are to achieve revenue growth. The competition for qualified marketing and sales personnel in our industry, and particularly in Silicon Valley, is very intense. If we are unable to hire, train, deploy and manage qualified sales personnel in a timely manner, our ability to grow our business will be impaired. In addition, if we

36

are unable to retain our existing sales personnel, our ability to maintain or grow our current level of revenues will be adversely affected. Further, if we are unable to integrate and retain personnel acquired through our various acquisitions, we may not be able to fully capitalize on such acquisitions.

In addition, we rely on stock-based awards as one means for recruiting, motivating and retaining highly skilled talent. If the value of such stock awards does not appreciate as measured by the performance of the price of our common stock or if our share-based compensation otherwise ceases to be viewed as a valuable benefit, our ability to attract, retain, and motivate employees could be weakened, which could harm our results of operations. A decline in the trading price of our common stock would result in the exercise price of a portion of our outstanding options to exceed the trading price of our common stock, reducing the effectiveness of these stock-based awards. Consequently, we may not continue to successfully attract and retain key personnel which would harm our business.

Some of our operations and a significant portion of our customers and contract manufacturers are located outside of the United States, which subjects us to additional risks, including increased complexity and costs of managing international operations and geopolitical instability.

We have international sales offices and research and development facilities and we conduct, and expect to continue to conduct, a significant amount of our business with companies that are located outside the United States, particularly in Asia and Europe. Even customers of ours that are based in the United States often use contract manufacturers based in Asia to manufacture their systems, and it is the contract manufacturers that purchase products directly from us. As a result of our international focus, we face numerous challenges, including:

- increased complexity and costs of managing international operations;
- longer and more difficult collection of receivables;
- difficulties in enforcing contracts generally;
- geopolitical and economic instability and military conflicts;
- limited protection of our intellectual property and other assets;
- compliance with local laws and regulations and unanticipated changes in local laws and regulations, including tax laws and regulations;
- trade and foreign exchange restrictions and higher tariffs;
- travel restrictions;
- timing and availability of import and export licenses and other governmental approvals, permits and licenses, including export classification requirements;
- foreign currency exchange fluctuations relating to our international operating activities;

transportation delays and limited local infrastructure and disruptions, such as large scale outages or interruptions of service from utilities or telecommunications providers;

difficulties in staffing international operations;

heightened risk of terrorism;

local business and cultural factors that differ from our normal standards and practices;

differing employment practices and labor issues;

regional health issues and natural disasters; and

work stoppages.

Table of Contents

We are subject to governmental export and import controls that may adversely affect our business.

We and our customers are subject to various import and export laws and regulations. Government export regulations apply to the encryption or other features contained in some of our products. If we fail to continue to receive licenses or otherwise comply with these regulations, we may be unable to manufacture the affected products at foreign foundries or ship these products to certain customers, or we may incur penalties or fines. In addition, changes in import or export laws and regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products or cause decreased use of our products by customers with international operations, each of which would adversely affect our business and results of operations.

We outsource our wafer fabrication, assembly, testing, warehousing and shipping operations to third parties, and rely on these parties to produce and deliver our products according to requested demands in specification, quantity, cost and time.

We rely on third parties for substantially all of our manufacturing operations, including wafer fabrication, assembly, testing, warehousing and shipping. We depend on these parties to supply us with material of a requested quantity in a timely manner that meets our standards for yield, cost and manufacturing quality. We do not have any long-term supply agreements with our manufacturing suppliers. Any problems with our manufacturing supply chain could adversely impact our ability to ship our products to our customers on time and in the quantity required, which in turn could cause an unanticipated decline in our sales and possibly damage our customer relationships.

The fabrication of integrated circuits is a complex and technically demanding process. Our foundries could, from time to time, experience manufacturing defects and reduced manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. In addition, our manufacturing processes with our foundries are unique and not within the customary manufacturing processes of these foundries, which may lead to manufacturing defects, reduced manufacturing yields and/or increases in manufacturing costs. Poor yields from our foundries, or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems, harm our financial results and result in financial or other damages to our customers. Our customers could also seek damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly to defend.

Our products are manufactured at a limited number of locations. If we experience manufacturing problems at a particular location, we would be required to transfer manufacturing to a backup location or supplier. Converting or transferring manufacturing from a primary location or supplier to a backup fabrication facility could be expensive and could take one to two quarters. During such a transition, we would be required to meet customer demand from our then-existing inventory, as well as any partially finished goods that can be modified to the required product specifications. We do not seek to maintain sufficient inventory to address a lengthy transition period because we believe it is uneconomical to keep more than minimal inventory on hand. As a result, we may not be able to meet customer needs during such a transition, which could delay shipments, cause a production delay or stoppage for our customers, result in a decline in our sales and damage our customer relationships. In addition, we have no long-term supply contracts with the foundries that we work with. Availability of foundry capacity has in the recent past been reduced due to strong demand. The ability of each foundry to provide us with semiconductor devices is limited by its available capacity and existing obligations. Foundry capacity may not be available when we need it or at reasonable prices which could cause us to be unable to meet customer needs, delay shipments, because a production delay or stoppage for our customers, result in a decline in our sales and harm our financial results.

In addition, a significant portion of our sales are to customers that practice just-in-time order management from their suppliers, which gives us a very limited amount of time in which to process and complete these orders. As a result, delays in our production or shipping by the parties to whom we outsource these functions could reduce our sales, damage our customer relationships and damage our reputation in the marketplace, any of which could harm our business, results of operations and financial condition.

Any increase in the manufacturing cost of our products could reduce our gross margins and operating profit.

The semiconductor business exhibits ongoing competitive pricing pressure from customers and competitors. Accordingly, any increase in the cost of our products, whether by adverse purchase price variances or adverse manufacturing cost variances, will reduce our gross margins and operating profit. We do not have any long-term supply agreements with our manufacturing suppliers and we typically negotiate pricing on a purchase order by purchase order basis. Consequently, we may not be able to obtain price reductions or anticipate or prevent future price increases from our suppliers.

Some of our competitors may be better financed than we are, may have long-term agreements with our main foundries and may induce our foundries to reallocate capacity to those customers. This reallocation could impair our ability to secure the supply of components that we need.

Although we use several independent foundries to manufacture substantially all of our semiconductor products, most of our components are not manufactured at more than one foundry at any given time, and our products typically are designed to be manufactured in a specific process at only one of these foundries. Accordingly, if one of our foundries is unable to provide us with components as needed, we could experience significant delays in securing sufficient supplies of those components. We cannot assure you that any of our existing or new foundries will be able to produce integrated circuits with acceptable manufacturing yields, or that our foundries will be able to deliver enough semiconductor devices to us on a timely basis, or at reasonable prices. These and other related factors could impair our ability to meet our customers needs and have a material and adverse effect on our operating results.

In order to secure sufficient foundry capacity when demand is high and mitigate the risks described in the foregoing paragraph, we may enter into various arrangements with suppliers that could be costly and harm our operating results, such as nonrefundable deposits with or loans to foundries in exchange for capacity commitments and contracts that commit us to purchase specified quantities of integrated circuits over extended periods. We may not be able to make any such arrangement in a timely fashion or at all, and any arrangements may be costly, reduce our financial flexibility, and not be on terms favorable to us. Moreover, if we are able to secure foundry capacity, we may be obligated to use all of that capacity or incur penalties. These penalties may be expensive and could harm our financial results.

Our failure to protect our intellectual property rights adequately could impair our ability to compete effectively or to defend ourselves from litigation, which could harm our business, financial condition and results of operations.

We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality and nondisclosure agreements and other methods, to protect our proprietary technologies and know-how. We have been issued 37 patents in the United States and 12 patents in foreign countries and have an additional 73 patent applications pending in the United States and 27 patent applications pending in foreign countries as of June 30, 2012. Even if the pending patent applications are granted, the rights granted to us may not be meaningful or provide us with any commercial advantage. For example, these patents could be opposed, contested, circumvented or designed around by our competitors or be declared invalid or unenforceable in judicial or administrative proceedings. The failure of our patents to adequately protect our technology might make it easier for our competitors to offer similar products or technologies. Our foreign patent protection is generally not as comprehensive as our U.S. patent protection and may not protect our intellectual property in some countries where our products are sold or may be sold in the future. Many U.S.-based companies have encountered substantial intellectual property infringement in foreign countries, including countries where we sell products. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

We enter into confidentiality agreements with our employees, consultants and strategic partners. We also control access to and distribution of our technologies, documentation and other proprietary information. However, internal or external parties may copy, disclose, obtain or use our proprietary information without our authorization. Further, current or former employees or third parties may attempt to misappropriate our proprietary information.

Monitoring unauthorized use of our intellectual property and the intellectual property of our customers and strategic partners is difficult and costly. Although we are not aware of any unauthorized use of our intellectual property in the past, it is possible that unauthorized use of our intellectual property may have occurred or may occur without our knowledge. We cannot assure you that the steps we have taken will prevent unauthorized use of our intellectual property.

Our failure to effectively protect our intellectual property could reduce the value of our technology in licensing arrangements or in cross-licensing negotiations, and could harm our business, results of operations and financial condition. We may in the future need to initiate infringement claims or litigation. Litigation, whether we are a plaintiff or a defendant, can be expensive, time consuming and may divert the efforts of our technical staff and managerial personnel, which could harm our business, whether or not such litigation results in a determination favorable to us.

Assertions by third parties of infringement by us of their intellectual property rights could result in significant costs and cause our operating results to suffer.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights and positions, which has resulted in protracted and expensive litigation for many companies. From time to time we receive communications that allege we have infringed certain patents, trade secrets or other intellectual property rights owned by others. Any such allegations, regardless of merit, could cause us to incur significant costs in responding to, defending and resolving such allegations. Any lawsuits resulting from such allegations could subject us to significant liability for damages and invalidate our proprietary rights. Any potential intellectual property litigation also could force us to do one or more of the following:

- stop selling products or using technology that contain the allegedly infringing intellectual property;

lose the opportunity to license our technology to others or to collect royalty payments based upon successful protection and assertion of our intellectual property against others;

Table of Contents

- incur significant legal expenses;
- pay substantial damages to a third party if we are found to be infringing;
- redesign those products that contain the allegedly infringing intellectual property; or
- attempt to obtain a license to the relevant intellectual property from third parties, which may not be available on reasonable terms or at all.

Any significant impairment of our intellectual property rights from any litigation we face could harm our business and our ability to compete.

Our customers have in the past and may in the future also become the target of allegations of infringement or litigation relating to the patent and other intellectual property rights of others. This could trigger technical support and indemnification obligations in some of our licenses or customer agreements. These obligations could result in substantial expenses, including the payment by us of costs and damages relating to claims of intellectual property infringement. In addition to the time and expense required for us to provide support or indemnification to our customers, any such litigation could disrupt the businesses of our customers, which in turn could hurt our relationships with our customers and cause the sale of our products to decrease. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business, operating results or financial conditions.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud.

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. Any inability to provide reliable financial reports or prevent fraud could harm our business. The Sarbanes-Oxley Act of 2002 requires management and our independent registered public accounting firm to evaluate and assess the effectiveness of our internal control over financial reporting. These Sarbanes-Oxley Act requirements may be modified, supplemented or amended from time to time. Implementing these changes may take a significant amount of time and may require specific compliance training of our personnel. In the future, we may discover areas of our internal controls that need improvement. If our independent registered public accounting firm or we discover a material weakness, the disclosure of that fact, even if quickly remedied, could reduce the market s confidence in our financial statements and harm our stock price. We may not be able to effectively and timely implement necessary control changes and employee training to ensure continued compliance with the Sarbanes-Oxley Act and other regulatory and reporting requirements. Our rapid growth in recent years and our possible future expansion through acquisitions, present challenges to maintain the internal control and disclosure control standards applicable to public companies. If we fail to maintain effective internal controls, we could be subject to regulatory scrutiny and sanctions and investors could lose confidence in the accuracy and completeness of our financial reports.

Our acquisition strategy may result in unanticipated accounting charges or otherwise adversely affect our results of operations, and result in difficulties in assimilating and integrating the operations, personnel, technologies and products of acquired companies or businesses, or be dilutive to existing shareholders.

In May 2008, we acquired certain assets of Parallogic Corporation, in August 2008 we acquired substantially all of the assets of Star Semiconductor Corporation; in December 2008, we acquired W&W Communications, Inc.; in December 2009 we acquired MontaVista Software, Inc.; in October 2010, we acquired substantially all of the assets of Celestial Systems; in January 2011, we acquired substantially all of the assets and assumed certain liabilities of Wavesat Inc.; and in March 2011, we acquired substantially all of the assets and assumed certain liabilities of Celestial Semiconductor, Ltd. We expect that we will in the future continue to acquire companies or assets of companies that we believe to be complementary to our business, including for the purpose of expanding our new product design capacity, introducing new design, market or application skills or enhancing and expanding our existing product lines. In connection with any such future acquisitions, we may need to use a significant portion of our available cash, issue additional equity securities that would dilute current stockholders percentage ownership and incur substantial debt or contingent liabilities. Such actions could adversely impact our operating results and the market price of our common stock. In addition, difficulties may occur in assimilating and integrating the operations, personnel, technologies, and products of acquired companies or businesses. Further, key personnel of an acquired company may decide not to work for us. Moreover, to the extent we acquire a company with existing products; those products may have lower gross margins than our customary products, which could adversely affect our gross margin and operating results. If an acquired company also has inventory that we assume, we will be required to write up the carrying value of that inventory to fair value. When that inventory is sold, the gross margins for those products will be reduced and our gross margins for that period would be negatively affected. Furthermore, the purchase price of any acquired businesses may exceed the current fair values of the net tangible assets of such acquired businesses. As a result, we would

be required to record material amounts of goodwill, and acquired in-process research and development charges and other intangible assets, which could result in significant impairment and acquired in-process research and development charges and amortization expense in future periods. These charges, in addition to the results of operations of such acquired businesses and potential restructuring costs associated with an acquisition, could have a material adverse effect on our business, financial condition and results of operations. We cannot forecast the number, timing or size of future acquisitions, or the effect that any such acquisitions might have on our operating or financial results.

We rely on third-party technologies for the development of our products and our inability to use such technologies in the future would harm our ability to remain competitive.

We rely on third parties for technologies that are integrated into our products, such as wafer fabrication and assembly and test technologies used by our contract manufacturers, as well as licensed MIPS and ARM architecture technologies. If we are unable to continue to use or license these technologies on reasonable terms, or if these technologies fail to operate properly, we may not be able to secure alternatives in a timely manner and our ability to remain competitive would be harmed, which could harm our business, results of operations and financial condition. In addition, if we are unable to successfully license technology from third parties to develop future products, we may not be able to develop such products in a timely manner or at all.

Our open source business could be seriously harmed by the outcome of lawsuits challenging the use and distribution of Linux-based software products.

We rely on Linux system software as the basis of our software products. Several lawsuits have been filed challenging the right to use and/or distribute Linux system software and software applications based on Linux. Although we are not a party to or directly involved in any of the lawsuits relating to Linux, we expect that further lawsuits could be filed against Linux in the future which would challenge the use and distribution of our Linux-based software products. It is impossible to estimate or anticipate all of the financial or other impacts the results of these litigation matters could have on our business. Success by a plaintiff in one or more of these lawsuits could have a material adverse effect on our open source business.

Legal uncertainty surrounding the use and distribution of open source software may cause the market for Linux-based products to disappear, fail to further develop or fail to develop at a rate sufficient to sustain our business.

The majority of our open source software products are licensed from third parties under the GNU General Public License (the GPL), and similar open source licenses. There remains some significant confusion among our customers about the scope of their obligations and rights with respect to using and distributing Linux-based products. One element of this confusion is whether the GPL and other open source licenses require customers to (i) make all of the source code for their products available to the public, and/or (ii) license all of the code underlying such products under an open source license. There is little or no legal precedent for interpreting the terms of the GPL and similar open source licenses, including the determination of which types of programs or products would be considered derived works and thus potentially subject to the terms of such open source licenses. If this confusion remains, increases or is prolonged by litigation, the market for Linux-based products may disappear, fail to further develop or fail to develop at a rate sufficient to sustain our open source business.

Our open source business depends on Linux developers to continue to improve Linux and Linux-based applications that are incorporated into our open source products.

Our ability to release major upgrades of MontaVista Linux is largely dependent upon the release of new versions of the Linux kernel. The Linux kernel is the heart of the Linux system software. Linus Torvalds and a small group of engineers are primarily responsible for the development, evolution and maintenance of the Linux kernel. In addition, other individuals and small groups of developers are largely responsible for Linux programs tailored to specific tasks or computer architectures. If Mr. Torvalds or other key developers fail to further develop the Linux kernel or other programs on which we rely, we will have to either develop them ourselves or rely on another party for development. This development effort could be costly and time consuming, and could delay or entirely prevent our open source product release and upgrade schedule.

We may be unsuccessful in marketing our open source products because we encounter widespread negative perceptions about Linux and open source software in general.

Some people still falsely believe that anyone who writes a software program that runs on Linux will necessarily have to publicly disclose the source code for that software. If a potential customer believes their source code will need to be made public if they use our open source product, they may be less likely to purchase our open source product. We devote substantial time and attention helping potential customers understand the legal implications of using our open source products, including that fact that in

most instances, applications developed to run on Linux may be distributed under a proprietary license. In many cases, we are required to address these issues at different levels across an organization (such as at the engineering, managerial and executive levels), which can be very time consuming. We are sometimes unsuccessful at convincing a potential customer that using Linux-based system software will not have negative consequences for that customer. Furthermore, many potential customers believe that they should not be required to pay for our open source products, since our open-source products are based on open source (also sometimes called free) software. They believe that open source products are all publicly available at no charge. There is also the misconception that distributors of Linux software cannot offer warranties or indemnifications with respect to Linux software. Each of these customer fears or misperceptions could cause us to lose potential orders or cause our customers to delay purchase decisions, which could significantly lengthen our sales cycle. These misperceptions could cause the market for Linux-based products to disappear, fail to further develop, or fail to develop at a rate sufficient to sustain our open source business.

Our open source software may contain errors or defects that could delay introduction of new products, result in costly remedial expenditures or cause disputes with customers.

Most of the open source software that we sell and distribute is developed by third parties with whom we have no business relationship, including thousands of individual software programmers. In order to successfully release our open source products, we must assemble and test software developed by thousands of disparate sources. Despite our efforts, errors have been and may continue to be found in our open source products. If errors are discovered, we may not be able to successfully correct them in a timely manner or at all. Errors and failures in our open source products could result in a loss of, or delay in, market acceptance of our open-source products and could damage our reputation and our ability to convince commercial users of the benefits of Linux-based systems software and other open source software products. In addition, we may need to make significant expenditures of capital resources in order to reduce errors and failures.

We face intense competition related to our open source products, and expect competition to increase in the future, which could reduce our open source-related revenue and customer base.

The market for Linux-based systems software is highly competitive, and we expect competition to intensify in the future. We consider the primary competitors for our MontaVista software products to be Wind River Systems, Inc., a subsidiary of Intel Corporation and, to a lesser extent, Canonical Programming, inc. and Mentor Graphics Corporation. In addition, potential customers for our open source products may believe that they can build their own open source product cheaper or more efficiently than purchasing our products.

In addition to competitors in the business of distributing a commercial Linux-based operating system, we face competition from certain hardware companies who offer Linux-based operating systems and related software components at little or no charge. We also face competition from Linux-based software distributions provided by new and emerging consortiums and software stacks such as Meego, Linaro, Moblin and Android. And because, apart from such hardware vendors and consortiums, there is a large Linux code base generally available at no charge, certain customers or potential customers have made, and will continue to make, efforts to develop their own Linux-based operating system without purchasing or otherwise obtaining it from a third-party vendor. To the extent that the quality and availability of non-commercial Linux-based operating system software continues to improve, it could have a material adverse effect on our ability to sell open source software.

Our third-party contractors are concentrated primarily in Asia, an area subject to earthquake and other risks. Any disruption to the operations of these contractors could cause significant delays in the production or shipment of our products.

Substantially all of our products are manufactured by third-party contractors located in Taiwan and to a lesser extent manufactured by third party contractors located in Japan, Malaysia and Korea. The risk of an earthquake in any of those countries or elsewhere in Asia is significant due to the proximity of major earthquake fault lines to the facilities of our foundries and assembly and test subcontractors. For example, several major earthquakes have occurred in Taiwan and Japan since our incorporation in 2000, the most recent being the major earthquake and tsunami that occurred in March 2011 in Japan. Although our third-party contractors did not suffer any significant damage as a result of these most recent earthquakes, the occurrence of additional earthquakes or other natural disasters could result in the disruption of our foundry or assembly and test capacity. Any disruption resulting from such events could cause significant delays in the production or shipment of our products until we are able to shift our manufacturing, assembling or testing from the affected contractor to another third-party vendor. We may not be able to obtain alternate capacity on favorable terms, if at all.

We may experience difficulties in transitioning to new wafer fabrication process technologies or in achieving higher levels of design integration, which may result in reduced manufacturing yields, delays in product deliveries and increased expenses.

In order to remain competitive, we expect to continue to transition our semiconductor products to increasingly smaller line width geometries. This transition requires us to modify our designs to work with the manufacturing processes of our foundries. We periodically evaluate the benefits, on a product-by-product basis, of migrating to new process technologies to reduce cost and improve performance. We may face difficulties, delays and expenses as we continue to transition our products to new processes. We are dependent on our relationships with our foundry contractors to transition to new processes successfully. We cannot assure you that the foundries that we use will be able to effectively manage the transition or that we will be able to maintain our existing foundry relationships or develop new ones. If any of our foundry contractors or we experience significant delays in this transition or fail to efficiently implement this transition, we could experience reduced manufacturing yields, delays in product deliveries and increased expenses, all of which could harm our relationships with our customers and our results of operations. As new processes become more prevalent, we expect to continue to integrate greater levels of functionality, as well as customer and third-party intellectual property, into our products. However, we may not be able to achieve higher levels of design integration or deliver new integrated products on a timely basis.

Our investment portfolio may become impaired by further deterioration of the capital markets.

Our cash equivalents at June 30, 2012 consisted primarily of an investment in a money market fund, which is invested primarily in United States treasury securities, bonds of government agencies, and corporate bonds. We follow an established investment policy and set of guidelines to monitor, manage and limit our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes.

As a result of current adverse financial market conditions, investments in some financial instruments, such as structured investment vehicles, sub-prime mortgage-backed securities, European sovereign debt and collateralized debt obligations, may pose risks arising from liquidity and credit concerns. As of June 30, 2012, we had no direct holdings in these categories of investments and our indirect exposure to these financial instruments through our holdings in money market instruments was immaterial. As of June 30, 2012, we had no impairment charges associated with our cash equivalents relating to such adverse financial market conditions. Although we believe our current investment portfolio has very little risk of impairment, we cannot predict future market conditions or market liquidity and can provide no assurance that our investment portfolio will remain unimpaired.

We may need to raise additional capital, which might not be available or which, if available, may be on terms that are not favorable to use.

We believe our existing cash and cash equivalent balances and cash expected to be generated from our operations will be sufficient to meet our working capital, capital expenditures and other needs for at least the next 12 months. In the future, we may need to raise additional funds, and we cannot be certain that we will be able to obtain additional financing on favorable terms, if at all. If we issue equity securities to raise additional funds, the ownership percentage of our stockholders would be reduced, and the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If we borrow money, we may incur significant interest charges, which could harm our profitability. Holders of debt would also have rights, preferences or privileges senior to those of existing holders of our common stock. If we cannot raise needed funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could harm our business, operating results and financial condition.

We may incur impairments to goodwill or long-lived assets.

We review our long-lived assets, including goodwill and other intangible assets, for impairment annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable.

Significant negative industry or economic trends, including a significant decline in the market price of our common stock, reduced estimates of future cash flows for our reporting units or disruptions to our business could lead to an impairment charge of our long-lived assets, including goodwill and other intangible assets.

Our valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and to rely heavily on projections of future operating performance. We operate in highly competitive environments and projections of future operating results and cash flows may vary significantly from results. Additionally, if our analysis results in impairment to our goodwill, we may be required to record a charge to earnings in our financial statements during a period in which such impairment is determined to exist, which may negatively impact our results of operations.

Table of Contents

The complexity of accounting regulations and related interpretations and policies, particularly those related to revenue recognition, could materially affect our financial results for a given period.

Although we use standardized agreements designed to meet current revenue recognition criteria under generally accepted accounting principles, we must often negotiate and revise terms and conditions of these standardized agreements, particularly in multi-element license and services transactions. As we increase our transactions to more complex multi-element transactions, negotiation of mutually acceptable terms and conditions may require us to defer recognition of revenue on such licenses. We believe that we are in compliance with the guidance as provided under multiple element arrangements; however, bigger and more complex, multi-element transactions may require additional accounting analysis to account for them accurately. Errors in such analysis in any period could lead to unanticipated changes in our revenue accounting practices and may affect the timing of revenue recognition, which could adversely affect our financial results. If we later discover that we have interpreted and applied revenue recognition rules differently than prescribed by generally accepted accounting principles in the U.S., we could be required to devote significant management resources, and incur the expense associated with an audit, restatement or other examination of our financial statements.

Our future effective tax rates could be affected by the allocation of our income among different geographic regions, which could affect our future operating results, financial condition and cash flows.

As a global company, we are subject to taxation in the United States and various other countries and states. Significant judgment is required to determine and estimate worldwide tax liabilities. We may further expand our international operations and staff to better support our international markets. As a result, we anticipate that our consolidated pre-tax income will be subject to tax at relatively lower tax rates when compared to the United States federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the United States federal statutory rate. Our future effective income tax rates could be adversely affected if tax authorities were to successfully challenge our international tax structure or if the relative mix of United States and international income changes for any reason, or US or foreign tax laws were to change. Accordingly, there can be no assurance that our income tax rate will continue to be less than the United States federal statutory rate.

Any significant change in our future effective tax rates could adversely impact our consolidated financial position, results of operations and cash flows. Our future effective tax rates may be adversely affected by a number of factors including:

- changes in tax laws in the countries in which we operate or the interpretation of such laws;
- increase in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with the acquisitions;
- changes in share based compensation expense;
- change in the mix of income among different taxing jurisdictions;
- audit examinations with adverse outcomes;
- changes in generally accepted accounting principles; and
- our ability to use tax attributes such as research and development tax credits and net operating losses.

****Changes in valuation allowance of deferred tax assets may affect our future operating results***

We record a valuation allowance to reduce our net deferred tax assets to the amount that we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we consider historical levels of income, expectations and risks associated with estimates of future taxable income and ongoing prudent and practical tax planning strategies. On a periodic basis we evaluate our deferred tax asset balance for realizability. To the extent we believe it is more likely than not that some portion of our deferred tax assets will not be realized, we will increase the valuation allowance against the deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future taxable income in related tax jurisdictions.

As of June 30, 2012, we assessed that it is more-likely-than-not that we will realize our federal deferred tax assets based on positive evidence of our history of profits and projections of future income. Accordingly, we only applied a valuation allowance on certain state deferred tax assets. In the event future income by jurisdiction is less than what is currently projected, we may be required to record a valuation allowance to these deferred tax assets in jurisdictions where realization of such assets are no longer more-likely-than-not. This would have adverse impact in our operating results (see Note 9 of Unaudited Condensed Consolidated Financial Statements).

Table of Contents

Risks Related to our Common Stock

***The market price of our common stock may be volatile, which could cause the value of your investment to decline.**

The trading prices of the securities of technology companies have been highly volatile. Further, our common stock has a limited trading history. Since our initial public offering in May 2007 through June 30, 2012, our stock price has fluctuated from a low of $7.61 to a high of $47.60. We cannot predict the extent to which the trading market will continue to develop or how liquid the market may become. The trading price of our common stock is therefore likely to be highly volatile and could be subject to wide fluctuations in price in response to various factors, some of which are beyond our control. These factors include:

- quarterly variations in our results of operations or those of our competitors;
- general economic conditions and slow or negative growth of related markets;
- announcements by us or our competitors of design wins, acquisitions, new products, significant contracts, commercial relationships or capital commitments;
- our ability to develop and market new and enhanced products on a timely basis;
- commencement of, or our involvement in, litigation;
- disruption to our operations;
- the emergence of new sales channels in which we are unable to compete effectively;
- any major change in our board of directors or management;
- changes in financial estimates including our ability to meet our future revenue and operating profit or loss projections;
- changes in governmental regulations; and
- changes in earnings estimates or recommendations by securities analysts.

Furthermore, the stock market in general, and the market for semiconductor and other technology companies in particular, have experienced price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may seriously harm the market price of our common stock, regardless of our actual operating performance. These trading price fluctuations may also make it more difficult for us to use our common stock as a means to make acquisitions or to use options to purchase our common stock to attract and retain employees. In addition, in the past, following periods of volatility in the overall market and the market price of a company s securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management s attention and resources.

Delaware law and our amended and restated certificate of incorporation and bylaws contain provisions that could delay or discourage takeover attempts that stockholders may consider favorable.

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

- the division of our board of directors into three classes;
- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or due to the resignation or departure of an existing board member;
- the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the requirement for the advance notice of nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders meeting;
- the ability of our board of directors to alter our bylaws without obtaining stockholder approval;
- the ability of the board of directors to issue, without stockholder approval, up to 10,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of our common stock;

Table of Contents

the elimination of the rights of stockholders to call a special meeting of stockholders and to take action by written consent in lieu of a meeting;

the required approval of at least 66 2/3% of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or repeal the provisions of our amended and restated certificate of incorporation regarding the election and removal of directors and the inability of stockholders to take action by written consent in lieu of a meeting; and

the required approval of at least a majority of the shares entitled to vote at an election of directors to remove directors without cause.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, particularly those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our amended and restated certificate of incorporation and bylaws and under Delaware law could discourage potential takeover attempts, could reduce the price that investors are willing to pay for shares of our common stock in the future and could potentially result in the market price being lower than they would without these provisions.

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

None.

Item 5. ***Other Information***

None.

Item 6. ***Exhibits***

See the Exhibit Index which follows the signature page of this Quarterly Report on Form 10-Q, which is incorporated here by reference.

Table of Contents

SIGNATURES

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

	CAVIUM, INC.
Date: August 3, 2012	By: /s/ ARTHUR D. CHADWICK **Arthur D. Chadwick** **Chief Financial Officer and Vice President of Finance and Administration and Secretary**

Table of Contents

EXHIBIT INDEX

Exhibit Number	Description
2.1	Asset Purchase Agreement, dated January 25, 2011, between Cavium, Inc., and Wavesat, Inc. (1)
2.2	Asset Purchase Agreement, dated January 31, 2011, between Cavium, Inc., Cavium Networks Singapore Pte. Ltd., and Celestial Semiconductor, Ltd (2)
2.3	Supplemental Agreement relating to the Asset Purchase Agreement dated January 31, 2011 between Cavium, Inc., Cavium Networks Singapore Pte. Ltd., and Celestial Semiconductor, dated March 4, 2011 (3)
3.1	Restated Certificate of Incorporation of the Registrant (4)
3.2	Amended and Restated Bylaws of the Registrant(5)
4.1	Reference is made to Exhibits 3.1 and 3.2
4.2	Form of the Registrant s Common Stock Certificate (6)
4.3	Shareholders Agreement by and between Cavium, Inc. and Celestial Semiconductor, dated March 4, 2011(7)
10.3	Amended 2007 Equity Incentive Plan (8)
31.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer
31.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Arthur D. Chadwick, Chief Financial Officer
32.1*	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer and Arthur D. Chadwick, Chief Financial Officer
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF**	XBRL Taxonomy Extension Definition Linkbase
101.LAB**	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

(1) Filed as Exhibit 2.1 to the Registrant s Current Report on Form 8-K (001-33435), filed with the SEC on January 31, 2011, and incorporated herein by reference.
(2) Filed as Exhibit 2.2 to the Registrant s Current Report on Form 8-K (001-33435), filed with the SEC on February 3, 2011, and incorporated herein by reference.
(3) Filed as Exhibit 1.1 to the Registrant s Current Report on Form 8-K (001-33435), filed with the SEC on March 9, 2011, and incorporated herein by reference.
(4) Filed as Exhibit 3.2 to the Registrant s Current Report on Form 8-K (No. 001-33435), filed with the SEC on June 20, 2011, and incorporated herein by reference.
(5) Filed as Exhibit 3.5 to the Registrant s registration statement on Form S-1/A (No. 333-140660), filed with the SEC on April 13, 2007, as amended, and incorporated herein by reference.
(6) Filed as Exhibit 4.2 to the Registrant s registration statement on Form S-1/A (No. 333-140660), filed with the SEC on April 24, 2007, as amended, and incorporated herein by reference.

(7) Filed as Exhibit 1.2 to the Registrant s Current Report on Form 8-K (001-33435), filed with the SEC on March 9, 2011.

(8) Filed as Exhibit 10.3 to the Registrant s Quarterly Report on Form 10-Q (001-33435) filed with the SEC on May 7,2012.

* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Registrant under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

** Pursuant to applicable securities laws and regulations, the Registrant is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and is not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Registrant has made a good faith attempt to comply with the submission requirements and promptly amends the interactive data files after becoming aware that the interactive data files fails to comply with the submission requirements. In accordance with Rule 406T of Regulation S-T, the information in these exhibits is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, except as expressly set forth by specific reference in such filing.