CAVIUM, INC.
Form 10-Q
May 06, 2013
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# 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 March 31, 2013**

**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 April 29, 2013 was: 51,337,794

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**CAVIUM, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

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## PART I. FINANCIAL INFORMATION

**Item 1.** ***Financial Statements***

**CAVIUM, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

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

**(unaudited)**

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 86,511 | $ 76,784 |
| Accounts receivable, net of allowances of $732 and $991, respectively | 36,127 | 33,567 |
| Inventories | 41,403 | 46,508 |
| Prepaid expenses and other current assets | 3,315 | 4,865 |
| Assets held for sale | | 2,609 |
| Deferred tax assets | 508 | 568 |
| Total current assets | 167,864 | 164,901 |
| Property and equipment, net | 28,805 | 30,692 |
| Intangible assets, net | 59,037 | 62,888 |
| Goodwill | 71,478 | 71,478 |
| Deferred tax assets, net of current portion | 512 | 449 |
| Other assets | 1,434 | 1,096 |
| Total assets | $ 329,130 | $ 331,504 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 13,110 | $ 16,083 |
| Other accrued expenses and other current liabilities | 6,698 | 8,680 |
| Deferred revenue | 10,657 | 12,944 |
| Notes payable | 1,012 | 1,012 |
| Capital lease and technology license obligations, current portion | 11,984 | 16,500 |
| Total current liabilities | 43,461 | 55,219 |
| Notes payable, net of current portion | 4,500 | 4,000 |
| Capital lease and technology license obligations, net of current portion | 23,843 | 24,832 |
| Deferred tax liability | 2,617 | 2,421 |
| Other non-current liabilities | 1,847 | 1,970 |
| Total liabilities | 76,268 | 88,442 |
| Commitments and contingencies (Note 11) | | |
| Stockholders equity | | |
| Common stock, par value $0.001: | | |
| 200,000,000 shares authorized; 51,335,518 and 50,630,991 shares issued and outstanding; as of March 31, 2013 and December 31, 2012, respectively | 51 | 51 |

| | | |
|---|---|---|
| Additional paid-in capital | 413,246 | 398,133 |
| Accumulated deficit | (157,276) | (154,092) |
| Total stockholders equity attributable to the Company | 256,021 | 244,092 |
| Non-controlling interest | (3,159) | (1,030) |
| Total stockholders equity | 252,862 | 243,062 |
| Total liabilities and stockholders equity | $ 329,130 | $ 331,504 |

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

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**CAVIUM, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(in thousands, except per share data)**

**(unaudited)**

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| Net revenue | $ 69,530 | $ 52,743 |
| Cost of revenue | 26,159 | 28,008 |
| Gross profit | 43,371 | 24,735 |
| Operating expenses: | | |
| Research and development | 32,415 | 27,058 |
| Sales, general and administrative | 15,240 | 12,484 |
| Total operating expenses | 47,655 | 39,542 |
| Loss from operations | (4,284) | (14,807) |
| Other expense, net: | | |
| Interest expense | (342) | (32) |
| Other, net | (261) | (94) |
| Total other expense, net | (603) | (126) |
| Loss before income taxes | (4,887) | (14,933) |
| Provision for (benefit from) income taxes | 426 | (1,104) |
| Net loss | (5,313) | (13,829) |
| Net loss attributable to non-controlling interest | (2,129) | |
| Net loss attributable to the Company | $ (3,184) | $ (13,829) |
| Earnings per share attributable to the Company: | | |
| Net loss per common share, basic | $ (0.06) | $ (0.28) |
| Shares used in computing basic net loss per common share | 51,001 | 49,323 |
| Net loss per common share, diluted | $ (0.06) | $ (0.28) |
| Shares used in computing diluted net loss per common share | 51,001 | 49,323 |

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

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**CAVIUM, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

**(unaudited)**

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net loss | $ (5,313) | $ (13,829) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Stock-based compensation expense | 8,274 | 9,013 |
| Depreciation and amortization | 9,324 | 7,543 |
| Deferred income taxes | 193 | (1,488) |
| Gain on sale of held for sale assets | (747) | |
| Changes in assets and liabilities, net of effects of acquisitions: | | |
| Accounts receivable, net | (2,560) | (109) |
| Inventories | 5,099 | 1,283 |
| Prepaid expenses and other current assets | 1,698 | (661) |
| Other assets | (338) | 123 |
| Accounts payable | (4,307) | 3,552 |
| Deferred revenue | (2,287) | 1,941 |
| Accrued expenses and other current and non-current liabilities | (629) | (572) |
| Net cash provided by operating activities | 8,407 | 6,796 |
| **Cash flows from investing activities:** | | |
| Purchases of property and equipment | (670) | (1,688) |
| Purchases of intangible assets | (2,343) | (1,450) |
| Proceeds received from sale of held for sale assets | 3,350 | |
| Net cash provided by (used in) investing activities | 337 | (3,138) |
| **Cash flows from financing activities:** | | |
| Proceeds from issuance of common stock upon exercise of options | 6,845 | 1,579 |
| Principal payment of capital lease and technology license obligations | (6,362) | (3,376) |
| Notes payable of the VIE to non-controlling interest | 500 | |
| Net cash provided by (used in) financing activities | 983 | (1,797) |
| Net increase in cash and cash equivalents | 9,727 | 1,861 |
| Cash and cash equivalents, beginning of period | 76,784 | 63,225 |
| Cash and cash equivalents, end of period | $ 86,511 | $ 65,086 |
| **Supplemental disclosure of cash flows from investing activities** | | |
| Property and equipment and intangible assets acquired included in accounts payable, other accrued expense and other current liabilities | 1,198 | 3,194 |

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

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**CAVIUM, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Organization and Basis of Presentation**

***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. The Company designs, develops and markets semiconductor processors for intelligent and secure networks.

***Basis of Presentation***

The condensed consolidated financial statements include the accounts of Cavium, Inc., its wholly owned subsidiaries, and a variable interest entity, or VIE, of which the Company is the primary beneficiary. Under the accounting principles generally accepted in the United States of America, or US GAAP, a VIE is required to be consolidated by its primary beneficiary. The primary beneficiary is the party that absorbs a majority of the VIE s anticipated losses and/or a majority of the expected returns. See Note 5 of Notes to Condensed Consolidated Financial Statements for detailed discussions of the VIE. Intercompany transactions and balances have been eliminated in consolidation.

The condensed consolidated financial statements have been prepared in accordance with 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, 2012.

The condensed consolidated financial statements contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to state fairly the Company s condensed consolidated financial position at March 31, 2013, and the condensed consolidated results of its operations for the three months ended March 31, 2013 and 2012, and condensed consolidated statements of cash flows for the three months ended March 31, 2013 and 2012. The results of operations for the three months ended March 31, 2013 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at December 31, 2012 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.

***Significant Accounting Policies***

The Company s significant accounting policies are disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2012. There had been no material changes to these accounting policies.

***Recent Accounting Pronouncements***

In February 2013, the Financial Accounting Standards Board, or FASB, issued updated guidance on reporting other comprehensive income. Under the updated guidance, an entity is required to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. This updated guidance does not change the current requirements for reporting net income or other comprehensive income in the financial statements. This guidance is effective for reporting periods beginning after December 15, 2012, with early adoption permitted. Due to the fact that the Company does not have any other comprehensive income (loss), the adoption of this additional guidance did not have an impact on the Company s condensed consolidated financial position, results of operations or cash flows.

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### 2. Net Loss Per Common Share

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

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| | (in thousands, except per share data) | |
| Net loss attributable to the Company | $ (3,184) | $ (13,829) |
| Weighted average common shares outstanding - basic | 51,001 | 49,323 |
| Dilutive effect of employee stock plans | | |
| Weighted average common shares outstanding - diluted | 51,001 | 49,323 |
| Net loss per common share, basic | $ (0.06) | $ (0.28) |
| Net loss per common share, diluted | $ (0.06) | $ (0.28) |

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

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| | (in thousands) | |
| Options to purchase common stock | 3,834 | 4,778 |
| Restricted stock units | 2,230 | 2,575 |

### 3. Fair Value Measurements

At March 31, 2013 and December 31, 2012, 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 for 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 $60.2 million and $50.2 million as of March 31, 2013 and December 31, 2012, respectively. Notes payable are carried at cost which approximates fair value based on current interest rates available to the Company and are a Level 2 measurement. There are no other financial assets and liabilities that require Level 2 or Level 3 fair value hierarchy measurements and disclosures.

### 4. Balance Sheet Components

*Inventories are comprised of the following:*

| | As of March 31, 2013 | As of December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Work-in-process | $ 28,701 | $ 33,418 |
| Finished goods | 12,702 | 13,090 |
| | $ 41,403 | $ 46,508 |

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*Property and equipment, net, consist of the following:*

| | As of March 31, 2013 | As of December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Mask costs and test equipment | $ 33,850 | $ 32,771 |
| Software, computer and other equipment | 36,307 | 35,563 |
| Furniture, office equipment and leasehold improvements | 1,088 | 1,089 |
| | 71,245 | 69,423 |
| Less: accumulated depreciation and amortization | (42,440) | (38,731) |
| | $ 28,805 | $ 30,692 |

Depreciation and amortization expense was $4.5 million and $3.5 million for the three months ended March 31, 2013 and 2012, respectively.

The Company leases certain design tools under time-based capital lease and certain financing arrangements which are included in property and equipment, which total cost, net of accumulated amortization amounted to $15.2 and $16.8 million at March 31, 2013 and December 31, 2012, respectively. Amortization expense related to assets recorded under capital lease and certain financing agreements was $1.6 million and $1.1 million for the three months ended March 31, 2013 and 2012, respectively.

*Other accrued expenses and other current liabilities consist of the following:*

| | As of March 31, 2013 | As of December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Accrued compensation and related benefits | $ 3,710 | $ 4,458 |
| Professional fees | 982 | 1,067 |
| Restructuring related payables | 210 | 210 |
| Income tax payable | 219 | 467 |
| Other | 1,577 | 2,478 |
| | $ 6,698 | $ 8,680 |

*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 March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Beginning balance | $ 440 | $ 412 |
| Accruals and adjustments | 85 | 219 |
| Settlements | (155) | (221) |
| Ending balance | $ 370 | $ 410 |

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*Deferred revenue consists of the following:*

| | As of March 31, 2013 | As of December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Services / Support and Maintenance | $ 5,724 | $ 8,017 |
| Software License / Subscription | 2,000 | 2,529 |
| Distributors | 2,933 | 2,398 |
| | $ 10,657 | $ 12,944 |

**5. Business Combinations and Divestitures**

***Variable Interest Entity***

In May 2012, the Company entered into a secured note purchase agreement with a VIE to provide cash advances. As of March 31, 2013, the Company had made cash advances of $4.0 million under three convertible notes receivable which mature between December 31, 2013 and August 31, 2014. In addition, a certain third-party company and a certain third party investor ( non-controlling interest ) had made cash advances of $5.0 million and $0.5 million, respectively, under three convertible notes receivable which mature between December 31, 2013 and August 31, 2014. Certain of the convertible notes are collateralized by a lien on the VIE s assets. Pursuant to the convertible notes, in the event of a qualified equity financing of the VIE, the outstanding principal balance plus the accrued interest of the convertible notes would be automatically converted into preferred stock of the VIE. The Company has a purchase option to acquire the assets of the VIE at a price specified in the secured note purchase agreement. The option to purchase expires on December 31, 2013, provided the VIE has met certain milestones specified in the secured note purchase agreement. If the certain milestones have not been met by December 31, 2013, the expiration shall be the date that is the earlier of 30 days after the VIE meets the specified milestones or July 31, 2014. The Company has concluded that it is the primary beneficiary of the VIE due to the Company s investment risk to absorb the losses of the VIE and the purchase option to acquire the assets of the VIE. As such, the Company has included the accounts of the VIE in the condensed consolidated financial statements. The significant components of the VIE s financial statements included in the Company s condensed consolidated financial statements as of and for the three months ended March 31, 2013 include cash of $1.5 million; property and equipment and intangible assets of $1.1 million; notes payable of $5.5 million, non-controlling interest of $3.2 million and a net loss, net of portion to non-controlling interest of $1.6 million.

***Sale of Held for Sale Assets***

In January 2013, the Company completed the sale of certain assets to a third-party company. The assets sold originated from the acquisition of MontaVista Software, Inc. in fiscal year 2009, which was part of the software and services reporting unit. Under the asset purchase agreement, the Company agreed to transfer certain assets for an aggregate cash consideration of $3.3 million. The carrying value of the assets held for sale was approximately $2.6 million, consisting of a portion of goodwill of $2.2 million and the remaining related to the carrying costs of the transferred property and equipment and intangible assets. These assets were classified as assets held for sale in the consolidated balance sheets as of December 31, 2012. The difference between the sale consideration and the carrying value of the assets held for sale of $0.7 million was recognized as a gain on sale of held for sale assets within sales, general and administrative expenses during the three months ended March 31, 2013.

**6. Goodwill and Intangible Assets, Net**

*Goodwill*

The carrying amount of goodwill at March 31, 2013 was unchanged from the balance at December 31, 2012. The carrying amount of the goodwill at December 31, 2012 was $71.5 million, of which, $56.3 million was in the semiconductor products reporting unit and $15.2 million was in the software and services reporting unit.

The Company reviews goodwill for impairment annually at the beginning of its fourth calendar quarter and whenever events or changes in circumstances that would more-likely-than-not reduce the fair value of a reporting unit below its carrying amount. For the most recent annual goodwill impairment analysis performed during the fourth quarter of 2012, the Company had two reporting units, namely, semiconductor product unit and software and services unit. The result of the most recent annual impairment test showed that goodwill impairment does not exist in its semiconductor product reporting unit due to a significant excess of the fair value over the carrying value of the reporting unit. The Company however determined that goodwill impairment existed in its software and services reporting unit as a result of the most recent annual goodwill impairment assessment. As such, the Company recorded $27.7 million of goodwill impairment charge in the fourth quarter of 2012.

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During the first quarter of 2013, due to the sale of certain assets of MontaVista and the reorganization of resources, the Company changed how it manages and operates the business which resulted in the combination of the semiconductor product and software and services into one reporting unit. See related discussions in Note 10 of Notes to Condensed Consolidated Financial Statements. As such, beginning in the first quarter of 2013, the Company assesses the goodwill impairment at the reporting unit level which is at the Company level as a whole. Due to the change in the reporting unit structure, the Company performed a qualitative assessment of the goodwill at the Company level as a whole and concluded that it was more-likely-than-not that the fair value of the reporting unit exceeded the carrying amount as of March 31, 2013. As such, it was not necessary to perform the two-step goodwill impairment test at that time. In assessing the qualitative factors, the Company considered the impact of these key factors: overall financial performance, industry and competitive market environment, market capitalization and stock price.

*Intangible assets, net consisted of the following:*

| | As of March 31, 2013 | | | |
|---|---|---|---|---|
| | Gross | Accumulated Amortization (in thousands) | Net | Weighted average remaining amortization period (years) |
| Existing and core technology - product | $ 46,533 | $ (35,690) | $ 10,843 | 2.19 |
| Technology licenses | 66,258 | (22,356) | 43,902 | 7.65 |
| Customer contracts and relationships | 8,991 | (5,490) | 3,501 | 4.69 |
| Trade name | 2,296 | (1,505) | 791 | 1.85 |
| Order backlog | 640 | (640) | | |
| Total amortizable intangible assets | $ 124,718 | $ (65,681) | $ 59,037 | 6.41 |

| | As of December 31, 2012 | | | |
|---|---|---|---|---|
| | Gross | Accumulated Amortization (in thousands) | Net | Weighted average remaining amortization period (years) |
| Existing and core technology - product | $ 47,658 | $ (35,326) | $ 12,332 | 2.39 |
| Technology licenses | 66,034 | (20,078) | 45,956 | 7.94 |
| Customer contracts and relationships | 8,991 | (5,291) | 3,700 | 4.93 |
| Trade name | 2,296 | (1,396) | 900 | 2.10 |
| Order backlog | 640 | (640) | | |
| Total amortizable intangible assets | 125,619 | (62,731) | 62,888 | 6.57 |

Amortization expense was $4.8 million and $4.1 million for the three months ended March 31, 2013 and 2012, respectively. The estimated future amortization expense from amortizable intangible assets is as follows (in thousands):

| | |
|---|---|
| Remainder of 2013 | $ 12,605 |
| 2014 | 14,035 |
| 2015 | 7,346 |
| 2016 | 5,215 |
| 2017 | 4,409 |
| 2018 and thereafter | 15,427 |
| | $ 59,037 |

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**7. Restructuring Accrual**

In the first quarter of 2012, the Company recorded a restructuring accrual of $0.4 million related to the leased facility in Canada which the Company no longer occupies. The lease will expire in March 2014.

In connection with a workforce reduction during the three months ended March 31, 2013, the Company incurred $1.4 million in expense primarily related to severance and other related benefits.

A summary of the accrued restructuring liabilities, net of related activities during the three months ended March 31, 2013 is as follows:

| | Severance and other benefits | Excess Facility Related Cost (in thousands) | Total |
|---|---|---|---|
| Balance at December 31, 2012 | $ | $ 262 | $ 262 |
| Additions | 1,371 | | 1,371 |
| Cash payments and other non-cash adjustments | (1,371) | (52) | (1,423) |
| Balance at March 31, 2013 | $ | $ 210 | $ 210 |

**8. Stockholders Equity**

***Equity Incentive Plans***

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 three months ended March 31, 2013:

| | Number of Shares Outstanding | Weighted Average Exercise Price |
|---|---|---|
| Balance as of December 31, 2012 | 4,197,704 | $ 16.83 |
| Options granted | 189,375 | 37.63 |
| Options exercised | (420,318) | 16.25 |
| Options cancelled and forfeited | (132,295) | 33.93 |
| Balance as of March 31, 2013 | 3,834,466 | $ 17.34 |

The fair value of each employee option grant for the three months ended March 31, 2013 and 2012 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| Risk-free interest rate | 0.32% | 0.83% |
| Expected life | 4.53 years | 4.53 years |
| Dividend yield | 0% | 0% |
| Volatility | 49.6% | 53.6% |

The estimated weighted-average grant date fair value of options granted were $15.30 and $15.79 per share for the three months ended March 31, 2013 and 2012, respectively.

As of March 31, 2013, there is $8.5 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 2.47 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 three months ended March 31, 2013:

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| | Number of Shares | Weighted-Average Grant Date Fair Value Per Share |
|---|---|---|
| Balance as of December 31, 2012 | 1,823,563 | $ 33.17 |
| Granted | 860,850 | 36.95 |
| Issued and released | (284,295) | 31.24 |
| Cancelled and forfeited | (170,543) | 31.44 |
| Balance as of March 31, 2013 | 2,229,575 | $ 35.00 |

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 March 31, 2013, there was $64.6 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 2.86 years.

***Stock-Based Compensation***

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 March 31, 2013 | 2012 |
|---|---|---|
| | (in thousands) | |
| Cost of revenue | $ 287 | $ 517 |
| Research and development | 3,906 | 4,066 |
| Sales, general and administrative | 4,081 | 4,430 |
| | $ 8,274 | $ 9,013 |

The total stock-based compensation cost capitalized as part of inventory as of March 31, 2013 and December 31, 2012 was not significant.

***Changes in stockholders equity***

A reconciliation of the changes in stockholders equity for the three months ended March 31, 2013 is presented below:

| | Three months ended March 31, 2013 | | |
|---|---|---|---|
| | Attributable to the Company | Attributable to non-controlling interest | Total stockholders equity |
| | | (in thousands) | |
| Balance at December 31, 2012 | $ 244,092 | $ (1,030) | $ 243,062 |
| Common stock issued in connection with exercises of stock options | 6,845 | | 6,845 |
| Stock-based compensation | 8,268 | | 8,268 |
| Net loss | (3,184) | (2,129) | (5,313) |
| Balance at March 31, 2013 | $ 256,021 | $ (3,159) | $ 252,862 |

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### 9. Income Taxes

The quarterly tax provision for (benefit from) income taxes is 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 months ended March 31, 2013 and 2012:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (in thousands) | |
| Loss before income taxes | $ (4,887) | $ (14,993) |
| Provision for (benefit from) income taxes | 426 | (1,104) |
| Effective tax rate | -8.7% | 7.4% |

The provision for income taxes for the three months ended March 31, 2013 was primarily related to earnings in foreign jurisdictions. The difference between the provision for or benefit from income taxes that would be derived by applying the statutory rate to the Company s loss before income taxes and the provision for income taxes recorded for the three months ended March 31, 2013 was primarily attributable to the impact of the losses that are not benefited, difference in foreign tax rates and increase in indefinite lived intangible related deferred tax liability. The benefit from income taxes for the three months ended March 31, 2012 was primarily related to the year-to-date pre-tax losses. The difference between the provision for or benefit from income taxes that would be derived by applying the statutory rate to the Company s loss before income taxes and the benefit from income taxes recorded for the three months ended March 31, 2012 was primarily attributable to the impact of the differential in foreign tax rates, non-deductible stock-based compensation charges, and recovery of non-taxable escrow related to the Celestial Semiconductor acquisition.

The Company s net deferred tax assets relate predominantly to its United States tax jurisdiction. The need for valuation allowance requires 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. In making such assessment, significant weight is given to evidence that can be objectively verified. After considering both negative and positive evidence to assess the recoverability of the Company s net deferred tax assets during the fourth quarter of 2012, the Company determined that it was more-likely-than-not it would not realize the full value of its federal and state deferred tax assets. As such, the Company determined that as of December 31, 2012, a full valuation allowance is required on its net federal and state deferred tax assets. Adjustments could be required in the future if the Company concludes that it is more-likely-than-not that these net deferred tax assets are recoverable. A release of the valuation allowance could have the effect of decreasing the income tax provision in the period the valuation allowance is released. The Company continues to monitor the likelihood that it will be able to recover its deferred tax assets. As of March 31, 2013, the Company believes that it is not more likely than not that it will be able to fully realize its United States federal and state deferred tax assets, as such, the Company continues to provide a full valuation allowance on those deferred tax assets.

As of March 31, 2013 and December 31, 2012, the Company had unrecognized tax benefits for income taxes associated with uncertain tax positions of $13.7 million and $12.7 million, respectively. If all of these unrecognized tax benefits were recognized, $0.8 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 Company s major tax jurisdictions are the United States federal government, the states of California and Massachusetts, Japan, India, China and Singapore. The Company files income tax returns in the United States federal jurisdiction, the states of California and Massachusetts, various other states, and foreign jurisdictions in which it has a subsidiary or branch operations. The United States federal corporation income tax returns beginning with the 2000 tax year remain subject to examination by the Internal Revenue Service. The California corporation income tax returns beginning with the 2000 tax year remain subject to examination by the California Franchise Tax Board. As of March 31, 2013, there are no on-going tax audits in the major tax jurisdictions other than India. The India tax audit is for the tax year 2011, and the Company does not expect any significant tax adjustments.

On January 2, 2013, the President of the United States of America signed into law The American Taxpayer Relief Act of 2012, or ATRA. Under prior law, a taxpayer was entitled to a research tax credit for qualifying amounts incurred through December 31,

2011. The ATRA extends the research credit for two years for qualified research expenditures incurred through the end of 2013. The extension of the research credit is retroactive and includes amounts incurred after 2011. The benefit of the reinstated credit did not impact the income statement in the period of enactment, which is the first quarter of 2013, as the research and development credit carryforwards are offset by a full valuation allowance.

**10. Segment and Geographic Information**

Operating segments are based on components of the Company that engage in business activity that earn revenue and incur expenses and (a) whose operating results are regularly reviewed by the Company s chief operating decision maker, or CODM, to make decisions about resource allocation and performance and (b) for which discrete financial information is available. The Company s primary business has been its semiconductor business, which comes from the development and sale of semiconductor products. Prior to fiscal year 2010, the Company was organized as, and operated in, one operating segment. In the fourth quarter of 2009, the Company acquired MontaVista which changed the way the CODM viewed and managed the business and allocated resources. This resulted in the Company to operate in two reporting units which is the same as the reportable segments namely, semiconductor products and software and services beginning first quarter of 2010.

During the first quarter of 2013, the Company sold certain assets and reorganized the software and services unit which resulted in a decrease in the significance of the related business unit to the overall operations of the Company. Due to such decrease in the significance of the software and services unit, the CODM now views, manages and allocates resources across the business as a whole and no longer reviews the discrete financial information for semiconductor products and software and services separately. As a result of this change, the Company manages and operates as one reporting unit which is also the same as the reportable segment beginning in the first quarter of 2013.

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 March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| | (in thousands) | |
| United States | $ 22,651 | $ 19,638 |
| China | 16,820 | 13,687 |
| Korea | 7,035 | 2,723 |
| Taiwan | 5,891 | 5,553 |
| Mexico | 4,150 | 955 |
| Malaysia | 3,465 | 4,486 |
| Other countries | 9,518 | 5,701 |
| Total | $ 69,530 | $ 52,743 |

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

| | As of March 31, 2013 | As of December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| United States | $ 25,896 | $ 27,678 |
| All other countries | 2,909 | 3,014 |
| Total | $ 28,805 | $ 30,692 |

**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 November 2020. The Company also acquires certain assets under capital leases.

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Minimum commitments under non-cancelable operating and capital lease agreements, excluding the accrued restructuring liability (See Note 7 of the Condensed Consolidated Financial Statements) as of March 31, 2013 are as follows:

| | Capital lease and technology license obligations | Operating leases (in thousands) | Total |
|---|---|---|---|
| Remainder of 2013 | $ 11,632 | $ 3,345 | $ 14,977 |
| 2014 | 11,968 | 4,103 | 16,071 |
| 2015 | 9,258 | 3,960 | 13,218 |
| 2016 | 5,150 | 4,070 | 9,220 |
| 2017 | | 4,182 | 4,182 |
| 2018 thereafter | | 8,959 | 8,959 |
| | $ 38,008 | $ 28,619 | $ 66,627 |
| Less: Interest component (3.75% annual rate) | 2,181 | | |
| Present value of minimum lease payment | 35,827 | | |
| Current portion of the obligations | $ 11,984 | | |
| Long-term portion of obligations | $ 23,843 | | |

Rent expense incurred under operating leases was $1.3 million and $1.6 million for the three months ended March 31, 2013 and 2012, 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.

**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.*

*OCTEON*®, *OCTEON*® *Plus*™, *OCTEON Fusion*®, *FusionStack*™, *NITROX*®, *NEURON*™, *Celestial*™ , *ECONA*®, *PureVu*® and WiVu™ are trademarks or registered trademarks of Cavium, Inc.

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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 product allows 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, or 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 2012, we announced Project Thunder, the development of a new family of 64-bit ARMv8 scalable multi-core processors for cloud and datacenter applications. We expect that this processor family will integrate high-performance computer, networking, security, and storage along with targeted workload application acceleration and high-speed industry standard IOs.

In August 2008, we acquired substantially all of the assets of 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 introduced our ECONA line of dual-core ARM processors that address a 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 complemented 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 Digital Media product development and Android commercialization and support.

In January 2011, we completed the acquisition of substantially all of the assets and assumed certain liabilities of Wavesat Inc. This acquisition added multicore wireless digital system processing to our embedded processor product line.

In March 2011, we completed the acquisition of substantially all of the assets and assumed certain liabilities of Celestial Semiconductor, Ltd. With the acquisition of Celestial Semiconductor, we have added capabilities to enable a processor family targeted for the large and growing market of converged media, gateway and wireless display applications.

Since inception, we have invested heavily in new product development and our net revenue has grown from $7.4 million in 2004 to $235.5 million in 2012 driven primarily by demand in the enterprise network and data center markets and increased demand in the broadband and consumer markets. We expect sales of our products for use in the enterprise network and data center 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 as well as the access and servicer provider markets.

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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.

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**Results of Operations**

*Three months ended March 31, 2013 and 2012*

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

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2013 | 2012 | change | % |
| | (in thousands) | | | |
| Net revenue | $ 69,530 | $ 52,743 | $ 16,787 | 31.8% |
| Cost of revenue | 26,159 | 28,008 | (1,849) | -6.6% |
| Gross Profit | $ 43,371 | $ 24,735 | $ 18,636 | 75.3% |
| Gross Margin | 62.4% | 46.9% | 15.5% | |

*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.

Cisco Systems, Inc. accounted for 19% and 28% of our net revenue for the three months ended March 31, 2013 and 2012, respectively. No other customer accounted for more than 10% of our revenues for the three months ended March 31, 2013 and 2012.

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 distributor to distribute our products primarily in the United States. Given the terms of the distribution agreement, for sales to this distributor, we defer revenue and costs until products are sold to its end customers. For the three months ended March 31, 2013 and 2012, 5.9%, 5.7%, 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.

We use our distributors, other than the distributor discussed above, primarily to support international sale logistics in Asia, including importation and credit management. Total net revenue through these distributors was $21.4 million and $14.7 million for the three months ended March 31, 2013 and 2012, respectively, which accounted for 30.8% and 27.8% of net revenue for the three months ended March 31, 2013 and 2012, 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 or 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.

Our net revenue increased by $16.8 million or 31.8% in the three months ended March 31, 2013 compared to the three months ended March 31, 2012. The increase in net revenue was attributable mainly to the increase in sales in our enterprise network; data center; and access and service provider markets, combined of $17.8 million, which was partially offset by the decrease in sales in our broadband and consumer market of $1.0 million. The overall increase in sales in our enterprise networks; data center; and access and service provider markets was mainly due to the increase in demand for our products, as a result of the timing of these customers volume production of our design wins. The decrease in sales of our broadband and consumer market resulted from lower demand from our customers, affected by the timing of volume production of our design wins in the broadband and consumer side.

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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 March 31, | |
|---|---|---|
| | 2013 | 2012 |
| | (in thousands) | |
| United States | $ 22,651 | $ 19,638 |
| China | 16,820 | 13,687 |
| Korea | 7,035 | 2,723 |
| Taiwan | 5,891 | 5,553 |
| Mexico | 4,150 | 955 |
| Malaysia | 3,465 | 4,486 |
| Other countries | 9,518 | 5,701 |
| Total | $ 69,530 | $ 52,743 |

*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, and Fujitsu Microelectronics, or Fujitsu. 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. There are no long-term agreements with any of these third-party contractors. A significant disruption in the operations of one or more of these third-party contractors would impact the production of our products for a substantial period of time, which could have a material adverse effect on our business, financial condition and results of operations.

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 increased from 46.9% in the three months ended March 31, 2012 to 62.4% in the three months ended March 31, 2013, an increase of 16.0%. During the first quarter of 2012, we wrote-down certain Celestial product inventories of approximately $4.8 million. Excluding this inventory write down in the first quarter of 2012, gross margin increased by 6.4% in the three months ended March 31, 2013 compared to the three months ended March 31, 2012. The increase in the overall gross margin percentage was mainly due to overall increases in revenue and shifts of product sales mix of our semiconductor products as we sold more of our higher performance products, which yield higher gross margins compared to our lower performance products.

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***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.

Total research and development expenses for the periods presented were:

| | Three Months Ended March 31, 2013 | 2012 | change | % |
|---|---|---|---|---|
| | (in thousands) | | | |
| Research and development expenses | $ 32,415 | $ 27,058 | $ 5,357 | 19.8% |
| Percent of total net revenue | 46.6% | 51.3% | -4.7% | |

Research and development expenses increased by $5.4 million or 19.8% in the three months ended March 31, 2013 compared to the three months ended March 31, 2012. Research and development expense in the three months ended March 31, 2013 included $3.6 million from a variable interest entity, or VIE. The remaining research and development expense increase of $1.8 million or 6.6%, was mainly due to increased depreciation and amortization expense of $1.1 million as a result of an increase in purchased technology licenses used for research and development projects. The other increase of $0.7 million was due to the increase in product development costs, facilities expense, design tools, increased headcount and other miscellaneous research and development, as a result of the increase in research and development activities to support the development of our new products. Research and development headcount was 534 at March 31, 2013 compared to 521 at March 31, 2012.

***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 March 31, 2013 | 2012 | change | % |
|---|---|---|---|---|
| | (in thousands) | | | |
| Sales, general and administrative | $ 15,240 | $ 12,484 | $ 2,756 | 22.1% |
| Percent of total net revenue | 21.9% | 23.7% | -1.8% | |

Sales, general and administrative expenses increased by $2.8 million or 22.1% in the three months ended March 31, 2013 compared to the three months ended March 31, 2012. The increase was mainly due to lower expense in the three months ended March 31, 2012 which resulted from a credit associated with the proceeds from settlement of an escrow claim of $4.4 million. Contributing to the increase is the cost incurred for severance and other benefits of $0.8 million related to restructuring activities during the three months ended March 31, 2013. The increase was partly offset by the decrease in salaries and employee benefits of $1.6 million due to decrease in headcount and the decrease in stock-based compensation expense of $0.5 million mainly due to the timing and reduced number of option and restricted stock unit grants. Further, during the first quarter of 2013, the Company recorded a credit of $0.7 million associated with the gain on sale of held for sale assets. Other sales, general and administrative expenses increased by $0.4 million mainly due to increased marketing related expenses which resulted from increased sales and increased outside services related to sale of certain assets of MontaVista. Sales, general and administrative headcount was 154 at March 31, 2013 compared to 192 at March 31, 2012.

***Other income (expense), net.*** Other income (expense), net primarily includes interest income on cash and cash equivalents, foreign currency gains and losses, financing expenses and interest expense associated with capital lease and technology license obligations.

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Other expense, net for the periods presented were:

| | Three Months Ended March 31, 2013 | 2012 | change | % |
|---|---|---|---|---|
| | (in thousands) | | | |
| Interest expense | $ (342) | $ (32) | $ (310) | 968.8% |
| Other, net | (261) | (94) | (167) | 177.7% |
| Total other expense, net | $ (603) | $ (126) | $ (477) | 378.6% |

Other expense, net, increased by $0.5 million in the three months ended March 31, 2013 compared to the three months ended March 31, 2012. The increase was primarily due to higher interest expense associated with long-term capital lease payable and higher foreign exchange losses resulting from balance sheet remeasurement.

***Provision for (benefit from) Income Taxes.*** For the three months ended March 31, 2013 and 2012, the provision for (benefit from) income taxes was based on our estimated annual effective tax rate, plus any discrete items, and taking into account valuation allowance, as necessary, 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 provision for (benefit from) income taxes and the effective tax rates for the respective periods presented:

| | Three Months Ended March 31, 2013 | 2012 | change | % |
|---|---|---|---|---|
| | (in thousands) | | | |
| Loss before income taxes | $ (4,887) | $ (14,993) | $ 10,106 | -67.4% |
| Provision for (benefit from) income taxes | 426 | (1,104) | 1,530 | -138.6% |
| Effective tax rate | -8.7% | 7.4% | -16.1% | |

The provision for income taxes for the three months ended March 31, 2013 was primarily related to earnings in foreign jurisdictions. The difference between the provision for or benefit from income taxes that would be derived by applying the statutory rate to our loss before income taxes and the provision for income taxes recorded for the three months ended March 31, 2013 was primarily attributable to the impact of losses that are not benefited, the difference in foreign tax rates and increase in indefinite lived intangible related deferred tax liability. The benefit from income taxes for the three months ended March 31, 2012 was primarily related to the year-to-date pre-tax losses. The difference between the provision for or benefit from income taxes that would be derived by applying the statutory rate to our loss before income taxes and the benefit from income taxes recorded for the three months ended March 31, 2012 was primarily attributable to the impact of the differential in foreign tax rates, non-deductible stock-based compensation charges, and recovery of non-taxable escrow related to the Celestial Semiconductor acquisition.

***Liquidity and Capital Resources***

Following is a summary of our working capital and cash and cash equivalents as of March 31, 2013 and December 31, 2012:

| | As of March 31, 2013 | As of December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Working capital | $ 124,403 | $ 109,682 |
| Cash and cash equivalents | 86,511 | 76,784 |

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

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| | (in thousands) | |
| Net cash provided by operating activities | $ 8,407 | $ 6,796 |
| Net cash provided by (used in) investing activities | 337 | (3,138) |
| Net cash provided by (used in) financing activities | 983 | (1,797) |

***Cash Flows from Operating Activities***

Net cash flows from operating activities increased by $1.6 million from $6.8 million in the three months ended March 31, 2012 compared to $8.4 million in the three months ended March 31, 2013. Total cash inflow from net loss, net of non-cash items in the three months ended March 31, 2013 was $11.7 million compared to $1.2 million in the three months ended March 31, 2012. The increase resulted mainly from higher net revenue which generated higher income from operations. Changes in assets and liabilities generated net cash outflow of $3.3 million in the three months ended March 31, 2013 compared to a cash inflow of $5.6 million in the three months ended March 31, 2012. The significant changes in assets and liabilities in the three months ended March 31, 2013 which resulted in cash outflows were lower accounts payable and accrued expenses resulting from the timing of payments to vendors, lower deferred revenue resulted from lower subscription licenses and professional services billings to customers and higher accounts receivable resulted from higher revenue. These cash outflows from changes in assets and liabilities was partially offset by the cash inflows resulted from the decrease in inventories due to the timing of inventory build-up and decrease in prepaid expenses and other current assets due to the timing of advance payments to vendors. The significant changes in the assets and liabilities for the three months ended March 31, 2012 were mainly due to decrease in inventories due to the timing of inventory build-up, higher accounts payable due to the timing of payments to vendors and higher deferred revenue due to the timing of the receipt of subscription license and professional billings from the customers.

***Cash Flows from Investing Activities***

Net cash provided by investing activities in the three months ended March 31, 2013 was $0.3 million compared to net cash used in investing activities in the three months ended March 31, 2012 of $3.1 million. Net cash provided by investing activities in the three months ended March 31, 2013 resulted from the receipt of cash proceeds of $3.4 million related to the sale of certain assets of MontaVista, which was partially offset by the cash payments made to purchase intangible assets of $2.3 million and property and equipment of $0.7 million. Net cash used in investing activities in the three months ended March 31, 2012 resulted from cash payments made to purchase property and equipment of $1.7 million and intangible assets of $1.5 million.

***Cash Flows from Financing Activities***

Net cash provided by financing activities in the three months ended March 31, 2013 was $1.0 million compared to net cash used in financing activities in the three months ended March 31, 2012 of $1.8 million. Net cash provided by financing activities in the three months ended March 31, 2013 resulted mainly from the proceeds received from issuance of common stock upon exercise of options of $6.8 million and cash received for a convertible note of the VIE to a third-party investor of $0.5 million, partially offset by the principal payments of capital lease and technology license obligations of $6.4 million. Net cash used in financing activities in the three months ended March 31, 2012 resulted from principal payments of capital lease and technology license obligations of $3.4 million, partially offset by the proceeds received from issuance of common stock upon exercise of options of $1.6 million.

***Capital Resources***

Cash equivalents consist primarily of an investment in a money market fund. We believe that our $86.5 million of cash and cash equivalents at March 31, 2013, and expected cash flow from operations, if any, will be sufficient to fund our projected operating requirements for at least 12 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, other than disclosed in Note 5 of Notes to Condensed Consolidated Financial Statements, 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.

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**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 March 31, 2013, we believe our exposure related to the above indemnities at March 31, 2013, 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.

**Contractual Obligations**

The following table describes our commitments to settle contractual obligations in cash as of March 31, 2013:

| | Payments Due By Period | | | | |
|---|---|---|---|---|---|
| | Total | Remainder of 2013 | 1 to 3 Years | 3 to 5 Years | More Than 5 Years |
| | | | (in thousands) | | |
| Operating lease obligations | $ 28,619 | $ 3,345 | $ 8,063 | $ 8,252 | $ 8,959 |
| Capital lease and technology license obligations | 38,008 | 11,632 | 21,226 | 5,150 | |
| Total | $ 66,627 | $ 14,977 | $ 29,289 | $ 13,402 | $ 8,959 |

As of March 31, 2013, the liability for uncertain tax positions was $0.8 million. 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.

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, 2012 filed on February 28, 2013.

**Recent Accounting Pronouncements**

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

**Item 3. Quantitative and Qualitative Disclosure About Market Risk**

During the three months ended March 31, 2013, 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, 2012 as filed with the SEC on February 28, 2013.

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**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 March 31, 2013. 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 March 31, 2013 that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**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 28, 2013.

**Risks Related to Our Business and Industry**

****We have sustained loses in our last five quarters, and we may not achieve or sustain profitability in the future, on a quarterly or annual basis.***

We incurred a net loss for the quarter ended December 31, 2011, and for each of the quarters since then. As of March 31, 2013, our accumulated deficit was $157.3 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. As a public company, we also incur significant legal, accounting and other expenses. Additionally, we may encounter unforeseen difficulties, complications, product delays and other unknown factors that may require additional expenditures. As a result of these expenditures, we may need to generate substantially increased revenue to achieve profitability. Our revenue growth trend in 2012 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, which could adversely affect the price of our common stock.***

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.

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

- fluctuations in demand, sales cycles, product mix and prices for our products;

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- 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, which may vary the size of their orders;
- 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 in which 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, and therefore our stock price.

***We may have difficulty accurately predicting our future revenues for the purpose of appropriately budgeting and adjusting our expenses, which could adversely affect our operating results.***

The 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 revenues, gross margin and/or 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 and Marvell Technology Group Ltd. 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 and Realtek Semiconductor Corp.

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. In the future, further development by our competitors, and development by our potential competitors, could cause our products to become obsolete. 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;
- 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 project customer requirements to be less than the demand that materializes, 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. In the past, we have had customers dramatically increase their requested production quantities with little or no advance notice. 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. 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 some of their 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, financial condition, and results of operations.

****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 49% of our net revenues from our top five customers for the three months ended March 31, 2013 and 2012. We received approximately 19% and 28% of our net revenue from Cisco for the three months ended March 31, 2013 and 2012, 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 that the portion of our revenues attributable to some of these customers may increase in the future. However, we may not be able to maintain or increase sales to some 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 relationships with customers that are technology leaders in our target markets. We intend to continue expanding these relationships and forming new 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 need to devote a substantial amount of our resources to our relationships, which could detract from or delay our completion of other important development projects. Delays in development could impair our relationships with our other large 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 some 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 business, financial condition, and results of operations.

***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 in which we expend significant resources, 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. The product mix was relatively constant throughout 2010 and 2011; however, in 2012, the product mix shifted slightly towards the sale of our lower performance products. If the sales mix shifts towards 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 rely on our customers to design our products into their systems, and the nature of the design process requires us to incur expenses prior to customer commitments to use our products or 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.

***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 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.

***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 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, and office automation. If these customers sell fewer products or otherwise face significant economic difficulties, particularly in the current global economic recession, our software and license revenues may decline.

***In the event one of our distributor arrangements terminates, 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 loss of revenues until a replacement distributor can be established to service the affected end-user customers, or a permanent loss of revenues if no replacement can be established. 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 some locations or to some 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.

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***We rely on our ecosystem partners to enhance our product offerings and our inability to continue to develop or maintain these 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 may 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 would 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 which would 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 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 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.

We rely on stock-based awards as one means for recruiting, motivating and retaining highly skilled talent. If the value of the 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 business, financial condition and results of operations.

***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 located outside the United States, particularly in Asia and Europe. Even customers 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;

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- 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.

***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. Although our processes and procedures are designed to maintain compliance, we cannot assure you that we have been or will be at all times in complete compliance with these laws and regulations. If we fail 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 some customers, or we may incur penalties or fines and civil and criminal liabilities or other sanctions. 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.

***New regulations related to conflict minerals may force us to incur additional expenses, may make our supply chain more complex and may result in damage to our reputation with customers.***

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, or the Dodd-Frank Act, the Securities and Exchange Commission has adopted new requirements for companies that use certain minerals and metals, known as conflict minerals, in their products, whether or not these products are manufactured by third parties. These requirements will require companies to diligence, disclose and report whether or not such minerals originate from the Democratic Republic of Congo and adjoining countries. The implementation of these new requirements could adversely affect the sourcing, availability and pricing of minerals used in the manufacture of semiconductor devices, including our products. In addition, we will incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the relevant minerals and metals used in our products. Since our supply chain is complex, we may not be able to sufficiently verify the origins for these minerals and metals used in our products through the due diligence procedures that we implement, which may harm our reputation. In such event, we may also face difficulties in satisfying customers who require that all of the components of our products are certified as conflict mineral free.

***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.

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, financial condition and results of operations.

***Our products are manufactured at a limited number of locations and if we experience manufacturing problems at a particular location, we could experience a delay in obtaining our manufactured products, which could harm our business and reputation.***

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 from other sources. 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. 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.

***If we experience delays or loss of manufacturing availability when demand is high, we would experience a delay in obtaining our manufactured products, which could harm our business and reputation.***

We have no long-term supply contracts with the foundries with which we work. 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. Further, 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.

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.

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

The semiconductor business experiences 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, may not be able to be passed on to our customers and we may experience reduced 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.

****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. The failure of our patents and other intellectual property protections to adequately protect our technology might make it easier for our competitors to offer similar products or technologies, which would harm our business. We have been issued 43 patents in the United States and 16 patents in foreign countries and have an additional 88 patent applications pending in the United States and 36 patent applications pending in foreign countries as of March 31, 2013. 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. 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. 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, financial condition, and results of operations. We may in the future need to initiate infringement claims or litigation to defend or enforce our intellectual property rights. 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.

***A breach of our security systems may have a material adverse effect on our business.***

Our security systems are designed to maintain the physical security of our facilities and protect our customers , suppliers and employees confidential information. However, we are also dependent on a number of third-party cloud-based service providers of critical corporate infrastructure services relating to, among other things, human resources, electronic communication services and some finance functions, and we are, of necessity, dependent on the security systems of these providers. Accidental or willful security breaches or other unauthorized access by third parties to our facilities, our information systems or the systems of our cloud-based service providers or the existence of computer viruses in our or their data or software could expose us to a risk of information loss and misappropriation of proprietary and confidential information. Any theft or misuse of this information could result in, among other things, unfavorable publicity, damage to our reputation, difficulty in marketing our products, allegations by our customers that we have not performed our contractual obligations, litigation by affected parties and possible financial obligations for liabilities and damages related to the theft or misuse of this information, any of which could have a material adverse effect on our business, profitability and financial condition. Since the techniques used to obtain unauthorized access or to sabotage systems change frequently and are often not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures.

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***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 specified patents, trade secrets or other intellectual property rights owned by others. Any of these allegations, regardless of merit, could cause us to incur significant costs in responding to, defending and resolving these allegations. Any lawsuits resulting from these 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;
- 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, 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, the 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 remediated, 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, including through numerous acquisitions 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, disposition and investment strategies may result in unanticipated accounting charges or otherwise adversely affect our business, financial condition and results of operations.***

Since May 2008, we have acquired two companies and acquired assets of, and assumed liabilities of, five other companies. During 2012, we made advances to a third-party company, which was considered a variable interest entity, for convertible notes receivable. We expect that we will in the future continue to acquire companies or assets of companies or invest in third-party companies that we believe to be complementary to our business, including for the purpose of expanding our new product design

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capacity, introducing new design, market or application skills or enhancing and expanding our existing product lines. In connection with any such future acquisitions or investments, 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. These actions could adversely impact our operating results and the market price of our common stock. In addition, acquisitions of companies exposes us to risks, including:

- difficulties may occur in assimilating and integrating the operations, personnel, technologies, and products of acquired companies or businesses;

- key personnel of an acquired company may decide not to work for us;

- 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, and 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; and

- the purchase price of any acquired businesses may exceed the current fair values of the net tangible assets of the acquired businesses, in which case 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, which charges, in addition to the results of operations of the 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 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 these 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, financial condition and results of operations. 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 General Public License, or 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 need 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 incorrectly believe that anyone who writes a software program that runs on Linux will necessarily need 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 understands 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 customers 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. 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 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 some 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, other natural disasters or other events causing closures 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.***

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.

***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 seek 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. During the year ended December 31, 2012, we recorded goodwill and intangible asset impairment charges of $27.7 million and $5.6 million, respectively.

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. If our actual results, or the plans and estimates used in future impairment analyses are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges. 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 business, financial condition and results of operations.

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***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. Further, because we have established valuation allowance against our deferred tax assets in the United States, combined with lower foreign tax rates, 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 United States 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;
- 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.

Although we reserve for uncertain tax positions, including related penalties and interest, the amounts ultimately paid upon resolution of audits could be materially different from the amounts previously included in our income tax expense and therefore could have a material impact on our tax provision, net income and cash flows. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to record additional income tax expense or establish an additional valuation allowance, which could materially impact our financial position and results of operations. (See Note 9 of the Notes to Consolidated Financial Statements).

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***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. If our assumptions and consequently our estimates change in the future, the valuation allowances may be increased or decreased, resulting in a respective increase or decrease in income tax expense.

We assessed that it was more-likely-than-not that we will not realize our federal and state deferred tax assets based on the absence of sufficient positive objective evidence that we would generate sufficient taxable income in our United States tax jurisdiction to realize the deferred tax assets. Accordingly, we recorded a valuation allowance on our federal and state deferred tax assets during the fourth quarter of 2012.

**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 March 2013, 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.

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***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;
- 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 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.

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## SIGNATURES

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

| | | |
|---|---|---|
| | CAVIUM, INC. | |
| Date: May 6, 2013 | By: | /s/ ARTHUR D. CHADWICK |
| | | **Arthur D. Chadwick** |
| | | **Chief Financial Officer and Vice President of Finance and Administration and Secretary** |

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**EXHIBIT INDEX**

| Exhibit Number | Description |
|---|---|
| 3.1 | Restated Certificate of Incorporation of the Registrant (1) |
| 3.2 | Amended and Restated Bylaws of the Registrant (2) |
| 4.1 | Reference is made to Exhibits 3.1 and 3.2 |
| 4.2 | Form of the Registrant s Common Stock Certificate (3) |
| 10.1 | Amended 2007 Equity Incentive Plan |
| 10.2 | Letter Agreement, dated March 22, 2013, between the Registrant and Madhav Rajan |
| 10.3 | Executive 2013 Salaries |
| 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 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.
(2) 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.
(3) 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.
Management contract or compensatory plan or arrangement.
* 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.