NETLOGIC MICROSYSTEMS INC
Form 10-K
March 04, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

FORM 10-K

(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

OR

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

For the Transition Period from to

Commission File Number: 000-50838

NETLOGIC MICROSYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Delaware	77-0455244
(State or Other Jurisdiction of Incorporation)	(I.R.S. Employer Identification No.)
1875 Charleston Road, Mountain View, California	94043
(Address of principal executive office)	(Zip Code)

(650) 961-6676
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $0.01 par value per share	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer ¨ Accelerated filer x 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 x

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2008, the last business day of the registrant's most recently completed second fiscal quarter, was approximately $588,857,975 (based on the last reported sale price of $33.20 on June 30, 2008).

21,895,133 shares of the Registrant's common stock, par value $0.01 per share, were outstanding as of January 31, 2009.

DOCUMENTS INCORPORATED BY REFERENCE

Portions registrant's proxy statement to be delivered to stockholders in connection with the registrant's 2009 Annual Meeting of Stockholders to be held on or about May 15, 2009 are incorporated by reference into Part III of this Form 10-K. The registrant intends to file its proxy statement within 120 days after its fiscal year end.

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FISCAL 2008 FORM 10-K

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PART I

Forward-looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include, without limitation, statements about our future business operations and results, the market for our technology, our strategy and competition. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed forward-looking statements. For example, the words “believes”, “anticipates”, “plans”, “expects”, “intends” and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a discrepancy include, but are not limited to, those discussed in “Business”, “Risks Factors”, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Quantitative and Qualitative Disclosures About Market Risk” below. All forward-looking statements in this report are based on information available to us as of the date of this report, and we assume no obligation to update any such forward-looking statements. The information contained in this report should be read in conjunction with our condensed financial statements and the accompanying notes contained in this report. Unless expressly stated or the context otherwise requires, the terms “we”, “our”, “us” and “NetLogic Microsystems” refer to NetLogic Microsystems, Inc.

ITEM 1. BUSINESS.

Overview

We are a semiconductor company that designs, develops and sells proprietary high-performance processors and high-speed integrated circuits that are used by original equipment manufacturers (OEMs) in routers, switches, wireless infrastructure equipment, network security appliances, datacenter servers, network access equipment and network storage devices to accelerate the delivery of voice, video, data and multimedia content for advanced enterprise, datacenter, communications and mobile wireless networks. Our knowledge-based processors, physical layer products and network search engine products are incorporated in systems used throughout multiple types of networks that comprise the global Internet infrastructure, including the enterprise, datacenter, metro, access, edge and core networking markets, and are designed into systems offered by leading networking OEMs such as AlaxalA Networks Corporation, Alcatel-Lucent, ARRIS Group, Inc., Brocade Communications Systems, Inc., Cisco Systems, Inc., Huawei Technologies Co., Ltd., and Juniper Networks, Inc.

The products and technologies we have developed and acquired are targeted to enable our customers to develop systems that support the increasing speeds and complexity of the Internet infrastructure. We believe there is a growing need to include knowledge-based processors and high speed integrated circuits in a larger number of such systems as networks transition to all Internet Protocol (IP) packet processing at increasing speeds.

The equipment and systems that use our products are technically complex. As a result, the time from our initial customer engagement design activity to volume production can be lengthy and may require considerable support from our design engineering, research and development, sales, and marketing personnel in order to secure the engagement and commence product sales to the customer. Once the customer’s equipment is in volume production, however, it generally has a life cycle of three to five years and requires less ongoing support.

In general, we recognize revenue from sales of our products upon shipment to our customers or our international stocking sales representatives. Usually, we sell the initial shipments of a product for a new design engagement directly

to the OEM customer. Once the design enters volume production, the OEM frequently outsources its manufacturing to contract manufacturers who purchase the products directly from us.

As a fabless semiconductor company, our business is less capital intensive than others because we rely on third parties to manufacture, assemble, and test our products. In general, we do not anticipate making significant capital expenditures aside from business acquisitions that we might make from time to time. In the future, as we launch new products or expand our operations, however, we may require additional funds to procure product mask sets, order elevated quantities of wafers from our foundry partners, perform qualification testing and assemble and test those products.

Because we purchase all wafers from suppliers with fabrication facilities and outsource the assembly and testing to third party vendors, a significant portion of our costs of revenue consists of payments to third party vendors. We do not have long-term agreements with any of our suppliers and rely upon them to fulfill our orders.

Some of our challenges in fiscal 2008 and in fiscal 2009 include improving operating efficiencies in the light of recently deteriorating macroeconomic conditions, diversifying our product offerings and inventory management. While we achieved a year-over-year growth in total revenue from $109.0 million for fiscal year 2007 to $139.9 million for fiscal year 2008, we did experience a quarter-over-quarter decline in revenue from $38.3 million for our third fiscal quarter in 2008 to $30.9 million for our fourth fiscal quarter in 2008. We believe the decrease in demand was primarily due to macroeconomic conditions that decreased customer demand for our products. We also expect revenue for the first quarter of fiscal 2009 to decline further relative to the first quarter of fiscal 2008. In response, we have focused on operating efficiencies and lowered our operating expenses from $20.8 million for the third quarter of fiscal 2008 to $20.1 million for our fourth fiscal quarter in 2008. We expect to remain focused on maintaining our operating expenses at an appropriate level relative to our revenue during this period of macroeconomic weakness.

For the years ended December 31, 2008, 2007, and 2006, our top five customers accounted for approximately 68%, 79% and 84% of total product revenue, respectively. Favorable market trends, such as the increasing number of 10 Gigabit ports as enterprises and datacenters upgrade their legacy networks to better accommodate the proliferation of video and virtualization applications, growth in the cable infrastructure area of our business, and the growing mobile wireless infrastructure and IPTV markets, have enabled us to broaden our customer base and increase demand for our knowledge-based processors and network search engines. Additionally, we have further diversified our customer and product revenues by expanding our product portfolio to address Layer 7 content processing with our NETL7™ processor family, the Layer 1 physical layer with our 10 Gigabit Ethernet products, and entry level equipment with our NETLite™ processors.

As an integral part of our efforts to diversify our product and customer base, as well as strengthen our competitive positioning, and broaden our technology portfolio and research and development capabilities, we have entered into strategic acquisitions of products and technology, including:

- The acquisition of the majority of products and assets of the network search engine business from Cypress Semiconductor Corporation (“Cypress”) in February 2006, where we obtained the Sahasra™ algorithmic technology that we integrated into our NL9000 knowledge-based processor which we announced in January 2008;

- The acquisition of TCAM2 and TCAM2-CR network search engine products from Cypress in August 2007 that have resulted in immediate revenue expansion, as well as extension of our market leadership in the desktop switching market segment; and

- The acquisition of Aeluros Inc., a privately-held, fabless provider of industry-leading 10-Gigabit Ethernet physical layer products in October 2007, which extends our product offerings to the physical layer, or Layer 1, of the Open Systems Interconnection reference model, and is consistent with our strategy to target

customer systems that are being built to handle the increasing speeds of network traffic. This acquisition also increased our analog design capabilities and our ability to integrate higher speed, lower power I/O functionality into our next generation knowledge-based processors.

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Our Markets

We sell our products primarily to OEMs that supply networking equipment for the Internet infrastructure, which consists of various networking systems that process packets of information to enable communication between the networking systems. This networking equipment includes routers, switches, application acceleration equipment, network security appliances, network access equipment and networked storage devices that are utilized by networking systems such as:

- core networks, for long-distance city-to-city communications which may span hundreds or thousands of miles;
- enterprise networks, for internal corporate communications, including access to storage environments;
- datacenter networks, for high-density server farms;
- metro networks, for intra-city communications which may span several miles;
- edge networks, which link core, metro, enterprise and access networks; and
- access networks, which connect individual users to the edge network.

Sales of networking equipment have increased overall during the past five years, as the Internet has continued to grow and evolve to accommodate the continued growth in the amount of digital media content available and provide converged support for the quad-play applications of voice, data, video and mobility over a single unified Internet Protocol, or IP, infrastructure. These applications include:

- Internet Protocol Television, or IPTV;
- Video on demand, or VoD;
- Voice transmission over the Internet, or VoIP;
- On-line gaming;
- Filtering of malware (e.g., virus, spyware and spam) and intrusion attempts;
- Music, picture and video file downloading and sharing;
- Email communications;
- E-commerce;
- Music, picture and video file downloading and sharing to mobile devices such as cell phones and portable music/video devices; and
- Internet Web-surfing and video portal viewing, such as You-Tube, delivered over the IP infrastructure to cell phones and other mobile devices.

Due to the increased usage of the Internet, as well as the greater complexity of Internet-based infrastructure to support quad-play applications, OEM systems must increasingly make complex decisions about individual packets of information using knowledge about the overall network, which includes the method and manner in which networking systems are interconnected, as well as traffic patterns and congestion points, connection availability, user-based privileges, priorities and other attributes. These systems also need knowledge about the content carried by the network and the applications that use the network. Using this knowledge of the network to make complex decisions about individual packets of information involves network awareness, while using knowledge of packet content to make complex decisions about individual packets of information involves content awareness, also known as deep-packet inspection. Network awareness and content awareness include the following:

- Preferential transmission of packets based upon assigned priority;
- Restrictions on access based upon security designations;
- Changes to packet forwarding destinations based upon traffic patterns and bandwidth availability, or packet content; and
- Addition or deletion of information about networks and users and applications.

Moreover, network and content awareness in advanced systems require multiple classes of packet processing, in addition to forwarding packets in the network. These additional classes of processing include access control for network security, prioritization of packets to maintain quality of service ("QoS") and statistical measurement of Internet traffic for transaction billing. Compared to the basic processing task of forwarding, these additional classes of packet processing require a significantly higher degree of processing of IP packets to enable network and content awareness, or network-aware and content-aware processing.

Further, in designing high performance systems, networking OEMs need to address other performance issues, such as power dissipation. Minimizing the power dissipated by integrated circuits is becoming more important for networking systems such as routers and switches, which are increasingly designed in smaller form factors. As a result, networking OEMs increasingly seek third party providers of advanced processing solutions that complement their core competencies to enable network and content awareness within their systems and meet their escalating performance requirements for rapid processing speeds, complex decision-processing capabilities, low power dissipation, small form factor and rapid time-to-market.

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Our Strategy

Our objectives are to be the leading provider of network-aware and content-aware processing solutions, as well as 10 to 100 Gigabit physical layer solutions, to networking OEMs and to expand into new markets and applications. To achieve these goals, we are pursuing the following strategies:

Maintain and Extend our Market and Technology Leadership Positions. We were the first supplier of knowledge-based processors to offer a "hybrid" architecture that integrates our advanced Sahasra algorithmic technology with knowledge-based processing engines; the first supplier to offer 64Gbps of interconnect bandwidth, the first supplier to offer approximately 256 thousand Internet Protocol Version 6 ("IPv6") database entries and 1 million Internet Protocol Version 4 ("IPv4") data entries, the first supplier to achieve 1.0 Volt operation of knowledge-based processors for lower power dissipation; and the first supplier to achieve operating frequencies of up to 500 MHz. We were also the first supplier of knowledge-based processors that are capable of processing application networking and security functions with a single 10 Gigabit-per-second engine. In addition, we were the first supplier of quad-port 10 Gigabit and 100 Gigabit PHY solutions targeted at next-generation carrier optical transport networks and advanced data-center networks. We intend to expand our market and technology leadership positions by continuing to invest in the development of successive generations of our knowledge-based processors and our other products to meet the increasingly high performance needs of networking OEMs, and as well as potentially acquire such capabilities through strategic partnerships and purchases of other businesses when we encounter favorable opportunities. We intend to leverage our engineering capabilities and continue to invest significant resources in recruiting and developing additional expertise in the area of high performance circuit design, custom circuit layout, high performance I/O interfaces, and applications engineering. By utilizing our proprietary design methodologies, we intend to continue to target the most demanding, advanced applications for our products.

Focus on Long-Term Relationships with Industry-Leading OEM Customers. The design and product life cycles of our OEM customers' products have traditionally been lengthy, and we work with our OEM customers at the pre-design and design stages. As a result, our sales process typically requires us to maintain a long-term commitment and close working relationship with our existing and potential OEM customers. This process involves significant collaboration between our engineering team and the engineering and design teams of our OEM customers, and typically involves the concurrent development of our processors and the internally-designed packet processors of our OEM customers. We intend to continue to focus on building long-term relationships with industry-leading networking OEMs to facilitate the adoption of our products and to gain greater insight into the needs of our OEM customers.

Leverage Technologies to Create New Products and Pursue New Market Opportunities. We intend to leverage our core design expertise to develop our products for a broader range of applications to further expand our market opportunities. We plan to address new market segments that are increasingly adopting network-aware processing, such as corporate storage networks that use IP-based packet-switching networking protocols. By utilizing our proprietary design methodologies, we intend to continue to target the most demanding, advanced applications for our products.

Capitalize on Highly Focused Business Model. We are a fabless semiconductor company, utilizing third parties to manufacture, assemble and test our products. This approach reduces our capital and operating requirements and enables us to focus greater resources on product development. We work closely with our wafer foundries to incorporate advanced process technologies in our solutions to achieve higher levels of performance and to reduce costs. These technologies include advanced 130, 110, 80 and 55 nanometer complimentary metal oxide semiconductor ("CMOS") processing nodes with up to eight layers of copper interconnect and 300 millimeter wafer sizes. Our business model allows us to benefit from the large manufacturing investment of our wafer foundries which are able to leverage their investment across many markets.

Expand International Presence. We sell our products on a worldwide basis and utilize a network of direct sales and independent sales representatives in the U.S., Europe and Asia. We intend to continue to expand our sales and technical support organization to broaden our customer reach in new markets. We believe that Asia, in particular China, and Europe, where we have already established customer relationships, provides the potential for significant additional long-term growth for our products. Given the continued globalization of OEM supply chains, particularly with respect to design and manufacturing, we believe that having a global presence will become increasingly important for securing new customers and design wins and to support OEMs in bringing their products to markets.

Our Products

Our products include high-performance knowledge-based processors, NETLiteTM processors, network search engines and physical layer products.

Knowledge-based Processors

Knowledge-based processors are integrated circuits that employ an advanced processor architecture and a large knowledge or signature database containing information on the network, as well as applications and content that run on the network, to make complex decisions about individual packets of information traveling through the network. Our knowledge-based processors significantly enhance the ability of networking OEMs to supply network service providers with systems offering more advanced functionality for the Internet, such as support for IPTV, VoIP, unified threat management, or UTM, virtual private networks, or VPNs, rich content delivery over mobile wireless networks, and streaming video and audio.

Our knowledge-based processors incorporate advanced technologies that enable rapid processing, such as a superscalar architecture, which uses parallel-processing techniques, and deep pipelining, which segments processing tasks into smaller sub-tasks, for higher decision throughput. These technologies enable wireline and wireless networking systems to perform a broad range of network-aware and content-aware processing functions, such as application-based routing, UTM network security, intrusion detection and prevention, virus inspection, access control for network security, prioritization of traffic flow to maintain quality of service and statistical measurement of Internet traffic for transaction billing.

We offer knowledge-based processors in two main product families: Layer 3-4 knowledge-based processors for use in routers, switches, network access equipment and networked storage devices; and Layer 7 knowledge-based processors for use in Layer 7 application switches and routers, UTM appliances, intrusion detection and prevention systems, and anti-virus gateways.

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Layer 3-4 Knowledge-based Processors. Layers 3 and 4 refer to the data and transport layers, respectively, of the OSI reference model. For networking infrastructure that supports Layer 3-4 routing, decisions on how to handle IP packets are made using the data that is contained in the packet header. The packet header information consists of key data regarding the packet, including the IP address of the system that generated the packet, referred to as the source IP address, and the IP address of the device to which the packet is to be transmitted, referred to as the destination IP address. Our proprietary NL5000, NL6000, NL7000, NL8000 and NL9000 families of knowledge-based processors operate in conjunction with an OEM-developed custom integrated circuits, programmable logic devices, and one or more network processing units (NPUs), and feature a proprietary interface that provides advanced interface technology to enable networking OEMs to meet their system performance requirements for Layer 3-4 processing. We also provide versions of our proprietary interface knowledge-based processors that work with proprietary custom integrated circuits and application software developed by or in collaboration with Cisco Systems.

Networking OEMs typically require solutions at different prices in order to target different market segments with the same design. To satisfy this demand, we offer knowledge-based processors with a range of knowledge database sizes, and all of our knowledge-based processors are designed to be connected in groups to increase the knowledge database available for processing.

In 2008, we announced initial production shipments of the NL71024XT knowledge-based processor, which is optimized for Terabit routing and switching applications. Multiple NL71024XT processor can be clustered together to increase processing performance, and our customers have incorporated as many as 30 NL71024XT processors in a system for full Terabit routing performance.

Also in 2008, we announced production shipments of our NL91024 and NL91024XT knowledge-based processors, which are capable of processing 1.5 billion decisions per second. These latest additions to our NL9000 processor family integrate 128 knowledge-based processing engines, feature our Intelligent Load Balancing Engine that efficiently allocates multiple tasks and coordinates communications among processing engines, ands incorporate our advanced Sahasra technology to lower power consumption.

We also offer our Sahasra family of knowledge-based processors which use advanced algorithms to achieve low power dissipation and are particularly well suited for applications using exact match or longest-prefix match functions. This family of devices scales up to 1.5 million IPv4 entries in a single device.

NETL7™ Layer 7 Knowledge-based Processors. For networking infrastructure that supports Layer 7 routing, decisions on how to handle IP packets are made using the information that is contained in the packet payload or packet content. The packet content contains the actual data being transmitted between applications using the network. Layer 7 of the OSI reference model, known as the application layer, facilitates communication between software applications and lower-layer network services. Our NETL7 TM knowledge-based processors are designed to accelerate Layer 7 content processing and signature recognition tasks for enterprise and carrier-class networks. In 2008, we announced the availability of the NLS205 NETL7 processor capable of scaling from 250 Megabits per second to 2.5 Gigabits per second line rates, and the NLS2000 NETL7 processing solution that provides up to 20 Gigabits per second of deep-packet inspection performance-. This extends the processing capabilities of our knowledge-based processors into the packet payload, thereby enabling the design and deployment of next-generation networking systems that can make packet processing decisions based on an awareness of the packet content. Typical applications for the NETL7 processors include Layer 7 application switches and routers, mobile wireless infrastructure equipment, unified threat management appliances, intrusion detection and prevention systems and malware protection gateways.

NETLite™ Processors

Our NETLite™ processor families are specifically designed for cost-sensitive, high-volume applications such as entry-level switches, routers and access equipment. The NETLite processor families leverage circuit techniques developed and refined during the design of our knowledge-based processor families, and benefit from die size optimization, lower power dissipation and redundant computing techniques. In addition, the NETLite processors utilize a simplified pipeline architecture, as compared to our knowledge based processors, that allows for lower cost manufacturing and assembly in less expensive packages, and allows for lower cost system designs. As such, the NETLite processors are ideal for entry-level systems that do not require the advanced parallel processing and deep pipelining performance of our high-end knowledge-based processors.

Our NETLite processors also include the Ayama™10000 and Ayama 20000 processors. We offer these processors in densities ranging from 128K to 512K IPv4 entries, and they include differentiated features such as Mini-Key™ power management. The Ayama 20000 processors incorporate all the features of the Ayama 10000 processors and work seamlessly with industry-leading NPUs. To help reduce development time and cost, we also offer the Ayama processors with our Cynapse TM software platform for customers to more easily integrate these processors into their systems.

In 2008, we announced the availability and production shipment of two new NETLite processors, the NL56615 and NL3380, designed utilizing 55 nanometer process geometries. These new NETLite processors are targeted to operate in conjunction with a new generation of merchant silicon switches and network processors to enable higher performance, lower power and lower system costs for customers developing next-generation enterprise desktop switches.

Network Search Engines

We continue to support our legacy network search engines, which include the NSE1000 through NSE4000, the NSE70000 network search engine families and the NSE3128GLM network search engines, a device that interfaces directly to certain NPUs from Applied Micro Circuits Corporation. We introduced our network search engine products between 1998 and 2001. These products are fabricated by UMC or TSMC using a range of process technologies from 0.35 micron to 0.15 micron.

In August 2007, we purchased the TCAM2 network search engine products and certain related assets from Cypress. The acquisition of the TCAM2 products has expanded our revenue base and extended our market presence in the desktop switching market segment.

Physical Layer Products

Our PLP, or physical layer, family of products provides high-performance, single and dual-channel low-power interface technology for high-density data communication and storage systems, and offers comprehensive support for multiple 10-Gigabit Ethernet standards. The PLP products also integrate advanced electronic dispersion compensation, technology. We expect our PLP family of products to benefit from the same market drivers as our knowledge-based processors, including growth in 10-Gigabit Ethernet ports in switches and routers, upgrades of the telecom infrastructure to support IPTV, and the deployment of the 10Gbit Ethernet IP-backbone for advanced mobile wireless networks.

In 2008, we introduced several new physical layer products, including dual-port 10 Gigabit Ethernet products, the industry’s first quad-port physical layer products and our NLP10000, the industry’s first 100 Gigabit Ethernet physical layer solution which is targeted at next-generation core, metro, data center and access aggregation systems.

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Customers

The markets for networking systems utilizing our products and services are mainly served by large networking OEMs, such as AlaxalA Networks Corporation, Alcatel-Lucent, ARRIS Group, Inc., Brocade Communications Systems, Inc., Cisco Systems, Inc., Extreme Networks, Inc., Fujitsu Limited, Hitachi, Ltd., Huawei Technologies Co., Ltd., and Juniper Networks, Inc.

We work with these and other networking OEMs to understand their requirements, and provide them with solutions that they then qualify and, in some cases, specify for use within their systems. While we sell directly to some networking OEMs, we also provide our products and services indirectly to other networking OEMs through their contract manufacturers, who in turn assemble our products into systems for delivery to our OEM customers. Sales to contract manufacturers accounted for 41%, 65% and 78% of total revenue in 2008, 2007 and 2006, respectively. Sales of our products are made under short-term, cancelable purchase orders. As a result, our ability to predict future sales in any given period is limited and subject to change based on demand for our OEM customers' systems and their supply chain decisions.

We also provide our products and services indirectly to our OEM customers through our international stocking sales representatives. Our stocking sales representatives are independent entities that assist us in identifying and servicing foreign networking OEMs and generally purchase our products directly from us for resale to OEMs or contract manufacturers located outside the U.S. These international stocking sales representatives generally exclusively service a particular foreign region or customer base, and purchase our products pursuant to cancelable and reschedulable purchase orders containing our standard warranty provisions for defects in materials, workmanship and product performance. At our option, defective products may be returned for their purchase price or for replacement. To date, our international stocking sales representatives have returned a small number of defective products to us. Our international stocking sales representatives may also act as a sales representative and receive commissions on sales of our products. Our international stocking sales representatives include Bussan Microelectronics Corporation/Mitsui Comtek Corporation and Lestina International Limited. Sales through our international stocking sales representatives accounted for 10%, 11% and 13% of total revenue in 2008, 2007 and 2006, respectively. While we have purchase agreements with our international stocking sales representatives, they do not have long-term contracts with any of our OEM customers that use our products and services.

On November 7, 2005, we entered into master purchase agreements with each of Cisco Systems, Inc. and Cisco Systems International B.V. Cisco, who together with their contract manufacturers, are our largest customers. Pursuant to these agreements, we agreed to supply to Cisco (including its subsidiaries and contract manufacturers) certain of our products for incorporation into Cisco's products. These agreements set forth the general business terms and conditions applicable to our sales to Cisco, including,

- our obligation to accept all purchase orders from Cisco, unless we are unable to meet Cisco's schedule;
- our obligation to ensure that we have the capacity to increase or decrease production of our knowledge-based processors based upon Cisco's demand forecasts;
- our obligation to use our best efforts to meet Cisco's stated cost reduction targets and to provide to Cisco all price decreases that we achieve;
- "most favored nation" pricing and related audit rights in favor of Cisco, providing that, in any quarter, the prices paid by Cisco for our products (including progeny and replacements), will be

the lowest prices paid for those products by any of our other customers who purchase as much or less than Cisco;

- our obligation to provide Cisco, in the event of any short supply of products or components, an allocation that is no less favorable than that provided to our other customers purchasing similar quantities of similar products;

- Cisco's cancellation rights for standard and custom products;

- Cisco's approval and related rights with respect to any proposed changes to, or discontinuation of, our products purchased by Cisco;

- Cisco's right to purchase our knowledge-based processors directly from our manufacturers under the following circumstances;

  · product discontinuation;

  · bankruptcy, insolvency and similar situations;

  · transfer of at least 50% of our voting control to a Cisco competitor that generates less than 50% of its annual sales from integrated circuit products;

- in all cases, subject, among other things, to Cisco's continuing obligation to pay us for the product and our obligation to disclose the costs charged to us by our manufacturers;

- perpetual, royalty-free, non-exclusive, worldwide license grant to Cisco to use binary code versions of our software in connection with Cisco's manufacture, sale, license, loan or distribution of its products; and

- Cisco's extended product warranties, generally for three years and, in the case of epidemic failures, for five years and our indemnification obligation for epidemic failures which will not exceed the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months (approximately $13.2 million at December 31, 2008) or $9.0 million, plus replacement costs. The initial term of these agreements is three years, subject to renewal and termination rights, and which was automatically renewed through November 2009.

During the second half of 2007, at Cisco's request we transitioned into a just-in-time inventory model covering substantially all of our product shipments to Cisco and its contract manufacturers. In conjunction with this transition, in the third quarter of 2007, we entered into a purchase agreement with Wintec Industries who, during the second half of 2007, became the primary purchaser of our products on a consignment basis for resale to Cisco and Cisco's contract manufacturers. We generally have provided to Wintec the same terms and conditions that we provide to Cisco under the master purchase agreement between us and Cisco, including: our obligations to accept all purchase orders from Wintec (unless we are unable to meet Wintec's schedule), ensure that we have the capacity to increase or decrease production of our products based upon Wintec's demand forecasts, use our best efforts to meet Wintec's stated cost reduction targets and provide to Wintec all price decreases that we achieve, cancellation rights for standard and custom products, and extended product warranties. We also have extended to Wintec a credit limit sufficient to cover our anticipated annual business with Cisco and Cisco's contract manufacturers. Given the volume of business that we have with Wintec, we have received from Wintic irrevocable letters of credit and reliable guarantees to support the credit limit we have extended to Wintec. In our discretion, we may accept orders from Wintec that exceed the credit limit based on our analysis of the collectability of such orders and Wintec's payment history. Sales through Wintec accounted for 35% of total revenue in 2008.

In 2008, 2007 and 2006, Cisco, including its contract manufacturers, accounted for 38%, 50% and 61% of our total revenue, respectively. Cisco accounted for a smaller portion of our total sales in 2008 as we increased our customer diversification. Notably, Alcatel-Lucent became a 12% customer, by revenue, in 2008. We expect to continue to further diversify our customer account base in 2009.

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Sales, Marketing and Distribution

Our sales and marketing strategy is to achieve design wins with leaders and emerging participants in the networking systems market and to maintain these design wins primarily through leading-edge products and superior customer service. We focus our marketing and sales efforts at a high organizational level of our potential customers to access key decision makers. In addition, as many networking OEMs design custom integrated circuits to interface to our products, we believe that applications support at the early stages of design is critical to reducing time-to-market and minimizing costly redesigns for our customers.

Our product sales cycles can take up to 24 months to complete, requiring a significant investment in time, resources and engineering before realization of income from product sales, if at all. Such long sales cycles mean that OEM customers' vendor selections, once made, are normally difficult to change. As a result, a design loss to the competition can negatively impact our financial results for several years. Similarly, design wins can result in an extended period of revenue opportunities with that customer.

We market and sell our products through our direct sales force and through independent sales representatives throughout the world. Our direct sales force is dedicated to enhancing relationships with our customers. We supplement our direct sales force with independent sales representatives, who have been selected based on their understanding of the networking systems market and their level of penetration at our target OEM customers. We also use application engineers to provide technical support and design assistance to existing and potential customers.

Our marketing group is responsible for market and competitive analyses and defining our product roadmaps and specifications to take advantage of market opportunities. This group works closely with our research and development group to align development programs and product launches with our OEM customers' schedules. Additionally, this group develops and maintains marketing materials, training programs and our web site to convey our benefits to networking OEMs.

We operate in one business segment and sell our products directly to customers in the United States, Asia and Europe. Sales for the geographic regions reported below are based upon the customer headquarter locations. Following is a summary of the geographic information related to revenues for the years ended December 31, 2008, 2007 and 2006 (in thousands):

	Year ended December 31,		
	2008	2007	2006
Revenue:			
United States	$ 46,287	$ 48,221	$ 54,952
Malaysia	42,435	34,017	21,349
China	30,378	14,126	3,257
Other	20,827	12,699	2,201
Total	$ 139,927	$ 109,063	$ 81,759

Research and Development

We devote substantial resources to the development of new products, improvement of existing products and support of the emerging requirements of networking OEMs. We have assembled a team of product designers possessing extensive experience in system architecture, analog and digital circuit design, hardware reference board design, software architecture and driver design and advanced fabrication process technologies. In 2005 we opened a design center in Bangalore, India to accelerate introduction of our product development. As of December 31, 2008, we had

approximately 161 full-time employees engaged in research and development worldwide. Our research and development expense was $51.6 million, $45.2 million and $36.6 million for the years ended December 31, 2008, 2007 and 2006, respectively.

We use a number of standard design tools in the design, manufacture and verification of our products. Due to the highly complex design requirements of our products, we typically supplement these standard tools with our own tools to create a proprietary design method that allows us to optimize the performance of our products at the circuit-level.

Manufacturing and Materials

We design and develop all of our products and electronically transfer our proprietary designs to third party wafer foundries to manufacture our products. Wafers processed by these foundries are shipped to our subcontractors, where they are assembled into finished products and electronically tested before delivery to our customers. We believe that this manufacturing model significantly reduces our capital requirements and allows us to focus our resources on the design, development and marketing of our products.

Our principal wafer foundry is TSMC in Taiwan. We are actively involved with product development on next-generation processes, and are designing products on TSMC's most advanced logic processes. The latest generation of our products employs up to eight layers of copper interconnect and 300 millimeter wafer sizes.

Our products are designed to use industry standard packages and be tested using widely available automatic test equipment. We develop and control product test programs used by our subcontractors based on our product specifications. We currently rely on Amkor Technology, Inc., Advanced Semiconductor Engineering, Inc. in Taiwan, King Yuan Electronics Co., Ltd. in Taiwan, ISE Labs, Inc. and Viko Test Lab in the U.S. to assemble and test our products. We also have an office in Taiwan that employs local personnel to work directly with our Asian wafer manufacturers and assembly and test houses to facilitate manufacturing operations.

We have designed and implemented an ISO9001-certified quality management system that provides the framework for continual improvement of our products, processes and customer service. We apply well-established design rules and practices for CMOS devices through standard design, layout and test processes. We also rely on in-depth simulation studies, testing and practical application testing to validate and verify our products. We emphasize a strong supplier quality management practice in which our manufacturing suppliers are pre-qualified by our operations and quality teams. To ensure consistent product quality, reliability and yield, we closely monitor the production cycle by reviewing electrical, parametric and manufacturing process data from each of our wafer foundries and assembly subcontractors.

We currently do not have long-term supply contracts with any of our significant third party manufacturing service providers. We generally place purchase orders with these providers according to terms and conditions of sale which specify price and 30-day payment terms and which limit the providers' liability.

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Competition

The markets for our products are highly competitive. We believe that the principal bases of competition are:

- processing speed;
- power dissipation;
- capacity of the knowledge or signature database that can be processed;
- advanced product features allowing OEM and system customer product differentiation;
- price;
- product availability and reliability;
- customer support and responsiveness;
- timeliness of new product introductions; and
- credibility in designing and manufacturing products.

We believe that we compete favorably on each of the bases identified above. However, some of our competitors have greater financial resources and a longer track record as a semiconductor supplier than we do. We anticipate that the market for our products will be subject to rapid technological change. As we enter new markets and pursue additional applications for our products, we expect to face competition from a larger number of competitors. Within our target market, we primarily compete with certain divisions of Integrated Device Technology, Inc. and Renesas Technology, Corp. In the Layer 7 market, we primarily compete with certain divisions of LSI Corporation. In the 10-Gigabit Ethernet physical layer market, we primarily compete with certain divisions of Applied Micro Circuits Corporation, Broadcom Corporation, Marvell Technology Group Ltd., Cortina Systems, Inc. and Vitesse Semiconductor Corporation. We expect to face competition in the future from our current competitors, other manufacturers and designers of semiconductors, including large integrated device manufacturers, and innovative start-up semiconductor design companies.

Intellectual Property

Our success and future growth will depend, in part, on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark and trade secret laws to protect our intellectual property. We also attempt to protect our trade secrets and other proprietary information through agreements with our customers, suppliers, employees and consultants and through security protection of our computer network and physical premises. However, these measures may not provide meaningful protection for our intellectual property. While our patents and other intellectual property rights are important, we believe that our technical expertise and ability to introduce new products in a timely manner will also be important factors in maintaining our competitive position.

As of February 5, 2009, we held 246 issued U.S. patents and 12 issued foreign patents with expiration dates ranging from 2011 to 2027. We also have numerous patent applications pending in the U.S and abroad. We may not receive any additional patents as a result of these applications or future applications. Nonetheless, we continue to pursue the filing of additional patent applications. Any rights granted under any of our existing or future patents may not provide

meaningful protection or any commercial advantage to us.

Many participants in the semiconductor industry have a significant number of patents and have frequently demonstrated a willingness to commence litigation based on allegations of patent and other intellectual property infringement. From time to time, we have received, and expect to continue to receive, notices of claims of infringement or misappropriation of other parties' proprietary rights. In the event any such claims result in legal actions, we cannot assure you that we will prevail in these actions, or that other actions alleging infringement by us of third party intellectual property rights, misappropriation or misuse by us of third party trade secrets, or invalidity or unenforceability of our patents will not be asserted against us or that any assertions of infringement, misappropriation, misuse, invalidity or unenforceability will not materially and adversely affect our business, financial condition and results of operations.

We intend to protect our rights vigorously, but there can be no assurance that our efforts will be successful. Thus, despite our precautions, a third party may copy or otherwise obtain and use our products, services or technology without authorization, develop similar technology independently or design around our patents. In addition, effective patent, copyright, trademark and trade secret protection may be unavailable or limited in certain foreign countries. Moreover, we often incorporate the intellectual property of third parties into our designs, which is subject to certain obligations with respect to the non-use and non-disclosure of such intellectual property. We cannot assure you that the steps we have taken to prevent infringement, misappropriation or misuse of our intellectual property or the intellectual property of third parties will be successful. Furthermore, enforcement of our intellectual property rights may divert the efforts and attention of our management team and may be costly to us.

Employees

As of December 31, 2008, we had 255 full-time employees worldwide, including 161 in research and development, 46 in operations, 27 in sales and marketing and 21 in general and administrative. None of our employees are covered by collective bargaining agreements. We believe our relations with our employees are good.

Available Information

Our Web site address is www.netlogicmicro.com. The information in our Web site is not incorporated by reference into this report. Through a link on the Investor Relations section of our Web site, we make available our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after they are filed with, or furnished to, the Securities and Exchange Commission.

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ITEM 1A. RISK FACTORS.

If any of the following risks actually occur, our business, results of operations and financial condition could suffer significantly.

We derive most of our revenue from sales of our knowledge-based processors, and, if the demand for these products and other products does not grow, we may not achieve our growth and strategic objectives.

Our knowledge-based processors are used primarily in networking systems, including routers, switches, network access equipment and networked storage devices. We derive a substantial portion of our total revenue from sales of our knowledge-based processors in the networking market and expect to continue to derive a substantial portion of our total revenue from this market for the foreseeable future. We believe our future business and financial success depends on continued market acceptance and increasing sales of our knowledge-based processors. In order to meet our growth and strategic objectives, networking original equipment manufacturers, or OEMs, must continue to incorporate, and increase the incorporation of, our products into their systems as their preferred means of enabling network-aware processing of IP packets, and the demand for their systems must grow as well. We cannot provide assurance that sales of our knowledge-based processors will increase substantially in the future or that the demand for our customers' systems will increase as well. In addition, a majority of the total increase in our revenue in 2008 came from sales of TCAM2 and PLP products that we acquired in 2007. Our future revenues from these products may not increase in accordance with our growth and strategic objectives if the OEM customers modify their current product designs or select products sold by our competitors instead. Thus, our future success depends in large part on factors outside our control, and sales of our knowledge-based processors and other products may not meet our revenue growth and strategic objectives. Additionally, due to the high concentration of our sales with a small number of networking OEMs, we cannot guarantee that the demand for the systems offered by these customers will increase or that our sales will increase outside this core customer base, and, accordingly, prior quarterly or annual results may not be an indication of our future revenue growth or financial results.

Because we rely on a small number of customers for a significant portion of our total revenue, the loss of, or a significant reduction in, orders for our products from these customers would negatively affect our total revenue and business.

To date, we have been dependent upon orders for sales of knowledge-based processors to a limited number of customers, and, in particular, Cisco, for most of our total revenue. During the years ended December 31, 2008, 2007 and 2006, Cisco and its contract manufacturers accounted for 38%, 50% and 61% of our total revenue, respectively. We expect that our future financial performance will continue to depend in large part upon our relationship with Cisco and several other networking OEMs.

We cannot assure you that existing or potential customers will not develop their own solutions, purchase competitive products or acquire companies that use alternative methods in their systems. We do not have long-term purchase commitments from any of our OEM customers or their contract manufacturers. Although we entered into master purchase agreements with Cisco, one of Cisco's foreign affiliates and a Cisco purchasing agent, these agreements do not include any long-term purchase commitments. Cisco and our other customers do business with us currently only on the basis of short-term purchase orders (subject, in the case of Cisco, to the terms of the master purchase agreements), which often are cancelable prior to shipment. The loss of orders for our knowledge-based processors for Cisco products or products of other major users of our knowledge-based processors would have a significant negative impact on our business.

We face additional risks to our business success and financial condition because of our dependence on a small number of customers for sales of our products.

Our dependence on a small number of customers, especially Cisco and its contract manufacturers, for most of our revenue in the foreseeable future creates additional risks for our business, including the following:

- we may face increased pressure to reduce the average selling prices of our products;
- we may find it difficult to pass through increases in our manufacturing and other direct costs;
- the reputation of our products in the marketplace may be affected adversely if Cisco or other networking OEMs that represent a significant percentage of our sales of products reduce or cease their use of our products; and
- we may face problems in collecting a substantial portion of our accounts receivable if any of these companies faces financial difficulties or dispute payments.

We have a history of net losses, may incur significant net losses in the future and may not be able to sustain profitability.

Although we reported net income of $3.6 million, $2.6 million and $0.6 million during the years ended December 31, 2008, 2007 and 2006, we reported net losses in years prior to fiscal 2005. At December 31, 2008, we had an accumulated deficit of approximately $76.0 million. To sustain profitability, we will have to continue to generate greater total revenue and control costs and expenses. We cannot assure you that we will be able to generate greater total revenue, or limit our costs and expenses, sufficiently to sustain profitability on a quarterly or annual basis.

Because we sell our products on a purchase order basis and rely on estimated forecasts of our customers' needs, inaccurate forecasts could adversely affect our business.

We sell our products pursuant to individual purchase orders (subject, in the case of Cisco, to the terms of a master purchase agreement), and not pursuant to long-term purchase commitments. Therefore, we rely on estimated demand forecasts, based upon input from our customers, to determine how much product to manufacture. Because our sales are based on purchase orders, our customers may cancel, delay or otherwise modify their purchase commitments with little or no consequence to them and with little or no notice to us. For these reasons, we generally have limited visibility regarding our customers' product needs. We cannot provide assurance as to the quantities or timing required by our customers for our products. We cannot assure you that we will not experience subsequent substantial warranty claims or that warranty claims will not result in cancellation of existing orders or reluctance of customers to place future orders. In addition, the product design cycle for networking OEMs is lengthy, and it may be difficult for us to accurately anticipate when they will commence commercial shipments of products that include our knowledge-based processors. Whether in response to changes affecting the industry or a customer's specific business pressures, any cancellation, delay or other modification in our customers' orders could significantly reduce our revenue, cause our operating results to fluctuate from period to period and make it more difficult for us to predict our revenue. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business, and we may purchase too much inventory and spend more capital than expected.

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We are dependent on contract manufacturers for a significant portion of our revenue.

Many of our OEM customers, including Cisco, use third party contract manufacturers to manufacture their networking systems. These contract manufacturers represented 41%, 65% and 78% of our total revenue for the year ended December 31, 2008, 2007 and 2006, respectively. Contract manufacturers purchase our products directly from us on behalf of networking OEMs. Although we work with our OEM customers in the design and development phases of their systems, these OEM customers are gradually giving contract manufacturers more authority in product purchasing decisions. As a result, we depend on a concentrated group of contract manufacturers for a substantial portion of our revenue. If we cannot compete effectively for the business of these contract manufacturers or if any of the contract manufacturers, which work with our OEM customers, experience financial or other difficulties in their businesses, our revenue and our business could be adversely affected. In particular, if one of our OEM customer's contract manufacturers becomes subject to bankruptcy proceedings, neither we nor our OEM customer may be able to obtain any of our products held by the contract manufacturer. In addition, we may not be able to recover any payments owed to us by the contract manufacturer for products already delivered or recover the products held in the contract manufacturer's inventory when the bankruptcy proceeding is initiated. If we are unable to deliver our products to our OEM customers in a timely manner, our business would be adversely affected.

The average selling prices of our products may decline, which could reduce our revenue and gross margin.

In our experience the average selling prices of our products have declined over the course of their commercial lives, principally due to the supply of competing products, reduction in demand from customers, pressure from customers to reduce prices and product cycle changes, we expect these trends to continue. In addition, under our master purchase agreements with Cisco, we agreed to provide to Cisco all price decreases that we achieve, and granted to Cisco the right (under limited circumstances) to purchase our knowledge-based processors directly from our manufacturers (subject to payments to us, net of specified costs). Declining average selling prices can adversely affect our future operating results. To maintain acceptable operating results, we will need to develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs. If we are unable to offset any reductions in our average selling prices by increasing our sales volumes and achieving corresponding production cost reductions, or if we fail to develop and introduce new products and enhancements on a timely basis, our revenue and operating results will suffer.

We rely on third parties for the manufacture of our products, and a significant increase in wafer pricing or our failure to secure sufficient capacity could limit our growth and adversely affect our operating results.

As a fabless semiconductor company, we rely on third-party wafer foundries to manufacture our products. We currently do not have long-term supply contracts with either of our wafer foundries, Taiwan Semiconductor Manufacturing Co., Ltd., or TSMC, and United Microelectronics Corporation, or UMC. Neither TSMC nor UMC is obligated to perform services or supply products to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. As a result, there are numerous risks associated with our reliance on these wafer foundries, including the possibilities that TSMC or UMC may give higher priority to their other customers or that our relationships with either wafer foundry may deteriorate. We cannot assure you that TSMC and UMC will continue to provide us with our products at acceptable yields or in sufficient quantities, for reasonable costs and on a timely basis to meet our customers' needs. A failure to ensure the timely fabrication of our products could cause us to lose customers and could have a material adverse effect on our operating results.

If either wafer foundry, and in particular TSMC, ceases to provide us with required production capacity with respect to our products, we cannot assure you that we will be able to obtain manufacturing capacity from other wafer foundries on commercially reasonable terms or that these arrangements, if established, will result in the successful

manufacturing of our products. These arrangements might require us to share our technology and might be subject to unilateral termination by the wafer foundries. Even if such capacity is available from another manufacturer, we would need to convert the production of our integrated circuits to a new fabrication process and qualify the other manufacturer, which process could take nine months or longer. Furthermore, we may not be able to identify or qualify manufacturing sources that would be able to produce wafers with acceptable manufacturing yields.

We also rely on third parties for other products and services, including the assembly, testing and packing of our products, and engineering services, and any failure by third parties to provide the tools and services we require could limit our growth and adversely affect our future operating results.

All of our products are assembled and tested by third-party vendors and require the use of high performance assembly and test equipment. In addition, in connection with the design of our products, we use software tools, which we obtain from third party software vendors, for simulation, layout and other design purposes. Our reliance on independent assembly, testing, software and other vendors involves a number of risks, including reduced control over delivery schedules, quality assurance and costs. We currently do not have long-term supply contracts with all of these third party vendors. As a result, most of these third party vendors are not obligated to provide products or perform services to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. The inability of these third party vendors to deliver high performance products or services of acceptable quality and in a timely manner, could lengthen our design cycle, result in the loss of our customers and reduce our revenue.

We also rely on third party component suppliers to provide custom designed integrated circuit packages for our products. In some instances, these package designs are provided by a single supplier. Our reliance on these suppliers involves a number of risks, including reduced control over delivery schedules, quality assurance and costs. We currently do not have long-term supply contracts with all of these package vendors. As a result, most of these third party vendors are not obligated to provide products or perform services to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. The inability of these third party vendors to deliver packages of acceptable quality and in a timely manner, particularly the sole source vendors, could adversely affect our delivery commitments and adversely affect our operating results or cause them to fluctuate more than anticipated. Additionally, these packages may require specialized or high-performance component parts that may not be available in quantities or in time frames that meet our requirements or the anticipated requirement of our customers.

In connection with the design of our products, we have and may license third party intellectual property, and use third party engineering services. Our reliance on these third party intellectual property and engineering services providers involves a number of risks, including reduced control over and quality of the intellectual property and service deliverables, quality and costs. The inability of these third party providers to deliver high performance products or services of acceptable quality and in a timely manner, could lengthen our design cycle, result in the loss of our customers and reduce our revenue.

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Our costs may increase substantially if the wafer foundries, assembly and test vendors that supply and test our products do not achieve satisfactory product yields, reliability or quality.

The wafer fabrication process is an extremely complicated process where the slightest changes in the design, specifications or materials can result in material decreases in manufacturing yields or even the suspension of production. From time to time, we and our wafer foundries have experienced, and are likely to continue to experience manufacturing defects and reduced manufacturing yields related to errors or problems in our wafer foundries' manufacturing processes or the interrelationship of their processes with our designs. In some cases, our wafer foundries may not be able to detect these defects early in the fabrication process or determine the cause of such defects in a timely manner, which may affect the quality or reliability of our products. We may incur substantial research and development expense for prototype or development stage products as we qualify the products for production.

Generally, in pricing our products, we assume that manufacturing, assembly and test yields will continue to increase, even as the complexity of our products increases. Once our products are initially qualified with our wafer foundries, minimum acceptable yields are established. We are responsible for the costs of the wafers if the actual yield is above the minimum. If actual yields are below the minimum, we are not required to purchase the wafers. The minimum acceptable yields for our new products are generally lower at first and increase as we achieve full production. Whether as a result of a design defect or manufacturing, assembly or test error, unacceptably low product yields or other product manufacturing, assembly or test problems could substantially increase the overall production time and costs and adversely impact our operating results on sales of our products. Product yield losses will increase our costs and reduce our gross margin. In addition to significantly harming our operating results and cash flow, poor yields may delay shipment of our products and harm our relationships with existing and potential customers.

To be successful we must continue to develop and have manufactured for us, innovative products to meet the evolving requirements of networking OEMs.

To remain competitive, we devote substantial resources to research and development, both to improve our existing technology and to develop new technology. We also seek to improve the manufacturing processes for our products, including the use of smaller process geometries, which we believe is important for our products to serve our OEM customers' requirements for enhanced processing. Our failure to migrate our products to logic processes at smaller process geometries could substantially reduce the future competitiveness of our products. In addition, from time to time, we may have to redesign some of our products or modify the manufacturing process for them. We cannot give you any assurance that we will be able to improve our existing technology or develop and integrate new technology into our products. Even if we design better products, we may encounter problems during the manufacturing or assembly process, including reduced manufacturing yields, production delays and increased expenses, all of which could adversely affect our business and results of operations.

In addition, given the highly complex nature of these products, even the slightest change or adjustment to our integrated circuit designs could require substantial resources to implement them. We may not be able to make these changes or adjustments to our products or correct any errors or defects arising from their implementation. Failure to make these changes or adjustments or correct these errors or defects during the product development stages, or any resulting delays, could severely harm our existing and potential customer relationships and could likely increase our development costs, adversely affecting our operating results. If these changes, adjustments, errors or defects are not identified or requested until after commercial production has begun or after products have been delivered to customers, we may be required to re-test existing inventory, replace products already shipped or re-design the products, all of which would likely result in significant time delays and additional costs and expenses.

We have sustained substantial losses from low production yields in the past and may incur such losses in the future.

Designing and manufacturing integrated circuits is a difficult, complex and costly process. Once research and development has been completed and the foundry begins to produce commercial volumes of the new integrated circuit, products still may contain errors or defects that could adversely affect product quality and reliability. We have experienced low yields and have incurred substantial research and development expenses in the design and initial production phases of all of our legacy network search engine products and knowledge-based processors. We cannot assure you that we will not experience low yields, substantial research and development expenses, product quality, reliability or design problems, or other material problems with our products that we have shipped or may ship in the future.

If we fail to retain key personnel and hire additional personnel, our business and growth could be negatively affected.

Our business has been dependent to a significant degree upon the services of a small number of executive officers and technical employees. We generally do not have non-competition agreements or term employment agreements with any of our executive officers, whom we generally employ at will. We do not maintain key-man life insurance on the lives of any of our key personnel. The loss of any of these individuals could negatively impact our technology development efforts and our ability to service our existing customers and obtain new customers.

Our future growth will also depend, in part, upon our ability to recruit and retain other qualified managers, engineers and sales and marketing personnel. There is intense competition for these individuals in our industry, and we cannot assure you that we will be successful in recruiting and retaining these individuals. If we are unable to recruit and retain these individuals, our technology development and sales and marketing efforts could be negatively impacted.

If we fail to maintain competitive equity compensation packages for our employees, or if our stock price declines materially for a protracted period of time, we might have difficulty retaining our employees and our business may be harmed.

In today’s competitive technology industry, employment decisions of highly skilled personnel are influenced by equity compensation packages, which offer incentives above traditional compensation only where there is a consistent, long-term upward trend over time of a company’s stock price. If our stock price declines due to market conditions, investors’ perceptions of the technology industry or managerial or performance problems we have, our equity compensation incentives, especially stock options may lose value to key employees, and we may lose these employees or be forced to grant additional options to retain them. This in turn could result in:

- immediate and substantial dilution to investors resulting from the grant of additional equity awards necessary to retain employees; and
- potential compensation charges against the company, which could negatively impact our operating results.

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A failure to successfully address the potential difficulties associated with international business could reduce our growth, increase our operating costs and negatively impact our business.

We conduct a significant amount of our business with companies that operate primarily outside of the United States, and intend to increase sales to companies operating outside of the United States. For example, our customers based outside the United States accounted for 67%, 56% and 52% of our total revenue during the years ended December 31, 2008, 2007 and 2006. Not only are many of our customers located abroad, but our two wafer foundries are based in Taiwan, and we outsource the assembly and some of the testing of our products to companies based in Taiwan and Hong Kong. We face a variety of challenges in doing business internationally, including:

- foreign currency exchange fluctuations;
- unanticipated changes in local regulations;
- potentially adverse tax consequences, such as withholding taxes;
- timing and availability of export and import licenses;
- political and economic instability;
- reduced or limited protection of our intellectual property;
- protectionist laws and business practices that favor local competition; and
- additional financial risks, such as potentially longer and more difficult collection periods.

Because we anticipate that we will continue to rely heavily on foreign based customers for our future growth, the occurrence of any of the circumstances identified above could significantly increase our operating costs, delay the timing of our revenue and harm our business and financial condition.

We must design our products to meet the needs of our OEM customers and convince them to use our products, or our revenue will be adversely affected.

In general, our OEM customers design our products into their equipment during the early stages of their development after an in-depth technical evaluation of both our and our competitors' products. These design wins are critical to the success of our business. In competing for design wins, if a competitor's product is already designed into the product offering of a potential customer, it becomes very difficult for us to sell our products to that customer. Changing suppliers involves additional cost, time, effort and risk for the customer. In addition, our products must comply with the continually evolving specifications of networking OEMs. Our ability to compete in the future will depend, in large part, on our ability to comply with these specifications. As a result, we expect to invest significant time and effort and to incur significant expense to design our products to ensure compliance with relevant specifications. Even if a networking OEM designs our products into its systems, we cannot assure you that its systems will be commercially successful or that we will receive significant revenue from sales our products for those systems.

Factors that negatively affect the businesses of the networking OEMs that use or could use our products could negatively impact our total revenue.

The timing and amount of our revenue depend on the ability of the networking OEMs who use our knowledge-based processors to market, produce and ship systems incorporating our technology. Factors that negatively affect a significant customer or group of customers could negatively affect our results of operations and financial condition. Many issues beyond our control influence the success of the networking OEMs that use our products, including, for example, the highly competitive environment in which they operate, the strength of the markets for their products, their engineering capabilities, their ability or inability to obtain other components from other suppliers, the compatibility of any of their other components with our products, the impact of the worldwide recession on their capital spending and sales of their networking equipment, and their financial and other resources. Likewise, we have no control over their product development or pricing strategies, which directly affect sales of their products and, in turn, our revenue and the current worldwide recession is likely to reduce our year over year total revenue in at least the first half of fiscal 2009 as our customers in Japan and the markets for high-end enterprise, cable and datacenter equipment have reduced their capital expenditures. A decline in sales of our OEM customers' systems that use our knowledge-based processors would reduce our revenue. In addition, seasonal and other fluctuations in demand for their products could cause our operating results to fluctuate, which could cause our stock price to fall.

We have a lengthy sales cycle, which may result in significant expenses that do not generate significant revenue or delayed revenue generation from our selling efforts and limits our ability to forecast our revenue.

We expect that our product sales cycle, which results in our products being designed into our customers' products, could take up to 24 months. It can take an additional nine months to reach volume production of these products. A number of factors can contribute to the length of the sales cycle, including technical evaluations of our products by networking OEMs, the design process required to integrate our products into our OEM customers' products and the timing of networking OEMs' new product announcements. In anticipation of product orders, we may incur substantial costs before the sales cycle is complete and before we receive any customer payments. As a result, in the event that a sale is not completed or is cancelled or delayed, we may have incurred substantial expenses, making it more difficult for us to become profitable or otherwise negatively impacting our financial results. Furthermore, because of our lengthy sales cycle, our receipt of revenue from our selling efforts may be substantially delayed, our ability to forecast our future revenue may be more limited and our revenue may fluctuate significantly from quarter to quarter.

Our operating results could be adversely affected if we have to satisfy product warranty or liability claims.

If our products are defective or malfunction, we could be subject to product warranty or product liability claims that could have significant related warranty charges or warranty reserves in our financial statements. Further, we may spend significant resources investigating potential product design, quality and reliability claims, which could result in additional charges in our financial statements until such claims are resolved. We cannot guarantee that warranty reserves will either increase or decrease in future periods. Further, in connection with the master purchase agreements that we entered into with Cisco in 2005, we agreed to extended product warranties for the benefit of Cisco. Specifically, we agreed to general three-year warranties and, in the case of epidemic failures, to five-year warranties. In addition, under the Cisco agreements, we have agreed to indemnify Cisco for costs incurred in rectifying epidemic failures, up to the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months (approximately, $13.2 million at December 31, 2008) or $9.0 million, plus replacement costs. If we are required to make payments under this indemnity, our operating results may be adversely affected. Moreover, these claims in the future, regardless of their outcome, could adversely affect our business.

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Our revenue and operating results may fluctuate significantly from period to period, on a quarterly or annual basis, causing volatility in our stock price.

Our total revenue and operating results have fluctuated from quarter to quarter in the past and are expected to continue to do so in the future. As a result, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of our future performance. Fluctuations in our total revenue and operating results could negatively affect the trading price of our stock. In addition, our total revenue and results of operations may, in the future, be below the expectations of analysts and investors, which could cause our stock price to decline. Factors that are likely to cause our revenue and operating results to fluctuate include, for example, the periodic costs associated with the generation of mask sets for new products and product improvements and the risk factors discussed throughout this section. Additional factors that could cause our revenue and operating results to fluctuate from period to period include:

- the timing and volume of orders received from our customers;
- market demand for, and changes in the average selling prices of, our products;
- the rate of qualification and adoption of our products by networking OEMs;
- fluctuating demand for, and lengthy life cycles of, the products and systems that incorporate our products;
- the market success of the OEMs' networking systems that incorporate our products;
- the ability of our wafer foundries to supply us with production capacity and finished products to sell to our OEM customers;
- changes in the level of our costs and operating expenses;
- our ability to receive our manufactured products from our wafer foundries and ship them within a particular reporting period;
- deferrals or cancellations of customer orders in anticipation of the development and commercialization of new technologies or for other reasons;
- changes in our product lines and revenue mix;
- the timing of the introduction by others of competing, replacement or substitute products technologies;
- our ability or the ability of networking OEM customers that use our products to procure required components or fluctuations in the cost of such components;
- our ability to enforce our intellectual property rights or to defend claims that we infringe the intellectual property rights of others, and the significant costs to us of related litigation;
- cyclical fluctuations in semiconductor or networking markets; and
-

general economic conditions that may affect end-user demand for products that use our products.

We have grown rapidly, and a failure to manage any continued growth could reduce our potential revenue and could negatively impact our future operating results.

In order to successfully implement our overall growth strategies, we will need to carefully and efficiently manage our planned expansion. Among other things, this will require us to continue to:

- improve our products technology and develop new technologies;
- implement and manage new marketing and distribution channels to penetrate different and broader markets for our products;
- manage an increasing number of complex relationships with our customers, wafer foundries and other third parties;
- monitor and improve our operating systems, procedures and financial controls on a timely basis;
- retain existing, and hire additional, key management and technical personnel; and
- expand, train and manage our workforce and, in particular, our development, sales, marketing and support organizations.

We may not be able to adequately manage our growth or meet the foregoing objectives. A failure to do so could jeopardize our future revenue and cause our stock price to decline. Also, our ability to execute our business plan and grow our business will be heavily dependent on our management team’s ability to work effectively together.

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We have recently implemented a new enterprise resource planning system, which could disrupt our ability to timely and accurately process transactions, report our financial position, and complete evaluation of our internal controls.

We may experience difficulties with our new enterprise resource planning ("ERP") system implemented as of January 2008 that could disrupt our ability to timely and accurately process and report key components of the results of our consolidated operations, our financial position and cash flows. Any disruptions or difficulties that may occur in connection with this new ERP system or any future systems also could adversely affect our ability to maintain effective internal control over financial reporting and to complete the evaluation of our internal controls and pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, resulting in delayed reporting of material financial information and filing of required reports with the SEC. In addition, system failure or malfunctioning may result in disruption of operations and the inability to process transactions and could adversely affect our financial results. Any of these events could cause our operating results to be misstated, our reputation to be harmed and the trading price of our common stock to be adversely affected.

The cyclical nature of the semiconductor industry and the networking markets could adversely affect our operating results and our business.

We expect our business to be subject to the cyclicality of the semiconductor industry, especially the market for communications integrated circuits. Historically, there have been significant downturns in this industry segment, characterized by reduced demand for integrated circuits and accelerated erosion of average selling prices. At times, these downturns have lasted for prolonged periods of time. Furthermore, from time to time, the semiconductor industry also has experienced periods of increased demand and production constraints, in which event we may not be able to have our products produced in sufficient quantities, if at all, to satisfy our customers' needs. It is likely that the communications integrated circuit business will experience similar downturns in the future and that, during such times, our business could be affected adversely. It is also likely that the semiconductor industry will experience periods of strong demand. We may have difficulty in obtaining enough products to sell to our customers or may face substantial increases in the wafer prices charged by our foundries.

In addition, the networking industry from time to time has experienced and may experience a pronounced downturn. To respond to a downturn, many networking service providers may be required to slow their research and development activities, cancel or delay new product developments, reduce their workforces and inventories and take a cautious approach to acquiring new equipment and technologies from networking OEMs, which would have a significant negative impact on our business. In the future, a downturn in the networking industry may cause our operating results to fluctuate significantly from year to year, which also may tend to increase the volatility of the price of our common stock. For example, the worldwide recession that commenced in fiscal 2008 has reduced capital spending and sales of some of our larger customers, particularly those customers in Japan and those that sell high-end enterprise, cable and datacenter equipment, which reduced our quarter-over-quarter revenues in the fourth fiscal quarter of 2008 and is likely to reduce our year-over-year total revenue in at least the first half of fiscal 2009.

We may not be able to protect and enforce our intellectual property rights, which could impair our ability to compete and reduce the value of our technology.

Our success and future revenue growth depend, in part, on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality procedures, to protect our proprietary technologies and processes. However, these measures may not provide meaningful protection for our intellectual property.

We cannot assure you that any patents will issue from any of our pending applications. Any rights granted under any of our existing or future patents may not provide meaningful protection or any commercial advantage to us. For example, such patents could be challenged or circumvented by our competitors or declared invalid or unenforceable in judicial or administrative proceedings. The failure of any patents to adequately protect our technology would make it easier for our competitors to offer similar products. We do not have foreign patents or pending applications corresponding to many of our U.S. patents and patent applications, including in some foreign countries where our products are sold or may be sold in the future. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

With respect to our other proprietary rights, it may be possible for third parties to copy or otherwise obtain and use our proprietary technology or marks without authorization or to develop similar technology independently. Monitoring unauthorized use of our proprietary technology or marks is difficult and costly, and we cannot be certain that the steps we have taken will prevent misappropriation or unauthorized use of our technology or marks. In addition, effective patent, copyright, trademark and trade secret protection may not be available or may be limited in certain foreign countries. Many companies based in the U.S. have encountered substantial infringement problems in foreign countries, including countries in which we sell products. Our failure to effectively protect our intellectual property could reduce the value of our technology and could harm our business, financial condition and operating results.

Furthermore, we have in the past and may in the future initiate claims or litigation against third parties to determine the validity and scope of proprietary rights of others. In addition, we may in the future initiate litigation to enforce our intellectual property rights or the rights of our customers or to protect our trade secrets. Litigation by us could result in significant expense and divert the efforts of our technical and management personnel and could materially and adversely affect our business, whether or not such litigation results in a determination favorable to us.

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Any claim that our products or our proprietary technology infringe third party intellectual property rights could increase our costs of operation and distract management and could result in expensive settlement costs.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights or positions, which have resulted in often protracted and expensive litigation. From time to time, we are involved in litigation relating to intellectual property rights. In addition, we have received notices from time to time that claim we have infringed upon or misappropriated intellectual property rights owned by others. We typically respond when appropriate and as advised by legal counsel. We cannot assure you that parties will not pursue litigation with respect to those allegations. We may, in the future, receive similar notices, any of which could lead to litigation against us. For example, parties may initiate litigation based on allegations that we have infringed their intellectual property rights or misappropriated or misused their trade secrets or may seek to invalidate or otherwise render unenforceable one or more of our patents. Litigation against us can result in significant expense and divert the efforts of our management, technical, marketing and other personnel, whether or not the litigation results in a determination adverse to us. We cannot assure you that we will be able to prevail or settle any such claims or that we will be able to do so at a reasonable cost. In the event of an adverse result in any such litigation, we could be required to pay substantial damages for past infringement and royalties for any future use of the technology. In addition, we may be required to cease the sale of certain products, recall certain products from the market, redesign certain products offered for sale or under development or cease the use of certain marks or names. We cannot assure you that we will be able to successfully redesign our products or do so at a reasonable cost. Additionally, we have in the past sought and may in the future seek to obtain a license to a third party's intellectual rights and have granted and may in the future grant a license to certain of our intellectual property rights to a third party in connection with a cross-license agreement or a settlement of claims or actions asserted against us. However, we cannot assure you that we would be able to obtain a license on commercially reasonable terms, or at all.

Our customers could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger technical support and indemnification obligations in some of our license or customer agreements. These obligations could result in substantial expenses, including the payment by us of costs and damages related to claims of patent infringement. In addition to the time and expense required for us to provide support or indemnification to our customers, any such litigation could disrupt the businesses of our customers, which in turn could hurt our relations with our customers and cause the sale of our products to decrease. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business, operating results or financial condition. We do not have any insurance coverage for intellectual property infringement claims for which we may be obligated to provide indemnification. If we are obligated to pay damages in excess of, or otherwise outside of, our insurance coverage, or if we have to settle these claims, our operating results could be adversely affected.

If we are unable to compete effectively, our revenue and market share may be reduced.

Our business is extremely competitive, especially during the design-in phase of networking OEMs' design cycles. We compete with the enterprise and networking divisions of large semiconductor manufacturers, many of which have more established reputations, more diverse customer bases and greater financial and other resources than we do. In addition, our OEM customers may design their own integrated circuits to address their needs for network-aware processing. As we develop new applications for our products and expand into new markets, we expect to face even greater competition. Our present and future competitors may be able to better anticipate customer and industry demands and to respond more quickly and efficiently to those demands, such as with product offerings, financial discounts or other incentives. Furthermore, our OEM customers may be able develop or acquire integrated circuits that satisfy their needs faster or most cost effectively than we can. We cannot assure you that we will be able to compete effectively against these and our other competitors. If we do not compete effectively, our revenue and market

share may decline.

Any acquisitions we make could disrupt our business, and harm our financial condition and dilute our stockholders.

In the future, we may consider opportunities to acquire other businesses or technologies that would complement our current offerings, expand the breadth of our markets or enhance our technical capabilities. Acquisitions present a significant number of potential challenges that could, if not met, disrupt our business operations, increase our operating costs, reduce the value to us of the acquired company or business, including:

- integration of the acquired employees, operations, technologies and products with our existing business and products;
- focusing management's time and attention on our existing core business;
- retention of business relationships with suppliers and customers of the acquired company;
- entering markets in which we may lack prior experience;
- retention of key employees of the acquired company or business;
- amortization of intangible assets, write-offs, stock-based compensation and other charges relating to the acquired business and our acquisition costs; and
- dilution to our existing stockholders from the issuance of additional shares of common stock or reduction of earnings per outstanding share in connection with an acquisition that fails to increase the value of our company.

We cannot provide assurances, however, that this acquisition or future acquisitions that we might make will achieve our business objectives or increase our value or the price of our common stock.

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Our success may depend on our ability to comply with new or evolving industry standards applicable to our products or our business.

Our ability to compete in the future may depend on our ability to ensure that our products comply with evolving industry standards affecting the networking equipment and other markets in which we compete. In addition, from time to time, new industry standards may emerge which could render our products incompatible with the products of our customers or suppliers. In order to ensure compliance with the relevant standards, we may be required to devote significant time, capital and other resources to modify or redesign our existing products or to develop new products. We cannot assure you that we will be able to develop products which comply with prevailing standards. If we are unable to develop these products in a timely manner, we may miss significant business opportunities, and our revenue and operating results could suffer.

If an earthquake or other natural disaster disrupts the operations of our third party wafer foundries or other vendors located in high risk regions, we could experience significant delays in the production or shipment of our products.

TSMC and UMC, which manufacture our products, along with most of our vendors who handle the assembly and testing of our products, are located in Asia. The risk of an earthquake in the Pacific Rim region is significant due to the proximity of major earthquake fault lines. In September 1999, a major earthquake in Taiwan affected the facilities of several of these third party vendors, as well as other providers of these services. As a result of this earthquake, these vendors suffered power outages and disruptions that impaired their production capacity. In March 2002 and September 2003, additional earthquakes occurred in Taiwan. The occurrence of additional earthquakes or other natural disasters could result in the disruption of the wafer foundry or assembly and test capacity of the third parties that supply these services to us. We may not be able to obtain alternate capacity on favorable terms, if at all.

Our stock price could drop, and there could be significantly less trading activity in our stock, if securities or industry analysts downgrade our stock or do not publish research or reports about our business.

Our stock price and the trading market for our stock are likely to be affected significantly by the research and reports concerning our company and our business which are published by industry and securities analysts. We do not have any influence or control over these analysts, their reports or their recommendations. Our stock price and the trading market for our stock could be negatively affected if any analyst downgrades our stock, publishes a report which is critical of our business, or discontinues coverage of us.

Our common stock has experienced substantial price volatility.

Our common stock has experienced substantial price volatility. Such volatility may occur in the future, particularly because of quarter-to-quarter variations in our actual or anticipated financial results, or the reported financial results of other semiconductor companies or our customers. Stock price volatility may also result from product announcements by us or our competitors, or from changes in perceptions about the various types of products we manufacture and sell. In addition, our stock price may fluctuate due to price and volume fluctuations in the stock market, especially in the technology sector.

A limited number of stockholders will have the ability to influence the outcome of director elections and other matters requiring stockholder approval.

Our executive officers, directors and entities affiliated with them will, in the aggregate, beneficially own a significant portion of our outstanding common stock. These stockholders acting together will have the ability to exert substantial influence over all matters requiring the approval of our stockholders, including the election and removal of directors

and any proposed acquisition, consolidation or sale of all or substantially all of our assets. In addition, they could dictate the management of our business and affairs. This concentration of ownership could have the effect of delaying, deferring or preventing a change in control, or impeding an acquisition, consolidation, takeover or other business combination, which might otherwise involve the payment of a premium for your shares of our common stock.

Provisions of our certificate of incorporation and bylaws, Delaware law and customer agreements might delay or prevent a change of control transaction and depress the market price of our stock.

Various provisions of our certificate of incorporation and bylaws might have the effect of making it more difficult for a third party to acquire, or discouraging a third party from attempting to acquire, control of us. These provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock. Certain of these provisions eliminate cumulative voting in the election of directors, limit the right of stockholders to call special meetings and establish specific procedures for director nominations by stockholders and the submission of other proposals for consideration at stockholder meetings.

We are also subject to provisions of Delaware law which could delay or make more difficult a merger, tender offer or proxy contest involving us. In particular, Section 203 of the Delaware General Corporation Law prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years unless specific conditions are met. Any of these provisions could have the effect of delaying, deferring or preventing a change in control, including, without limitation, discouraging a proxy contest or making more difficult the acquisition of a substantial block of our common stock.

Our board of directors might issue up to 50,000,000 shares of preferred stock without stockholder approval on such terms as the board might determine. The rights of the holders of common stock will be subject to, and might be adversely affected by, the rights of the holders of any preferred stock that might be issued in the future.

Under our master purchase agreements with Cisco, in the event of, among other things, the transfer of at least 50% of our voting control to a Cisco competitor that generates less than 50% of its annual sales from integrated circuit products, Cisco may exercise rights to purchase our knowledge-based processors directly from our manufacturers, subject to payments to us. This provision may discourage or complicate attempts by some third parties to acquire us.

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The price of our stock could decrease as a result of shares being sold in the market, including sales by directors, officers and other significant stockholders.

Sales of a substantial number of shares of common stock in the public market could adversely affect the prevailing market price of our common stock from time to time. Substantially all the shares of our common stock currently outstanding are eligible for sale in the public market but sales by our affiliates will be subject to conditions of Rule 144 (other than holding period requirements) including the volume restrictions set forth in SEC Rule 144(e). As of February 5, 2009, several of our executive officers and one board member have entered into plans for selling a portion of their shares of common stock in the manner described under Rule 10b5-1 of the Securities Exchange Act of 1934. Each plan is non-discretionary and is administered by an independent brokerage firm. Their individual plans provide for total sales of between 8,600 and 200,000 shares per plan pursuant to limit orders at specified prices, with total potential sales by all of these plans amounting to 440,000 shares of common stock combined during 2009. Sales of the shares are further subject to the volume restrictions set forth in SEC Rule 144(e). Each plan provides for termination upon the completion of the specified trading program, the instruction of the stockholder, or the occurrence of other specified events, whichever is earliest. All of the shares will be sold through broker-dealers in ordinary market transactions. Pre-designated trading under these plans may cause unexpected declines in the market price of our common stock. In addition, subject to compliance with applicable securities laws, each of these executive officers may sell shares of common stock outside of these plans.

Our stockholder rights plan could prevent stockholders from receiving a premium over the market price for their shares from a potential acquirer.

We adopted a stockholder rights plan that generally entitles our stockholders to rights to acquire additional shares of our common stock when a third party acquires 15.0% of our common stock or commences or announces its intent to commence a tender offer for at least 15.0% of our common stock, other than for certain stockholders that were stockholders prior to our initial public offering as to whom this threshold is 20.0%. This plan could delay, deter or prevent an investor from acquiring us in a transaction that could otherwise result in stockholders receiving a premium over the market price for their shares of common stock.

We may need to obtain financing in order to fund our growth strategy.

We believe that we have or will have access to capital sufficient to satisfy our working capital requirements for at least the next 12 months. After that time, it may be necessary for us to raise additional funds to support our growth. We cannot assure you that we will be able to obtain financing when needed or that, if available to us, the terms will be acceptable to us. If we issue equity securities in any financing, the new securities may have rights and preferences senior to our shares of common stock, and the ownership interest in us of our current stockholders will be proportionately reduced. If we issued debt securities, they will rank senior to all equity securities. If we are unable to raise additional capital, we may not be able to implement our growth strategy, and our business could be harmed significantly. Our future capital requirements will depend on many factors, including the amount of revenue we generate, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products, and any future business acquisitions that we might undertake. However, if we do not meet our plan, we could be required, or might elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all. We also might decide to raise additional capital at such times and upon such terms as management considers favorable and in the interests of the Company. For this purpose, we have a current effective universal shelf registration statement on Form S-3 under which we may sell up to $150 million of our debt and/or equity securities (before reductions for expenses, underwriting discounts and commissions), which may result in an increase in the number of

shares and decline in earnings per share. We may sell these securities from time-to-time without prior announcement.

If the recent credit market conditions worsen, it could have a material impact on our investment portfolio.

Although we manage our investment portfolio by purchasing only highly rated securities and diversifying our investments across various money market funds, investment types, and underlying issuers, recent volatility in the short-term financial markets has been unprecedented. In addition, the current credit and liquidity crisis has substantially reduced both the liquidity and asset transparency for many funds holding investment securities. Further deterioration, in the financial condition of the funds in which we have invested or of the issuers whose paper we have purchased remains possible. If such deterioration occurs, the value of our investments could be materially adversely affected.

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EXECUTIVE OFFICERS OF THE REGISTRANT

The following table provides the names, ages and offices of each of our executive officers as of February 13, 2009:

Title	Age	Position
Ronald Jankov	50	Director, Chief Executive Officer and President
Michael Tate	43	Vice President and Chief Financial Officer
Dimitrios Dimitrelis	51	Vice President of Engineering
Ibrahim Korgav	60	Senior Vice President of Worldwide Buiness Operations
Mozfar Maghsoudnia	42	Vice President of Worldwide Manufacturing
Varadarajan Sirnivasan	58	Vice President of Product Development and Chief Technical Officer
Marcia Zander	46	Senior Vice President of Worldwide Sales
Chris O'Reilly	36	Vice President of Marketing
Roland Cortes	44	Vice President, General Counsel and Secretary

Ronald Jankov has served as our President, Chief Executive Officer and as a member of our board of directors since April 2000.

Michael Tate has served as our Vice President of Finance and Chief Financial Officer since July 2007. Prior to joining us, Mr. Tate was interim chief financial officer, vice president, corporate controller, and treasurer at Marvell Technology Group Ltd. He joined Marvell in January 2001 as part of Marvell’s acquisition of Galileo Technology Ltd.

Dimitrios Dimitrelis has served as our Vice President of Engineering since July 2002. From July 1999 to March 2002, Mr. Dimitrelis was Director of Engineering for Vitesse Semiconductor Corp., a communications integrated circuit company, where he was primarily responsible for the development of a 10G network processor.

Ibrahim Korgav has served as our Senior Vice President of Worldwide Business Operations since January 2007 and as our Senior Vice President of Manufacturing and Business Operations from March 2002 to January 2007.

Mozafar Maghsoudnia has served as our Vice President of Worldwide Manufacturing since January 2007, as Vice President of Manufacturing since August 2006, and Director of Technology since June 2003. From June 1988 to June 2003, Mr. Maghsoudnia was employed by Analog Devices, Inc., where he was responsible for wafer fabrication and technology in his last assignment.

Varadarajan Srinivasan has served as our Vice President of Product Development since March 1996, as our Chief Technical Officer since August 2000.

Marcia Zander has served as our Senior Vice President of Worldwide Sales since January 2006 and Vice President of Sales since July 1999.

Chris O’Reilly has served as our Vice President of Marketing since August 2007. Prior to August 2007, Mr. O’Reilly served as our senior director of marketing, director of sales for the Asia Pacific region and senior marketing manager since 1999.

Roland Cortes has served as our Vice President, General Counsel and Secretary since April 2007. Prior to April 2007, Mr. Cortes served as our Secretary since May 2004, as our Senior Director of Legal Affairs and IP Management since

July 2002, and as our Director of Legal Affairs and IP Management since April 1999.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

Not applicable.

ITEM 2. PROPERTIES.

Our main executive, administrative and technical offices occupy approximately 42,000 square feet in Mountain View, California, under a lease that expires in July 2011. We also lease approximately 7,500 square feet in Bangalore, India under a lease that expires in February 2012, and approximately 2,000 square feet in Mumbai, India under a lease that expires in August 2010. We believe that these facilities are adequate for our current needs and that suitable additional or substitute space will be available as needed to accommodate foreseeable expansion of our operations.

ITEM 3. LEGAL PROCEEDINGS.

We are not involved in any legal proceedings that management believes will have a material adverse effect our business, results of operations, financial position or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information for Common Stock

Our common stock is traded on the Global Select Market of the NASDAQ Stock Market under the symbol "NETL". The following table sets forth, for the periods indicated, the intra-day high and low per share sale prices of our common stock, as reported on the Global Select Market.

	Price Range Per Share	
	High	Low
Fiscal 2008		
Fourth quarter	$30.45	$14.42
Third quarter	$39.10	$26.98
Second quarter	$40.26	$23.44
First quarter	$32.90	$20.15
Fiscal 2007		
Fourth quarter	$38.69	$27.46
Third quarter	$37.25	$26.76
Second quarter	$35.17	$26.08
First quarter	$28.61	$20.00

Holders

As of January 31,2009, there were approximately 117 holders of record (not including beneficial holders of stock held in street names) of our common stock.

Dividend Policy

We have not declared or paid cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We expect to retain future earnings, if any, to fund the development and growth of our business. Our board of directors will determine future dividends, if any.

Securities Authorized for Issuance Under Equity Compensation Plans

See Item 12 of Part III of this Report regarding information about securities authorized for issuance under our equity compensation plans.

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Performance Graph

The following graph shows the 54 month cumulative total stockholder return (change in stock price plus reinvested dividends) assuming the investment of $100 on July 9, 2004 (the day of the Company's initial public offering) in each of the Company's common stock, the S&P 500 Index and the Philadelphia Semiconductor Index. The comparisons in the table are required by the SEC and are not intended to forecast or be indicative of possible future performance of the Company's common stock.

COMPARISON OF 54 MONTH CUMULATIVE TOTAL RETURN*
Among NetLogic Microsystems, Inc., the S&P 500 Index
and the Philadelphia Semiconductor Index

	Cumulative Total Return					
	7/9/2004	12/31/2004	12/31/2005	12/31/2006	12/31/2007	12/31/2008
NetLogic Microsystems, Inc.	$ 100.00	$ 83.33	$ 227.00	$ 180.75	$ 268.33	$ 183.42
S&P 500 Index	$ 100.00	$ 108.91	$ 112.17	$ 127.45	$ 131.95	$ 81.17
Philadelphia Semiconductor Index	$ 100.00	$ 96.05	$ 106.28	$ 103.52	$ 90.45	$ 47.03

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data are qualified by reference to, and should be read in conjunction with, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the Financial Statements and related Notes included in Item 8 of this report, which discusses factors affecting the comparability of such financial data.

The selected balance sheet data as of December 31, 2008 and 2007 and selected statements of operations data for the years ended December 31, 2008, 2007 and 2006 are derived from our audited financial statements included elsewhere in this report. The selected balance sheet data as of December 31, 2006, 2005, and 2004 and the selected statements of operations data for the years ended December 31, 2005 and 2004 were derived from audited financial statements not included in this report. Our historical results are not necessarily indicative of our future results.

	Year Ended December 31,				
	2008	2007	2006	2005	2004
	(in thousands, except per share data)				
Statements of Operations Data:					
Revenue	$ 139,927	$ 109,033	$ 96,806	$ 81,759	$ 47,833
Cost of revenue	61,616	44,732	36,762	33,415	26,664
Gross profit	78,311	64,301	60,044	48,344	21,169
Operating expenses:					
Research and development	51,607	45,175	36,578	21,939	19,425
In-process research and development	-	1,610	10,700	-	-
Selling, general and administrative	26,567	19,672	15,455	10,936	9,932
Total operating expenses	78,174	66,457	62,733	32,875	29,357
Income (loss) from operations	137	(2,156)	(2,689)	15,469	(8,188)
Interest income	1,595	4,431	3,737	1,568	382
Interest expense	-	-	-	(203)	(4,076)
Other income (expense), net	(92)	32	3	(16)	(149)
Income (loss) before income taxes	1,640	2,307	1,051	16,818	(12,031)
Provision for (benefit from) income taxes	(1,937)	(288)	459	379	-
Net income (loss)	$ 3,577	$ 2,595	$ 592	$ 16,439	$ (12,031)
Net income (loss) per share - basic	$ 0.17	$ 0.13	$ 0.03	$ 0.93	$ (1.17)
Net income (loss) per share - diluted	$ 0.16	$ 0.12	$ 0.03	$ 0.87	$ (1.17)
Shares used in calculation - basic	21,472	20,747	19,758	17,725	10,318
Shares used in calculation - diluted	22,314	21,938	21,107	18,992	10,318

	December 31,				
	2008	2007	2006	2005	2004
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents and short-term investments	$ 96,541	$ 50,689	$ 89,879	$ 65,788	$ 41,411
Working capital	87,853	63,956	95,986	65,164	45,283
Total assets	245,771	203,151	157,769	85,529	59,454
Software licenses and other obligations	1,219	2,528	2,625	687	1,317
Stockholders' equity	200,267	171,888	142,524	68,658	48,102

Supplemental Information:

The tables present financial information including the acquisition of the TCAM2 and TCAM-CR network search engine products and certain related assets from Cypress Semiconductor Corp. and the acquisition of Aeluros, Inc. completed in fiscal 2007 and the acquisition of NSE Business from Cypress Semiconductor Corp. completed in 2006. See Note 2 of Notes to Consolidated Financial Statements under Item 8 of this Annual Report on Form 10-K for further discussion of these acquisitions, which may affect the comparability of the data. Effective in fiscal year 2006, we implemented Statement of Financial Accounting Standards ("SFAS") No. 123(R) "Share-Based Payment." It requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Overview

We are a semiconductor company that designs, develops and sells proprietary high-performance processors and high-speed integrated circuits that are used by original equipment manufacturers (OEMs) in routers, switches, wireless infrastructure equipment, network security appliances, datacenter servers, network access equipment and network storage devices to accelerate the delivery of voice, video, data and multimedia content for advanced enterprise, datacenter, communications and mobile wireless networks. Our knowledge-based processors, PLPs, and network search engine products are incorporated in systems used throughout multiple types of networks that comprise the global Internet infrastructure, including the enterprise, metro, access, edge and core networking markets, and are designed into systems offered by leading networking OEMs such as AlaxalA Networks Corporation, Alcatel-Lucent, ARRIS Group, Inc., Brocade Communication Systems, Inc., Cisco Systems, Inc., Huawei Technologies Co., Ltd., and Juniper Networks, Inc.

The products and technologies we have developed and acquired are targeted to enable our customers to develop systems that support the increasing speeds and complexity of the Internet infrastructure. We believe there is a growing need to include knowledge-based processors and high speed integrated circuits in a larger number of such systems as networks transition to all Internet Protocol (IP) packet processing at increasing speeds.

The equipment and systems that use our products are technically complex. As a result, the time from our initial customer engagement design activity to volume production can be lengthy and may require considerable support from our design engineering, research and development, sales, and marketing personnel in order to secure the engagement and commence product sales to the customer. Once the customer's equipment is in volume production, however, it generally has a life cycle of three to five years and requires less ongoing support.

In general, we recognize revenue from sales of our products upon shipment to our customers or our international stocking sales representatives. Usually, we sell the initial shipments of a product for a new design engagement directly to the OEM customer. Once the design enters volume production, the OEM frequently outsources its manufacturing to contract manufacturers who purchase the products directly from us.

As a fabless semiconductor company, our business is less capital intensive than others because we rely on third parties to manufacture, assemble, and test our products. In general, we do not anticipate making significant capital expenditures aside from business acquisitions that we might make from time to time. In the future, as we launch new products or expand our operations, however, we may require additional funds to procure product mask sets, order elevated quantities of wafers from our foundry partners, perform qualification testing and assemble and test those products.

Because we purchase all wafers from suppliers with fabrication facilities and outsource the assembly and testing to third party vendors, a significant portion of our costs of revenue consists of payments to third party vendors. We do not have long-term agreements with any of our suppliers and rely upon them to fulfill our orders.

On October 24, 2007, we completed the merger and acquisition of Aeluros, Inc (the "Aeluros Acquisition"). The acquisition was accounted for as a business combination during the fourth quarter of fiscal 2007. We paid $57.0 million in cash upon the closing of the transaction in exchange for all of the outstanding equity securities of Aeluros. We reserved 104,770 shares of common stock for future issuance upon the exercise of unvested employee stock options of Aeluros that we assumed and are subject to continued employment vesting requirements. In addition, under

the terms of the definitive agreement, we paid $15.5 million cash in February 2009 based on the attainment of revenue performance milestones for the acquired business over the one year period following the close of the transaction. Approximately $8.5 million of the initial purchase price has been withheld and placed in escrow as a form of security for certain indemnification and other obligations of the former Aeluros stockholders.

Some of our challenges in fiscal 2008 and in fiscal 2009 include improving operating efficiencies in the light of recently deteriorating macroeconomic conditions, diversifying our product offerings and inventory management. While we achieved a year-over-year growth in total revenue from $109.0 million for fiscal year 2007 to $139.9 million for fiscal year 2008, we did experience a quarter-over-quarter decline in revenue from $38.3 million for our third fiscal quarter in 2008 to $30.9 million for our fourth fiscal quarter in 2008. We believe the decrease in demand was primarily due to macroeconomic conditions that decreased customer demand for our products. We also expect revenue for the first quarter of fiscal 2009 to decline further relative to the first quarter of fiscal 2008. In response, we have focused on operating efficiencies and lowered our operating expenses from $20.8 million for the third quarter of fiscal 2008 to $20.1 million for our fourth fiscal quarter in 2008. We expect to remain focused on maintaining our operating expenses at an appropriate level relative to our revenue during this period of macroeconomic weakness.

For the years ended December 31, 2008, 2007, and 2006, our top five customers accounted for approximately 68%, 79% and 84% of total product revenue, respectively. Favorable market trends, such as the increasing number of 10 Gigabit ports as enterprises and datacenters upgrade their legacy networks to better accommodate the proliferation of video and virtualization applications, growth in the cable infrastructure area of our business, and the growing mobile wireless infrastructure and IPTV markets, have enabled us to broaden our customer base and increase demand for our knowledge-based processors and network search engines. Additionally, we have further diversified our customer and product revenues by expanding our product portfolio to address Layer 7 content processing with our NETL7™ processor family, the Layer 1 physical layer with our 10 Gigabit Ethernet products, and entry level equipment with our NETLite™ processors.

As an integral part of our efforts to diversify our product and customer base, as well as strengthen our competitive positioning, and broaden our technology portfolio and research and development capabilities, we have entered into strategic acquisitions of products and technology, including the acquisition of the TCAM2 products and Sahasra algorithmic technology from Cypress and the acquisition of Aeluros and its PLP products.

Cisco and its contract manufacturers have accounted for a majority of our historical revenue, although the percentage of our overall revenue attributable to Cisco and its contract manufacturers declined for 2008. At Cisco’s request, in the third and fourth quarters of 2007, we transitioned into a just-in-time inventory arrangement covering substantially all of our product shipments to Cisco and its contract manufacturers. Pursuant to this arrangement we deliver products to Wintec Industries (“Wintec”) based on orders they place with us, but we do not recognize product revenue unless and until Wintec reports that it has delivered the product to Cisco or its contract manufacturer to incorporate into its end products. Given this arrangement, unless Cisco or its contract manufacturers take possession of our products from Wintec in accordance with the schedules provided to us, our predicted future revenue stream could vary substantially from our forecasts, and our results of operations could be materially and adversely affected. Additionally, because we own the inventory physically located at Wintec until it is shipped to Cisco and its contract manufacturers, our ability to effectively manage inventory levels may be impaired, causing our total inventory levels to increase. This, in turn, could increase our expenses associated with excess and obsolete product and negatively impact our cash flows.

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Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make fair and reasonable estimates and assumptions that affect reported amounts of assets, liabilities and operating expenses during the period reported. The following accounting policies require management to make estimates and assumptions. These estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the period that they are determined to be necessary. If actual results differ significantly from management's estimates, our financial statements could be materially impacted. Our estimates are guided by observing the following critical accounting policies.

Revenue Recognition. We derive revenue mainly from product sales and, to a lesser extent, from engineering services. Historically, except for shipments to one distributor, we recognize revenue from product sales upon shipment when persuasive evidence of an arrangement exists, legal title and risk of ownership has transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured. Our sales agreements do not provide for any customer acceptance provisions. We have no obligation to provide any modification or customization, upgrades, enhancements, post-contract customer support, additional products or enhancements. Customers, generally, have no rights of return unless the product does not perform according to specifications. Provisions for warranty expenses are recorded when revenue is recognized.

We entered into a purchase agreement with Wintec Industries who has become the primary purchaser of our products on a consignment basis for resale to Cisco and its contract manufacturers. We generally recognize revenue when Wintec ships our product to Cisco or its contract manufacturers.

From time-to-time we perform engineering services for third parties. Engineering service revenue is recognized as services are performed, agreed-upon milestones are achieved and customer acceptance, if required, is received from the customer.

Inventory Valuation and Adverse Purchase Commitments. We value our inventories at the lower of cost or market. We record inventory reserves for estimated obsolescence or unmarketable inventories based upon assumptions about future demand and market conditions. These estimates are generally based on a 12-month forecast prepared by management. Once a reserve is established, it is maintained until the product to which it relates is sold or otherwise disposed of. If actual market conditions are less favorable than those expected by management, additional adjustment to inventory valuation may be required. The carrying value of inventory and the determination of possible adverse purchase commitments are dependent on our estimate of the yield that will be achieved, or the percent of good products identified when the product is tested.

Warranty Accrual. Our products are subject to warranty for a period ranging from one to five years from the date of sale and we provide for the estimated future costs of replacement upon shipment of the product in the accompanying statements of operations. We estimate our warranty accrual based on historical claims compared to historical revenue and assume that we will have to replace products subject to a claim.

Allowance for Doubtful Accounts. In order to determine the collectability of our accounts receivable, we continually assess factors such as previous customer transactions and the credit-worthiness of the customer. To date, our accounts receivable write-offs have been immaterial. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of certain customers to make required payments. In general, we establish such allowances for accounts aged over 90 days from the invoice date, unless specific circumstances indicate that the balance is collectible.

Accounting for Income Taxes. We account for income taxes under the provisions of Statement of Financial Accounting Standards (SFAS) No. 109 “Accounting for Income Taxes.” In applying SFAS 109, we are required to estimate our current tax exposure together with assessing temporary differences resulting from differing treatments of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Significant management judgment is required to assess the likelihood that our deferred tax assets will be recovered from future taxable income. During the third fiscal quarter of 2007, we reassessed the valuation allowance previously recorded against our net deferred tax assets which consisted primarily of net operating loss carryforwards and research and development tax credits. Based on our earnings history and projected future taxable income, management determined that it was more likely than not that the deferred tax assets would be realized.

In the first quarter of 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—an interpretation of SFAS No. 109” (FIN 48), and related guidance. As a result of the implementation of FIN 48, we recognize liabilities for uncertain tax positions based on the two-step process prescribed in the interpretation. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as we have to determine the probability of various possible outcomes. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision. Refer to Note 7—Income Taxes, of the “Notes to Consolidated Financial Statements ” in Item 8 for further information.

Goodwill. We evaluate goodwill for impairment at least on an annual basis or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flow. Applying the provision of SFAS No. 142, Goodwill and Other Intangible Assets, we perform goodwill impairment test for each reporting unit. If the fair value of the reporting unit exceeds the carrying value of the reporting unit, goodwill is not impaired. We perform the goodwill impairment assessment at the Company level, which is the sole reporting unit. We performed our annual goodwill impairment test in the fourth quarter of fiscal 2008 and there was no impairment of goodwill during the year ended December 31, 2008. Significant management judgment is required in the forecasts of future operating results that are used in the evaluation of carrying value of goodwill. 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.

Stock-based Compensation. We estimate the fair value of stock options using the Black-Scholes-Merton valuation model (the “Black-Scholes Model”), consistent with the provisions of SFAS 123(R), and SAB 107, as allowed by SAB 110. The Black-Scholes Model requires the input of highly subjective assumptions, including the option’s expected life, the price volatility of the underlying stock and future forfeitures and related tax effects. The expected stock price volatility assumption was determined using a combination of the historical and implied volatility of the Company’s common stock. Changes in the subjective assumptions required in the valuation models may significantly affect the estimated value of the awards, the related stock-based compensation expense and, consequently, our results of operations.

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Results of Operations

Comparison of Year Ended December 31, 2008 to Year Ended December 31, 2007

Revenue, cost of revenue and gross profit

The table below sets forth the fluctuations in revenue, cost of revenue and gross profit data for the years ended December 31, 2008 and 2007 (in thousands, except percentage data):

	Year ended December 31, 2008	Percentage of Revenue	Year ended December 31, 2007	Percentage of Revenue	Year-to-Year Increase	Increase Percentage
Revenue	$ 139,927	100.0%	$ 109,033	100.0%	$ 30,894	28.3%
Cost of revenue	61,616	44.0%	44,732	41.0%	16,884	37.7%
Gross profit	$ 78,311	56.0%	$ 64,301	59.0%	$ 14,010	21.8%

Revenue. Revenue for the year ended December 31, 2008 increased by $30.9 million compared with that of the year ended December 31, 2007. Revenue from sales to Wintec, Cisco and Cisco's contract manufacturers (collectively "Cisco") represented $52.7 million of our total revenue for the year ended December 31, 2008, compared to $55.1 million during the year ended December 31, 2007. The decrease in sales to Cisco was primarily due to a decrease of $22.4 million from 2007 in revenue from sales of NL5000 products, although this decline was largely offset by increased revenue of our new and additional products for Cisco, including NL7000, NL8000, and TCAM2 products which increased $20.7 million. Revenue from non-Cisco customers represented $87.2 million of total revenue for the year ended December 31, 2008 compared with $53.9 million during the year end December 31, 2007. The increase in sales to non-Cisco customers was driven primarily by increased demand for our products in several emerging new markets, such as 10 Gigabit Ethernet, which we address with the PLPs that we acquired in the Aeluros acquisition, and IPTV. During the year ended December 31, 2008, Alcatel-Lucent accounted for 12% of our total revenue compared with 11% in 2007.

Revenue for the fourth quarter of fiscal 2008 declined 4% from the fourth quarter of fiscal 2007. We also expect revenue for the first quarter of fiscal 2009 to decline further relative to the first quarter of fiscal 2008.

Cost of Revenue/Gross Profit/Gross Margin. Cost of revenue for the year ended December 31, 2008 increased by $16.9 million compared with that of the year ended December 31, 2007. Cost of revenue increased primarily due to the increase in product sales. Cost of revenue in 2008 also included amortization of intangible assets, and a provision for excess and obsolete inventory and product scrap charges. Cost of revenue for the years ended December 31, 2008 and 2007, respectively, included $11.9 million and $5.0 million of amortization of intangible assets expense, and $2.4 million and $1.0 million of a provision for excess and obsolete inventory.

Operating expenses

The table below sets forth operating expense data for the years ended December 31, 2008 and 2007 (in thousands, except percentage data):

	Year ended	Percentage of	Year ended	Percentage of	Year-to-Year Increase	Increase (Decrease)

	December 31, 2008	Revenue	December 31, 2007	Revenue	(Decrease)	Percentage
Operating expenses:						
Research and development	$ 51,607	36.9%	$ 45,175	41.4%	$ 6,432	14.2%
In-process research and development	-	0.0%	1,610	1.5%	(1,610)	-100.0%
Selling, general and administrative	26,567	19.0%	19,672	18.0%	6,895	35.0%
Total operating expenses	$ 78,174	55.9%	$ 66,457	60.9%	$ 11,717	17.6%

Research and Development Expenses. Research and development expenses increased during the year ended December 31, 2008, as compared to fiscal 2007, primarily due to increases in payroll related expenses of $3.8 million, product development and qualification expenses of $2.1 million, and consulting and outside vendor expenses of $1.0 million, which were partially offset by a decrease of stock-based compensation expense of $0.5 million. The increase in payroll related expenses resulted primarily from increases in engineering headcount in India to support our new product development efforts, and in the U.S. as a result of the Aeluros Acquisition. The increase in product development and qualification expense was primarily due to the production qualification and characterization of our newly introduced knowledge-based processors. The remainder of the increase in research and development expenses was caused by individually minor items.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased during the year ended December 31, 2008, as compared with fiscal 2007, primarily due to increased commission expenses of $1.7 million, payroll related expenses of $1.7 million, amortization expense of intangible assets – customer relationships of $1.1 million, consulting and outside vendor expense of $1.0 million, other professional services fess of $0.4 million, stock-based compensation expense of $0.6 million, and travel expense of $0.1 million. The increase in commission expenses was primarily a result of our increase in revenue. The increase in payroll related expenses and stock-based compensation expense resulted primarily from increased headcount to support our growing operations in the sales and marketing areas. The remainder of the fluctuation in selling, general and administrative expenses was caused by individually minor items.

During the fourth quarter of fiscal 2008, we focused on lowering operating expenses which resulted in a decline in expenses in that quarter to $20.1 million from $20.8 million in the previous quarter. We expect to remain focused on maintaining our operating expenses at an appropriate level relative to our revenues during the first quarter of fiscal 2009.

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Other items

The table below sets forth interest and other income (expense), net for the years ended December 31, 2008 and 2007 (in thousands, except percentage data):

	Year ended December 31, 2008	Percentage of Revenue	Year ended December 31, 2007	Percentage of Revenue	Year-to-Year (Decrease)	(Decrease) Percentage
Other income, net						
Interest income	$ 1,595	1.1%	$ 4,431	4.1%	$ (2,836)	-64.0%
Other income (expense), net	(92)	0.0%	$ 32	0.0%	$ (124)	-387.5%
Total other income, net	$ 1,503	1.1%	$ 4,463	4.1%	$ (2,960)	-66.3%

Interest and Other Income (Expenses), net. Interest and other income, net, decreased by $3.0 million during the year ended December 31, 2008, compared with the same period in 2007, primarily due to our lower invested balances after paying approximately $71.7 million in connection with the acquisitions of the TCAM2 Products from Cypress and the Aeluros Acquisition, and lower yields on our investments.

	Year ended December 31, 2008	Percentage of Revenue	Year ended December 31, 2007	Percentage of Revenue	Year-to-Year (Decrease)	(Decrease) Percentage
Provision for (benefit from) income taxes	$ (1,937)	-1.4%	$ (288)	-0.3%	$ (1,649)	572.6%

Provision for income taxes. During the year ended December 31, 2008, we recorded an income tax benefit of $1.9 million. Our effective tax rate of 35% for the year ended December 31, 2008 was primarily driven by a rate differential for book income generated in foreign jurisdictions and the tax impact of non-deductible stock options.

Stock-Based Compensation under SFAS No. 123(R)

On January 1, 2006, we adopted SFAS 123(R), on the modified prospective application method, which requires the measurement and recognition of compensation expense for all share-based awards made to our employees and directors including employee stock options and employee stock purchases outstanding as of and awarded after January 1, 2006. The total stock-based compensation expense recognized for the year ended December 31, 2008, 2007 and 2006 was as follows (in thousands):

	Year ended December 31,		
	2008	2007	2006
Cost of revenue	$ 1,030	$ 747	$ 548
Research and development	9,474	9,933	7,481
Selling, general and administrative	5,988	5,366	3,878
Total stock-based compensation expense	$ 16,492	$ 16,046	$ 11,907

In addition, we capitalized approximately $0.2 million and $0.2 million of stock-based compensation in inventory as of December 31, 2008 and 2007 which represented indirect manufacturing costs related to our inventory.

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Comparison of Year Ended December 31, 2007 to Year Ended December 31, 2006

Revenue, cost of revenue and gross profit

The table below sets forth the fluctuations in revenue, cost of revenue and gross profit data for the years ended December 31, 2007 and 2006 (in thousands, except percentage data):

	Year ended December 31, 2007	Percentage of Revenue	Year ended December 31, 2006	Percentage of Revenue	Year-to-Year Increase	Increase Percentage
Revenue	$ 109,033	100.0%	$ 96,806	100.0%	$ 12,227	12.6%
Cost of revenue	44,732	41.0%	36,762	38.0%	7,970	21.7%
Gross profit	$ 64,301	59.0%	$ 60,044	62.0%	$ 4,257	7.1%

Revenue. Revenue for the year ended December 31, 2007 increased by $12.2 million compared with the year ended December 31, 2006. Revenue from sales to Cisco and its contract manufacturers represented 50% of our total revenue for the year ended December 31, 2007, compared with 61% during the year ended December 31, 2006. The decrease in sales to Cisco and its contract manufacturers was primarily due to the implementation of Cisco's vendor managed inventory program during the second half of 2007 which resulted in lower levels of inventory at Cisco as well as the implementation of a just-in-time inventory model the second quarter of 2007 by Solectron Corporation, one of Cisco's contract manufacturers. The revenue loss attributable to the implementation of these new manufacturing models in 2007 was partially offset by increased revenues of new products to Cisco including the NL6000, NL7000, NL8000 and TCAM2 products which increased $7.9 million from 2006. The decrease in sales to Cisco and its contract manufacturers was mitigated by an increase in revenue from our non-Cisco customers, which totaled $54.0 million during the year ended December 31, 2007, compared with $37.7 million during the year ended December 31, 2006. The increase in sales to non-Cisco customers was primarily driven by the increasing demand for our products in several emerging new markets, such as 10 Gigabit Ethernet, cable infrastructure and IPTV, in addition to the enterprise networking infrastructure market that has driven the demand for our products historically. The average selling price of our products decreased approximately 41% from 2006 primarily due to increased revenues of our network search engine products into the high volume desktop switching segment. In addition, we began shipping our newly acquired 10 Gigabit Ethernet PLPs in the fourth quarter of 2007. During the year ended December 31, 2007, Alcatel-Lucent accounted for 11% of our total product revenue compared with 10 % in 2006.

Cost of Revenue/Gross Profit/Gross Margin. Cost of revenue for the year ended December 31, 2007 increased primarily due to the addition of intangible asset amortization expense and recording of the fair value inventory adjustments resulting from the acquisition of the TCAM2 Products from Cypress Semiconductor Corp. and the Aeluros Acquisition, both of which were completed in 2007. Intangible asset amortization expense for the year ended December 31, 2007 was $5.0 million compared with $2.0 million for the year ended December 31, 2006. The fair value inventory adjustments for the year ended December 31, 2007 totaled $1.8 million compared with $0.3 million for the year ended December 31, 2006. The intangible asset amortization expense and fair value inventory adjustment recorded during the year ended December 31, 2006 related to the acquisition of NSE Business from Cypress Semiconductor Corp. The remainder of the increase in cost of sales during the year ended December 31, 2007 was primarily due to the increase in sales of our products.

Operating expenses

The table below sets forth operating expense data for the years ended December 31, 2007 and 2006 (in thousands, except percentage data):

	Year ended December 31, 2007	Percentage of Revenue	Year ended December 31, 2006	Percentage of Revenue	Year-to-Year Increase (Decrease)	Increase (Decrease) Percentage
Operating expenses:						
Research and development	$ 45,175	41.4%	$ 36,578	37.8%	$ 8,597	23.5%
In-process research and development	1,610	1.5%	$ 10,700	11.1%	$ (9,090)	-85.0%
Selling, general and administrative	19,672	18.0%	15,455	16.0%	4,217	27.3%
Total operating expenses	$ 66,457	60.9%	$ 62,733	64.9%	$ 3,724	5.9%

Research and Development Expenses. Research and development expenses increased during the year ended December 31, 2007 compared with fiscal 2006, primarily due to increases in product development and qualification expenses of $3.0 million, stock-based compensation expense of $2.5 million, payroll related expenses of $1.8 million, and travel expenses of $0.5 million. The increase in product development and qualification expense was primarily due to the production qualification and characterization for the NL7000 and NL8000 processors. The increase in stock-based compensation expense was primarily due to the issuance of stock-based compensation options and awards for additional engineering headcount, including the new employees who joined us through the Aeluros Acquisition. The increase in payroll related expenses was primarily due to an increase in our engineering headcount in India to support our new product development efforts and the incremental employees as a result of the Aeluros Acquisition. Depreciation expense increased by $0.8 million during the year ended December 31, 2007 as we purchased software and other tools to support our research and development efforts. The remainder of the increase in research and development expenses was caused by individually minor items.

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In-Process Research and Development. During the year ended December 31, 2007, we recorded $1.6 million of in-process research and development ("IPRD") charge related to the Aeluros Acquisition. The value assigned to IPRD was determined by considering the importance of products under development to the overall development plan, estimating costs to develop the purchased IPRD into commercially viable products, estimating the resulting net cash flows from the projects when completed and discounting the net cash flows to their present value. The fair values of IPRD were determined using the income approach, which discounts expected future cash flows to present value. The discount rate of 24% used in the present value calculations was derived from a weighted-average cost of capital analysis, adjusted to reflect additional risks related to the product's development and success as well as the product's stage of completion. At December 31, 2007, we estimated that the aggregate costs to complete the projects would be $0.3 million. As of December 31, 2008, the projects had been completed.

During the year ended December 31, 2006, we recorded $10.7 million of IPRD charge related to our acquisition of the NSE Business from Cypress based upon our estimate of the fair values of assets acquired. We acquired only one IPRD project from Cypress, which was related to the acquired Sahasra algorithmic technology, that had not reached technological feasibility, and had no alternative use. The Sahasra algorithmic technology complemented our Layer 7 processing initiative and was a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions. As of December 31, 2007, we had completed the IPRD project and incurred total post-acquisition costs of approximately $1.9 million. We expect to benefit from it beginning in fiscal 2008, which is consistent with our original estimate.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased during the year ended December 31, 2007 compared with fiscal 2006, primarily due to increases in stock-based compensation expense of $1.5 million, payroll related expenses of $1.1 million, accounting fees of $0.3 million, legal expenses of $0.3 million, consulting and outside vendor expenses of $0.3 million, amortization of intangible assets expense of $0.3 million and recruiting fees expenses of $0.2 million. The increase in stock-based compensation expense and payroll related expenses was primarily due to an increase in headcount to support our growing operations. Selling, general and administrative expenses for 2007 also included $0.3 million of amortization expense for the customer relationship intangible asset related to the Aeluros Acquisition. The remainder of the increase in selling, general and administrative expenses was caused by individually minor items.

Other items

The table below sets forth other data for the years ended December 31, 2007 and 2006 (in thousands, except percentage data):

	Year ended December 31, 2007	Percentage of Revenue	Year ended December 31, 2006	Percentage of Revenue	Year-to-Year Increase	Increase Percentage
Other income, net						
Interest income	$ 4,431	4.1%	$ 3,737	4.6%	$ 694	18.6%
Other income (expense), net	32	0.0%	$ 3	0.0%	$ 29	966.7%
Total other income, net	$ 4,463	4.1%	$ 3,740	4.6%	$ 723	19.3%

Interest and Other Income (Expenses), net. The net interest and other income of $4.5 million generated during the year ended December 31, 2007 was due to a higher average cash and investment balance during the period and higher

market yields for our chosen investments.

	Year ended December 31, 2007	Percentage of Revenue	Year ended December 31, 2006	Percentage of Revenue	Year-to-Year (Decrease)	(Decrease) Percentage
Provision for (benefit from) income taxes	$ (288)	-0.3%	$ 459	0.5%	$ (747)	-162.7%

Provision for income taxes. During the year ended December 31, 2007, we recorded income tax benefit of $0.3 million, which included the release of the valuation allowance previously recorded against our net deferred tax assets and the tax impact of an intercompany license agreement. During the third fiscal quarter of 2007, we reassessed the valuation allowance previously recorded against our net deferred tax assets which consisted primarily of net operating loss carryforwards and research and development tax credits. Based on our earnings history and projected future taxable income, management determined that it was more likely than not that the deferred tax assets would be realized.

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Liquidity and Capital Resources

Financial Condition

At December 31, 2008, our principal sources of liquidity were our cash, cash equivalents, and short-term investments which totaled $96.5 million. In February 2009, we paid $15.5 million to the former Aeluros stockholders due to attainment of post-acquisition revenue milestones, subject to certain adjustments as provided in the Aeluros acquisition agreement

The Company's cash, cash equivalents and short-term investments are invested with financial institutions in deposits that, at times, may exceed federally insured limits. The Company had not experienced any losses on its deposits of cash and cash equivalents as of December 31, 2008. However, we believe that the capital and credit markets have been experiencing unprecedented levels of volatility and disruption and that recent U.S. sub-prime mortgage defaults have had a significant impact across various sectors of the financial markets, causing global credit and liquidity issues. We can provide no assurance that our cash, cash equivalents, and short-term investments will not be adversely affected by these matters in the future.

The table below (in thousands) sets forth the key components of cash flow for the years ended December 31, 2008, 2007, and 2006:

	Year ended December 31,		
	2008	2007	2006
Net cash provided by operating activities	$ 41,856	$ 24,907	$ 22,308
Net cash used in investing activities	$ (14,252)	$ (32,629)	$ (41,391)
Net cash provided by financing activities	$ 5,226	$ 7,674	$ 4,053

Cash Flows during the Year ended December 31, 2008

Net cash provided by operating activities was $41.9 million for the year ended December 31, 2008, which primarily consisted of $3.6 million of net income, $31.7 million of non-cash operating expenses and $6.6 million in changes in operating assets and liabilities. Non-cash operating expenses for the year ended December 31, 2008, included depreciation and amortization of $17.2 million, stock-based compensation of $16.5 million, and provision for inventory reserve of $2.4 million, offset by deferred income taxes, net of $3.9 million, and tax benefit from stock-based awards of $0.7 million. Changes in operating assets and liabilities were primarily driven by an increase in deferred margin of $1.3 million, inventory of $1.4 million, other liabilities of $1.1 million and accounts payable of $0.5 million on higher product sales, offset by a decrease in accounts receivables of $6.6 million, accrued liabilities of $2.1 million, which includes the $15.5 million Aeluros post-acquisition revenue milestone, and prepaid expenses and other assets of $0.6 million.

Net cash used in investing activities was $14.3 million during the year ended December 31, 2008, of which we used $13.0 million for the purchase of short-term investments, and $1.4 million to purchase computer equipment and research and development design tools to support our growing operations. We expect to make capital expenditures of approximately $3.0 million during fiscal 2009. These capital expenditures will be used primarily to support product development activities. We will use our cash and cash equivalents to fund these purchases.

Net cash provided by financing activities was $5.2 million for the year ended December 31, 2008, primarily from proceeds of stock option exercises of $7.9 million, and tax benefit from stock-based awards of $0.7 million. Cash provided by financing activities was offset by repayment of software license and other obligations of $3.4 million.

Cash Flows during the Year ended December 31, 2007

During the year ended December 31, 2007, our operating activities generated net cash of $24.9 million. During the period, we recorded non-cash items of $22.5 million primarily consisting of stock-based compensation of $16.0 million, depreciation and amortization of $9.1 million, in-process research and development charge of $1.6 million related to the Aeluros Acquisition, provision for inventory reserve of $1.0 million, offset by net impact of deferred tax asset valuation allowance release of $0.5 million, tax benefit from stock-based awards of $2.5 million, deferred income taxes, net of $1.7 million, and accretion of discount on debt securities of $0.7 million. We also generated cash from a decrease of inventory of $1.5 million, and an increase in accounts payable and accrued liabilities of $2.9 million, and other long-term liabilities of $1.0 million. The cash generated was partially offset by the increase in accounts receivable of $4.5 million on higher sales of our products during the period, increase in prepaid expenses and other assets of $1.3 million.

Our investing activities used cash of $32.6 million during the year ended December 31, 2007, of which we obtained $53.8 million in proceeds from sales and maturities of short-term investments, and used $13.9 million for the purchase of short-term investments. We used $2.2 million to purchase computer equipment and research and development design tools to support our growing operations. We expect to make capital expenditures of approximately $4.4 million during fiscal 2008. These capital expenditures will be used primarily to support product development activities. We will use our cash and cash equivalents to fund these purchases. We used $70.2 million to purchase the TCAM2 products and certain related assets from Cypress Semiconductor and for the Aeluros Acquisition.

Our financing activities provided net cash of $7.7 million for the year ended December 31, 2007, primarily from proceeds of stock option exercises of $8.3 million, and tax benefit from stock-based awards of $2.5 million. Cash provided by financing activities was offset by repayment of software license and other obligations of $3.1 million.

Cash Flows during the Year ended December 31, 2006

During the year ended December 31, 2006, our operating activities generated net cash of $22.3 million. During the period, we recorded non-cash items of $29.5 million primarily consisting of an in-process research and development charge of $10.7 million related to the acquisition of the Cypress NSE assets, stock-based compensation of $11.9 million, provision for inventory reserve of $2.5 million, accretion of discount on debt securities of $0.5 million and depreciation and amortization of intangibles of $4.9 million. The cash generated was offset by the increase in accounts receivable of $1.7 million on higher sales of our knowledge-based processors during the period, an increase in inventory of $2.6 million primarily due to the addition of NSE products acquired from Cypress and a decrease in accounts payable of $3.5 million due to the timing of payments to our vendors.

Our investing activities used cash of $41.4 million during the year ended December 31, 2006, of which $39.1 million was for the purchase of short-term investments. We used $1.5 million to purchase computer equipment and research and development design tools to support our growing operations. We expect to make capital expenditures of approximately $5.1 million during fiscal 2007. These capital expenditures will be used primarily to support product development activities. We will use our cash and cash equivalents to fund these purchases. We paid approximately $0.8 million for expenses directly associated with the acquisition of the NSE Business from Cypress.

Our financing activities provided net cash of $4.1 million for the year ended December 31, 2006, primarily from stock option exercises. Cash provided by financing activities was offset by repayment of software license and other obligations.

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Capital Resources

We believe that our existing cash, cash equivalents, and short-term investment balance of $96.5 million will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including the amount of revenue we generate, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products, and any future business acquisitions that we might undertake. However, if we do not meet our plan, we could be required, or might elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all. We also might decide to raise additional capital at such times and upon such terms as management considers favorable and in the interests of the Company, including, but not limited to, from the sale of up to $150 million of our debt and/or equity securities (before reductions for expenses, underwriting discounts and commissions) under our shelf registration statement.

Contractual Obligations

Our principal commitments as of December 31, 2008 are summarized below (in thousands):

	Total	Less than 1 year	1 - 3 years	4 -5 years	After 5 years
Operating lease obligations	$ 2,537	$ 1,000	$ 1,537	$ -	$ -
Software license obligations	1,287	803	484	-	-
Wafer purchases	2,902	2,902	-	-	-
Other	109	109	-	-	-
Total	$ 6,835	$ 4,814	$ 2,021	$ -	$ -

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

Other obligations shown above represent $0.1 million of adverse purchase commitments for which the inventory is considered unsalable.

In addition, due to uncertainty with respect to timing of future cash flows associated with our unrecognized tax benefits at December 31, 2008, we are unable to make a reasonably reliable estimate of the period of cash settlement with the respective taxing authority. Therefore, $15.2 million of unrecognized tax benefits have been excluded from the contractual obligations table above. See Note 7. – Income Taxes or a discussion on Income Taxes.

Off-Balance Sheet Arrangements

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, or SPEs, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of December 31, 2008, we were not involved in any unconsolidated SPE transactions.

Indemnities, Commitments and Guarantees

In the normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include agreements to indemnify our customers with respect to liabilities associated with the infringement of other parties' technology based upon our products, obligation to indemnify our lessors under facility lease agreements, and obligation to indemnify our directors and officers to the maximum extent permitted under the laws of the state of Delaware. The duration of such indemnification obligations, commitments and guarantees varies and, in certain cases, is indefinite. We have not recorded any liability for any such indemnification obligations, commitments and guarantees in the accompanying balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is estimable and probable.

Under master purchase agreements signed with Cisco in November 2005, we have agreed to indemnify Cisco for costs incurred in rectifying epidemic failures, up to the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months (approximately, $13.2 million at December 31, 2008) or $9.0 million, plus replacement costs. If we are required to make payments under the indemnity, our operating results may be adversely affected.

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Significant Accounting Pronouncements

Fair Value Measurement

In September 2006, the Financial Accounting Standards Board, or FASB, issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods of those fiscal years. In February 2008, the FASB released a FASB Staff Position (FSP FAS 157-2— Effective Date of FASB Statement No. 157) which delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. In October 2008, the FASB released a FASB Staff Position (FSP FAS 157-3 —Determining the fair value of a financial asset when the market for that asset is not active) which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The adoption of SFAS 157 for financial assets and liabilities had no impact on the Company's consolidated financial position, results of operations or cash flows. See Note 13 to the Notes to Consolidated Financial Statements for more information on investments and fair value measurements.

Business Combinations

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations ("SFAS 141(R)"), which replaces FAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. The Company will apply the provisions of SFAS 141(R) if and when a future acquisition occurs.

Noncontrolling Interests in Consolidated Financial Statements

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains it controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently assessing SFAS No. 160 and has not yet determined the impact, if any, that the adoption of SFAS No. 160 will have on its financial position, results of operations and cashflows.

Useful Life of Intangible Assets

In April 2008, the FASB issued FASB Staff Position 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP 142-3”). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS Statement No. 142, “Goodwill and Other Intangible Assets” (“SFAS 142”). The objective of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R), “Business Combinations”, and other U.S. generally accepted accounting principles. FSP 142-3 will be effective beginning in fiscal year 2010. The Company is currently assessing FSP142-3 and has not yet determined the impact, if any, that the adoption of FSP 142-3 will have on its consolidated financial statements.

Defensive Intangible Assets

In November 2008, the FASB ratified EITF Issue No. 08-7, Accounting for Defensive Intangible Assets, (“EITF 08-7”). EITF 08-7 applies to defensive intangible assets, which are acquired intangible assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting, which should be amortized to expense over the period the asset diminished in value. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141(R) and SFAS 157. EITF 08-7 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company is currently assessing EITF 08-7 and has not yet determined the impact, if any, that the adoption of EITF 08-7 will have on its consolidated financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The primary objective of our investment activities is to preserve principal while maximizing the income we receive from our investments without significantly increasing the risk of loss. Some of the investment securities permitted under our cash management policy may be subject to market risk for changes in interest rates. To mitigate this risk, we maintain a portfolio of cash equivalent and short-term investments in a variety of securities which may include money market funds, government debt issued by the United States of America, state debt, certificates of deposit and investment grade corporate debt. Presently, we are exposed to minimal market risks associated with interest rate changes. We manage the sensitivity of our results of operations to these risks by maintaining investment grade short-term investments. Our cash management policy does not allow us to purchase or hold derivative or commodity instruments or other financial instruments for trading purposes. Additionally, our policy stipulates that we periodically monitor our investments for adverse material holdings related to the underlying financial solvency of the issuer. As of December 31, 2008, our investments consisted of money market funds. Our results of operations and financial condition would not be significantly impacted by either a 10% increase or decrease in interest rates due mainly to the short-term nature of our investment portfolio.

Our sales outside the United States are transacted in U.S. dollars; accordingly our sales are not generally impacted by foreign currency rate changes. Our operating expenses are denominated primarily in U.S. Dollars, except for expenses incurred by our wholly owned subsidiaries in India, Taiwan, and China, which are denominated in the local currency. To date, fluctuations in foreign currency exchange rates have not had a material impact on our results of operations.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

NETLOGIC MICROSYSTEMS, INC.

Index to Financial Statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
NetLogic Microsystems, Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of NetLogic Microsystems, Inc. and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 7 to the consolidated financial statements, the Company changed the manner in which it accounts for uncertainty in income taxes in fiscal 2007.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may

deteriorate.

/s/ PricewaterhouseCoopers LLP
San Jose, California
March 4, 2009

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NETLOGIC MICROSYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	December 31, 2008	2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 83,474	$ 50,689
Short-term investments	13,067	-
Accounts receivables, net	8,382	14,838
Inventories	13,707	12,938
Deferred income taxes	3,217	5,396
Prepaid expenses and other current assets	1,937	3,320
Total current assets	123,784	87,181
Property and equipment, net	5,513	5,745
Goodwill	68,712	55,422
Intangible asset, net	39,538	52,837
Other assets	8,224	1,966
Total assets	$ 245,771	$ 203,151
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 7,618	$ 7,094
Accrued liabilities	25,920	13,286
Deferred margin	1,638	317
Software licenses and other obligations, current	755	2,528
Total current liabilities	35,931	23,225
Software licenses and other obligations, long-term	464	-
Other liabilities	9,109	8,038
Total liabilities	45,504	31,263
Commitments and contingencies (Note 8)		
Stockholders' equity		
Preferred stock; 50,000 shares authorized at December 31, 2008 and 2007; none issued and outstanding at December 31, 2008 and 2007	-	-
Common stock; 200,000 shares authorized at December 31, 2008 and 2007; 21,908 and 21,314 shares issued and outstanding at December 31, 2008 and 2007	219	213
Additional paid-in capital	276,042	251,241
Accumulated other comprehensive loss	(13)	(8)
Accumulated deficit	(75,981)	(79,558)
Total stockholders' equity	200,267	171,888
Total liabilities and stockholders' equity	$ 245,771	$ 203,151

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

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NETLOGIC MICROSYSTEMS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT FOR PER SHARE AMOUNTS)

	Year ended December 31,		
	2008	2007	2006
Revenue	$ 139,927	$ 109,033	$ 96,806
Cost of revenue	61,616	44,732	36,762
Gross profit	78,311	64,301	60,044
Operating expenses:			
Research and development	51,607	45,175	36,578
In-process research and development	-	1,610	10,700
Selling, general and administrative	26,567	19,672	15,455
Total operating expenses	78,174	66,457	62,733
Income (loss) from operations	137	(2,156)	(2,689)
Interest income	1,595	4,431	3,737
Other income (expenses), net	(92)	32	3
Income before income taxes	1,640	2,307	1,051
Provision for (benefit from) income taxes	(1,937)	(288)	459
Net income	$ 3,577	$ 2,595	$ 592
Net income per share-basic	$ 0.17	$ 0.13	$ 0.03
Net income per share-diluted	$ 0.16	$ 0.12	$ 0.03
Shares used in calculation-basic	21,472	20,747	19,758
Shares used in calculation-diluted	22,314	21,938	21,107

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

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NETLOGIC MICROSYSTEMS, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(IN THOUSANDS)

	Common Stock							
	Shares	Amount	Additional Paid-In Capital	Notes Receivable from Stockholders	Deferred Stock-based Compensation	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholder's Equity
Balance at December 31, 2005	18,075	$ 180	$ 152,379	$ (44)	$ (1,114)	$ -	$ (82,745)	$ 68,656
Issuance of common stock in connection with the acquisition of Cypress NSE business	1,653	17	56,184					56,201
Issuance of stock under stock compensation plans	697	7	4,803					4,810
Issuance of stock for warrant exercise	14							-
Amortization of deferred stock-based compensation					778			778
Reversal of deferred stock-based compensation due to terminations			(16)		16			-
Reversal of deferred stock-based compensation upon adoption of FAS 123R			(138)		138			-
Recording of stock-based compensation expense under SFAS 123R			11,316					11,316
Repayment of notes receivable				44				44
Tax benefits of stock options			119					119
Currency translation adjustments						8		8
Net income							592	592
Total comprehensive income								600
	20,439	204	224,647	-	(182)	8	(82,153)	142,524

Balance at December 31, 2006								
Issuance of stock under stock compensation plans	875	9	8,339					8,348
Amortization of deferred stock-based compensation					179			179
Reversal of deferred stock-based compensation due to terminations			(3)		3			-
Recording of stock-based compensation expense under SFAS 123R			15,793					15,793
Tax benefits of stock options			2,465					2,465
Currency translation adjustments						(16)		(16)
Net income							2,595	2,595
Total comprehensive income								2,579
Balance at December 31, 2007	21,314	213	251,241	-	-	(8)	(79,558)	171,888
Issuance of stock under stock compensation plans	594	6	7,879					7,885
Recording of stock-based compensation expense under SFAS 123R			16,354					16,354
Tax benefits of stock options			568					568
Currency translation adjustments						(45)		(45)
Unrealized gain (loss) on short-term investments						40		40
Net income							3,577	3,577
Total comprehensive income								3,572
Balance at December 31, 2008	21,908	$ 219	$ 276,042	$ -	$ -	$ (13)	$ (75,981)	$ 200,267

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

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NETLOGIC MICROSYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	Year ended December 31,		
	2008	2007	2006
Cash flows from operating activities:			
Net income	$ 3,577	$ 2,595	$ 592
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	17,213	9,134	4,937
Accretion of discount relating to debt securities	(13)	(709)	(544)
Stock-based compensation	16,492	16,046	11,907
Provision for (recovery of) doubtful accounts	49	(25)	(16)
Provision for inventory reserves	2,441	1,022	2,471
Loss on disposal of property and equipment	106	38	-
In-process research and development	-	1,610	10,700
Deferred income taxes, net	(3,893)	(1,688)	-
Tax benefit from stock-based awards	(717)	(2,465)	(119)
Net impact of deferred tax asset valuation allowance relase and tax effect of intercompany license agreement	-	(504)	-
Changes in current assets and liabilities, net of effects of acquisitions:			
Accounts receivables	6,571	(4,471)	(1,748)
Inventories	(1,448)	1,479	(2,598)
Prepaid expenses and other assets	646	(1,312)	284
Accounts payable	524	971	(3,528)
Accrued liabilities	(2,084)	1,947	(73)
Deferred margin	1,321	263	54
Other long-term liabilities	1,071	976	(11)
Net cash provided by operating activities	41,856	24,907	22,308
Cash flows from investing activities:			
Purchase of property and equipment	(1,438)	(2,220)	(1,510)
Purchase of short-term investments	(13,014)	(13,935)	(39,127)
Sales and maturities of short-term investments	-	53,771	-
Cash received from (paid for) acquisitions, net of cash acquired	200	(70,245)	(754)
Net cash used in investing activities	(14,252)	(32,629)	(41,391)
Cash flows from financing activities:			
Payments of software license and other obligations	(3,376)	(3,139)	(920)
Proceeds from issuance of Common Stock	7,885	8,348	4,810
Tax benefit from stock-based awards	717	2,465	119
Proceeds from payment of notes receivables from stockholders	-	-	44
Net cash provided by financing activities	5,226	7,674	4,053
Effects of exchange rate on cash and cash equivalents	(45)	(15)	(6)
Net increase (decrease) in cash and cash eqivalents	32,785	(63)	(15,036)
Cash and cash equivalents at beginning of year	50,689	50,752	65,788
Cash and cash equivalents at end of year	$ 83,474	$ 50,689	$ 50,752

Supplemental disclosures of cash flow information:			
Cash paid for interest	$ 19	$ -	$ -
Cash paid for income taxes	$ 562	$ 4,665	$ -
Supplemental disclosures of non-cash investing and financing activities:			
Acquisition of property and equipment under capital leases and software licenses obligations	$ 2,350	$ 1,697	$ 3,233
Issuance of common stock in connection with the acquisition of Cypress' NSE business	$ -	$ -	$ 56,201
Accrual for Aeluros earn-out payment	$ 15,501	$ -	$ -

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

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NETLOGIC MICROSYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008

NOTE 1—THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The Company

We are a semiconductor company that designs, develops and markets high-performance processors and high-speed integrated circuits that are deployed by original equipment manufacturers (OEMs) in routers, switches, wireless infrastructure equipment, network security appliances, datacenter servers, network access equipment and network storage devices to accelerate the delivery of voice, video, data and multimedia content for advanced enterprise, datacenter, communications and mobile wireless networks. Our knowledge-based processors, physical layer products and network search engine products are incorporated in systems used throughout multiple types of networks that comprise the global Internet infrastructure, including the enterprise, metro, access, edge and core networking markets, and are designed into systems offered by leading networking OEMs.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Reclassifications

Certain fiscal 2007 amounts in the accompanying consolidated balance sheet have been reclassified to conform to the fiscal 2008 presentation. Short-term deferred tax assets and long-term deferred tax liabilities have been reclassified to non-current deferred tax assets. These reclassifications had no effect on previously reported consolidated statements of operations or stockholders' equity.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue recognition

We derive revenue mainly from product sales and, to a lesser extent, from engineering services. Except for shipments to one distributor and to an inventory consignment agent for our largest customer, we recognize revenue from product sales upon shipment when persuasive evidence of an arrangement exists, legal title and risk of ownership has transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured. Our sales agreements do not provide for any customer acceptance provisions. We generally do not undertake any substantive obligation to provide any modification or customization, upgrades, enhancements, post-contract customer support, additional products or enhancements. Historically, returns have been insignificant for other than warranty. Provisions for warranty expenses are recorded when revenue is recognized.

We have a purchase agreement with Wintec Industries ("Wintec") who is the primary purchaser of our products on a consignment basis for resale to Cisco and its contract manufacturers. We generally recognize revenue when Wintec ships our product to Cisco or its contract manufacturers.

From time-to-time we perform engineering services for third parties. Engineering service revenue is recognized as services are performed, agreed-upon milestones are achieved and customer acceptance, if required, is received from the customer. Engineering service revenues were not significant in 2008, 2007, or 2006.

Warranty

We provide a limited warranty on our products for a period ranging from one to five years from the date of sale. We provide for the estimated future costs of repair or replacement upon shipment of the product. Our warranty accrual is estimated based on historical claims compared to actual revenue and assumes that we have to replace products subject to a claim.

Cash, cash equivalents and short-term investments

We consider all highly liquid investments purchased with a remaining maturity of three months or less at the date of purchase to be cash equivalents. These investments consist of money-market funds, which are readily convertible to cash and are stated at cost, which approximates market value. We deposit cash and cash equivalents with high credit quality financial institutions.

Short-term investments as of December 31, 2008 comprised government agency debt securities with remaining contractual maturities on the date of purchase greater than 90 days but less than one year. Investments in debt securities are classified as available-for-sale and carried at fair value. The cost of securities sold is based on the specific identification method. Investments are monitored for impairment periodically and reductions in carrying value are recorded when the declines are determined to be other-than-temporary.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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Risks and uncertainties and concentration of credit risk

While we achieved profitability in recent years, we had a history of net losses prior to 2005. Our ability to remain profitable is dependent, among other factors, upon the rate of growth of our target markets, continued customer acceptance of our products, continued end-user acceptance of our customer's products, the strategic position of our products related to current or future competitors, our ability to develop new products that fulfill customer's specifications, our ability to lower cost of goods sold through yield improvements and our ability to manage expenses. If we are unable to achieve profitability, we could be required, or could elect, to seek additional funding through public or private equity or debt financing. Such funds may not be available on terms acceptable to us or at all.

We depend on a few key customers for a substantial majority of our sales and the loss of, or a significant reduction in orders from any of them would likely significantly reduce revenues. For the years ended December 31, 2008, 2007, and 2006, our top five customers accounted for approximately 68%, 79%, and 84% of total product revenue, respectively. Because of the substantial market share owned by our top five customers, our revenue in the foreseeable future will likely continue to depend on sales to a relatively small number of customers, as well as the ability of these customers to sell products that use our products. Our revenue would likely decline if one or more of these customers were to significantly reduce, delay or cancel their orders for any reason. In addition, any difficulty associated with collecting outstanding accounts receivable amounts due from our customers, particularly for our top five customers, would harm our financial performance. Because our sales are based upon standard purchase orders and not on long-term contracts, we cannot assure you that our customers will continue to purchase our products at current levels, or at all.

We purchase all of our semiconductor products from third party foundries. Because future foundry capacity may be limited and because we do not have long-term supply agreements with our foundries, we may not be able to secure adequate manufacturing capacity to satisfy the demand for our products. Although we presently utilize two foundries for wafers, we rely on one for current generation products. We provide the two foundries with monthly rolling forecasts of our production requirements. The ability of each foundry to provide wafers to us could become limited in the future, by the foundry's available capacity. Moreover, the price of our wafers may fluctuate based on changes in available industry capacity. Because we do not have long-term supply contracts with any of our foundries, they could choose to prioritize capacity for other customers, particularly larger customers, reduce or eliminate deliveries to us on short notice or increase the prices they charge us. Accordingly, we cannot be certain that our foundries will allocate sufficient capacity to satisfy our requirements. If we are not able to obtain foundry capacity as required, our relationships with present and future customers would be harmed and our revenue, gross margin and operating results would be materially impacted.

Financial instruments that potentially subject us to a concentration of credit risk as of December 31, 2008 consist of cash, cash equivalents, short term investments and accounts receivable. Deposits held with financial institutions may exceed the amount of insurance provided on such deposits. To date we have not experienced any losses on our deposits of cash, cash equivalents, and short-term investments. Our accounts receivable are derived from revenue earned from customers primarily located in North America and Asia. We perform ongoing credit evaluations of our customers' financial condition and, generally, do not require collateral. In general, such allowances are established for accounts aged over 90 days from the invoice date, unless specific circumstances indicate that the balance is collectible.

The following table summarizes revenue from customers comprising 10% or more of the Company's net revenue for the periods indicated:

	December 31,		
	2008	2007	2006
Wintec Industries Inc	35%	17%	*
Celestica Corporation	12%	*	*
Solectron Corporation	*	28%	56%
Sanmina Corporation	*	11%	*

* Less than 10% of net revenue

The following table summarizes customers comprising 10% or more of the Company's gross account receivable for the periods indicated:

	December 31,	
	2008	2007
Wintec Industries Inc	48%	42%
Celestica Corporation	15%	14%
Sanmina Corporation	12%	11%
Jabil Circuit Incorporated	11%	*

* Less than 10% of gross accounts receivable

Inventory Valuation and Adverse Purchase Commitments

We value our inventories at the lower of cost or market. We record inventory reserves for estimated obsolescence or unmarketable inventories based upon assumptions about future demand and market conditions. These estimates are generally based on a 12-month forecast prepared by management. Once a reserve is established, it is maintained until the product to which it relates is sold or otherwise disposed of. If actual market conditions are less favorable than those expected by management, additional adjustment to inventory valuation may be required. The carrying value of inventory and the determination of possible adverse purchase commitments are dependent on our estimate of the yield that will be achieved, or the percent of good products identified when the product is tested.

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Property and equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leased assets and leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the term of the lease.

The depreciation and amortization periods for property and equipment categories are as follows:

Machinery and equipment	3 years
Software	3 years
Furniture and fixtures	5 years

Long-lived assets

We review the recoverability of our long-lived assets, such as property and equipment, and intangible assets, whenever events or changes in circumstances occur that indicate that the carrying value of the asset or asset group may not be recoverable. The assessment of possible impairment is based on our ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows, undiscounted and without interest charges, of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-lived assets.

Goodwill

We evaluate goodwill for impairment at least on an annual basis or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flow. Applying the provision of SFAS No. 142, Goodwill and Other Intangible Assets, we perform goodwill impairment test for each reporting unit. If the fair value of the reporting unit exceeds the carrying value of the reporting unit, goodwill is not impaired. We perform the goodwill impairment assessment at the Company level, which is the sole reporting unit. We performed our annual goodwill impairment test in the fourth quarter of fiscal 2008 and there was no impairment of goodwill during the year ended December 31, 2008. Significant management judgment is required in the forecasts of future operating results that are used in the evaluation of carrying value of goodwill. 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.

Fair value of financial instruments

Carrying amounts of certain of our financial instruments including cash and cash equivalents, short-term investments, accounts receivable, accounts payable and software license and other obligations approximate fair value due to their short maturities and interest rates currently available to us.

Foreign currency

The functional currencies of our significant foreign subsidiaries are the local currencies. Accordingly, all assets and liabilities of these foreign subsidiaries are translated to U.S. dollars at current period end exchange rates, and revenues and expenses are translated to U.S. dollars using average exchange rates in effect during the period. The gains and losses from foreign currency translation of these subsidiaries' financial statements are recorded directly into a separate component of stockholders' equity under the caption "Accumulated other comprehensive income." Assets and liabilities that are not denominated in the functional currency are remeasured into U.S. dollars and the resulting gains or losses are included in other income (expense), net. Such gains or losses have not been material for any period presented.

Segment Reporting

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the reporting of information about operating segments, including related disclosures about products and services, geographic areas and major customers. The standard for determining what information to report is based on available financial information that is regularly reviewed and used by NetLogic's chief operating decision maker in evaluating the Company's financial performance and resource allocation. NetLogic's chief operating decision-maker is considered to be the chief executive officer, or CEO. Based on the criteria stated in SFAS No. 131 for determining separately reportable operating segments and the financial information available to and reviewed by the CEO, the Company has determined that it operates as a single operating and reportable segment.

Income taxes

We account for income taxes under an asset and liability approach that requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of timing differences between the carrying amounts and the tax bases of assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to amounts expected to be realized.

In the first quarter of 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes—an interpretation of SFAS No. 109" (FIN 48), and related guidance. As a result of the implementation of FIN 48, we recognize liabilities for uncertain tax positions based on the two-step process prescribed in the interpretation. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as we have to determine the probability of various possible outcomes. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision.

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Computation of net income per share

We have computed net income per share under two methods, basic and diluted. Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income per share is computed by dividing net income by the sum of the weighted average number of common shares outstanding and potential common shares (when dilutive).

The following table sets forth the computation of basic and diluted net income attributable to common stockholders per share (in thousands):

	Year ended December 31,		
	2008	2007	2006
Numerator:			
Net income: basic and diluted	$ 3,577	$ 2,595	$ 592
Denominator:			
Add: common shares outstanding	21,506	20,781	19,805
Less: unvested common shares subject to repurchase	(34)	(34)	(47)
Total shares: basic	21,472	20,747	19,758
Add: stock options and warrants outstanding	808	1,157	1,302
Add: shares subject to repurchase	34	34	47
Total shares: diluted	22,314	21,938	21,107
Basic earnings per share	$ 0.17	$ 0.13	$ 0.03
Diluted earnings per share	$ 0.16	$ 0.12	$ 0.03

The following numbers of shares underlying outstanding common stock options were excluded from the computation of diluted net income per share as they had an anti-dilutive effect (in thousands):

	Year ended December 31,		
	2008	2007	2006
Stock options	2,239	1,665	795

Advertising costs

Advertising costs are expensed as incurred. Advertising costs were not significant in the year ended December 31, 2008, 2007 or 2006.

Research and development

Research and development costs are expensed as incurred.

Stock-based compensation

We estimate the fair value of stock options using the Black-Scholes Model, consistent with the provisions of SFAS 123(R), SAB 107 and our prior period pro forma disclosures of net income, including stock-based compensation determined under a fair value method as prescribed by SFAS 123. The Black-Scholes Model requires the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. The expected stock price volatility assumption was determined using both the historical and implied volatility of our common stock. Changes in the subjective assumptions required in the valuation models may significantly affect the estimated value of the awards, the related stock-based compensation expense and, consequently, our results of operations.

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards, including employee stock options and employee stock purchases, based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). We have applied the provisions of SAB 107 in the adoption of SFAS 123(R) and continued to do so, as allowed by SAB 110. We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our 2006 fiscal year. Our Consolidated Financial Statements as of and for the year ended December 31, 2006 reflect the adoption of SFAS 123(R).

Stock-based compensation expense recognized under SFAS 123(R) for the years ended December 31, 2008, 2007 and 2006 was $16.5 million, $16.0 million and $11.9 million, respectively and related to employee stock options and employee stock purchase rights. Under the modified prospective transition method, our Consolidated Financial Statements for prior periods need not be restated to reflect or include the effect of SFAS 123(R). Accordingly, there was no stock-based compensation expense related to employee stock options and employee stock purchase rights recognized in prior periods presented, other than stock-based compensation expense recognized and disclosed previously.

SFAS 123(R) requires companies to estimate the fair value of option and ESPP awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), we accounted for stock-based awards using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no stock-based compensation expense for options had been recognized in our Consolidated Statement of Operations if the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in our Consolidated Statement of Operations for the years ended December 31, 2008, 2007 and 2006 included (i) compensation expense for share-based payment awards granted prior to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and (ii) compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). We attribute the value of stock-based compensation to expense on a straight-line single option method for the awards granted subsequent to December 31, 2005, while the accelerated method is used for awards granted on or prior to December 31, 2005. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the years ended December 31, 2008, 2007 and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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Recent accounting pronouncements

Fair Value Measurement

In September 2006, the Financial Accounting Standards Board, or FASB, issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods of those fiscal years. In February 2008, the FASB released a FASB Staff Position (FSP FAS 157-2— Effective Date of FASB Statement No. 157) which delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. In October 2008, the FASB released a FASB Staff Position (FSP FAS 157-3 —Determining the fair value of a financial asset when the market for that asset is not active) which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The adoption of SFAS 157 for financial assets and liabilities had no impact on the Company's consolidated financial position, results of operations or cash flows. See Note 13 to the Notes to Consolidated Financial Statements for more information on investments and fair value measurements.

Business Combinations

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations ("SFAS 141(R)"), which replaces FAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. We will apply the provisions of SFAS 141(R) if and when a future acquisition occurs.

Noncontrolling Interests in Consolidated Financial Statements

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains it controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding

the interests of the parent and its noncontrolling interest. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently assessing SFAS No. 160 and has not yet determined the impact, if any, that the adoption of SFAS No. 160 will have on its financial position, results of operations and cashflows.

Useful Life of Intangible Assets

In April 2008, the FASB issued FASB Staff Position 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP 142-3”). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS Statement No. 142, “Goodwill and Other Intangible Assets” (“SFAS 142”). The objective of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R), “Business Combinations”, and other U.S. generally accepted accounting principles. FSP 142-3 will be effective beginning in fiscal year 2010. The Company is currently assessing FSP142-3 and has not yet determined the impact, if any, that the adoption of FSP 142-3 will have on its consolidated financial statements.

Defensive Intangible Assets

In November 2008, the FASB ratified EITF Issue No. 08-7, Accounting for Defensive Intangible Assets, (“EITF 08-7”). EITF 08-7 applies to defensive intangible assets, which are acquired intangible assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting, which should be amortized to expense over the period the asset diminished in value. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141(R) and SFAS 157. EITF 08-7 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company is currently assessing EITF 08-7 and has not yet determined the impact, if any, that the adoption of EITF 08-7 will have on its consolidated financial statements.

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NOTE 2—Business Combinations and Asset Purchase

Business Combinations:

Aeluros, Inc.

In October 2007, we acquired all outstanding equity securities of Aeluros, Inc. ("Aeluros") a privately-held, fabless provider of industry-leading 10-Gigabit Ethernet physical layer products ("PLPs"). The PLP family extended our product offerings to the physical layer, or Layer 1, of the Open Systems Interconnection ("OSI") reference model, which is a layered abstract description for communications and computer network protocol design developed as part of the Open Systems Interconnection initiative. The physical layer provides the physical and electrical means for transmitting data between different nodes on a network. We paid $57.1 million in cash. During the fourth quarter of fiscal 2008, we became obligated to pay an additional $15.5 million in cash to the former Aeluros stockholders due to our attainment of post-acquisition revenue milestones, subject to certain adjustments as provided in the Aeluros acquisition agreement. The additional consideration is included in goodwill and accrued liabilities at December 31, 2008. The results of operations relating to Aeluros have been included in our results of operations since the acquisition date.

The purchase price of Aeluros, including the additional $15.5 million earn-out based on the attainment of post-acquisition revenue milestones, was determined as follows (in thousands):

Cash	$ 56,402
Aeluros post-acquisition revenue milestone	15,501
Direct transaction costs	697
Total purchase price	$ 72,600

During the year ended December 31, 2008, we recorded additional purchase price allocation adjustments. As a result of the recorded purchase price allocation adjustments, goodwill increased by $13.3 million, net tangible assets increased by $2.5 million, deferred tax assets increased by $0.2 million and deferred tax liabilities increased by $0.5 million. Under the purchase method of accounting, the total purchase price (including the additional purchase price allocation adjustments recorded during the year ended December 31, 2008) was allocated to net tangible and intangible assets acquired based on their estimated fair values as follows (in thousands):

Net tangible assets	$ 5,181
Identifiable intangible assets:	
Developed technology	27,680
Patents and core technology	5,590
Customer relationships	6,900
Backlog	970
In-process research and development	1,610
Goodwill	31,645
Deferred tax asset	10,076
Deferred tax liabilities	(17,052)

Total purchase price allocation	$ 72,600

Developed technology consisted of products which have reached technological feasibility and shipped in volume to customers. The value of the developed technology was determined by discounting estimated net future cash flows of the products. We are amortizing the existing technology for the chip technology on a straight-line basis over estimated lives of four to five years.

Patents and core technology represent a combination of processes, patents and trade secrets developed though years of experience in design and development of the products. The value of the patents and core technology was determined by estimating a benefit from owning the intangible asset rather than paying a royalty to a third party for the use of the asset. We are amortizing the core technology on a straight-line basis over an estimated life of five years.

Customer relationships relate to our ability to sell existing, in process and future versions of its products to the existing customers of Aeluros. The value of the customer relationships was determined by discounting estimated net future cash flows from the customer contracts. We are amortizing customer relationships on a straight-line basis over an estimated life of five years.

The backlog intangible asset represents the value of the sales and marketing costs required to establish the order backlog and was valued using the cost savings approach. We estimated these orders to be delivered and billed within three months, over which the asset was amortized. As of December 31, 2007, the orders had been delivered and billed and the backlog intangible asset had been fully amortized.

Of the total estimated purchase price, approximately $1.6 million has been allocated to in-process research and development (“IPRD”) based upon management’s estimate of the fair values of assets acquired and was charged to expense in the three months ended December 31, 2007. Projects that qualify as IPRD represent those that have not reached technological feasibility and which have no alternative use and therefore were written-off immediately.

The value assigned to IPRD was determined by considering the importance of products under development to the overall development plan, estimating costs to develop the purchased IPRD into commercially viable products, estimating the resulting net cash flows from the projects when completed and discounting the net cash flows to their present value. The fair values of IPRD were determined using the income approach, which discounts expected future cash flows to present value. The discount rate of 24% used in the present value calculations was derived from a weighted-average cost of capital analysis, adjusted to reflect additional risks related to the product’s development and success as well as the product’s stage of completion. At the time of the acquisition, we estimated that the aggregate costs to complete the projects would be $0.3 million. The projects were completed during the year ended December 31, 2008.

Of the total estimated purchase price paid, including the $15.5 million due to the attainment of post-acquisition revenue milestones, approximately $31.6 million has been allocated to goodwill. Goodwill represents the excess of the purchase price of an acquired business over the fair value of the underlying net tangible and intangible assets, and is not deductible for tax purposes. Among the factors that contributed to a purchase price in excess of the fair value of the net tangible and intangible assets was the acquisition of an assembled workforce of experienced semiconductor engineers. We expect these experienced engineers to provide the capability of developing and integrating advanced interface technology into its next generation products.

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Cypress Semiconductor Corp. Network Search Engine (NSE) Business

On February 15, 2006, we completed the acquisition of net assets of the NSE business of Cypress ("the Business") including the Ayama ™ 10000, Ayama 20000, and NSE70000 Network Search Engine families, as well as the Sahasra ™ 50000 Algorithmic Search Engine family. The Sahasra algorithmic technology complemented our Layer 7 processing initiative and has been a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions. In addition, the NSE70000, Ayama 10000 and Ayama 20000 expanded our product offerings in the high-volume, entry-level Layer 3 switch market. These factors contributed to a purchase price in excess of the fair value of net tangible assets acquired from Cypress and as a result, we recorded goodwill in connection with this transaction. The results of operations relating to the Business have been included in our results of operations from the acquisition date.

In the acquisition, we paid $1,000 in cash and issued 1,488,063 shares of common stock valued at $49.7 million on February 15, 2006. On April 11, 2006, we issued an additional 165,344 shares of our common stock to Cypress. The value of the additional shares of $6.5 million was considered additional purchase price and recorded as an increase to goodwill during the year ended December 31, 2006. We also agreed to pay Cypress up to an additional $10.0 million in cash and up to an additional $10.0 million in shares of our common stock if certain revenue milestones associated with the Business were achieved in the twelve-month period after the close of the transaction, but such milestones were not achieved.

The acquisition was accounted for as a purchase business combination. The purchase price of the Business, including the additional 165,344 shares issued on April 11, 2006, was approximately $57.0 million, which has been determined as follows (in thousands):

Cash	$	1
Value of NetLogic common stock issued		56,201
Direct transaction costs		753
Total purchase price	$	56,955

The value of the 1,488,063 shares of common stock issued on February 15, 2006 was determined based on the average price of the common stock over a five-day period including the two days before and after January 25, 2006 (the date the definitive agreement was signed and announced), or $33.43 per share. The value of the additional 165,344 shares of the common stock issued on April 11, 2006 was determined based on the closing price of the common stock on that date, or $39.03 per share.

Under the purchase method of accounting, the total purchase price was allocated to the Business' net tangible and intangible assets based on their fair values as of the date of the completion of the acquisition. Based on management estimates of the fair values, the estimated purchase price was allocated as follows (in thousands):

Tangible assets	$	1,850
Amortizable intangible assets:		
Developed technology		6,500

Backlog	836
In-process research and development	10,700
Goodwill	37,069
Total purchase price allocation	$ 56,955

Developed technology comprised products that had reached technological feasibility and include the Ayama10000, Ayama 20000, and NSE70000 product families. The value assigned to developed technology was based upon future discounted cash flows related to the existing products' projected income streams using a discount rate of 20% which was considered appropriate given the business risks inherent in marketing and selling these products. Factors considered in estimating the discounted cash flows to be derived from the existing technology include risks related to the characteristics and applications of the technology, existing and future markets and an assessment of the age of the technology within its life span. We are amortizing the existing technology intangible asset on a straight-line basis over an estimated life of five years.

The backlog intangible asset represented the value of the sales and marketing costs required to establish the order backlog and was valued using the cost savings approach. We estimated those orders to be delivered and billed within six months from the acquisition date, which was the period over which we amortized that asset.

Of the total estimated purchase price, we allocated $10.7 million to IPRD based upon management's estimate of the fair values of assets acquired, all of which was charged to expense during the year ended December 31, 2006. We acquired only one IPRD project, which was related to the Sahasra algorithmic technology that had not reached technological feasibility and has no alternative use. The Sahasra algorithmic technology complements our Layer 7 processing initiative and was a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions.

The fair value assigned to IPRD was determined using the income approach, under which we considered the importance of products under development to its overall development plans, estimated the costs to develop the purchased IPRD into commercially viable products, estimated the resulting net cash flows from the products when completed and discounted the net cash flows to their present values. We used a discount rate of 23% in the present value calculations, which was derived from a weighted-average cost of capital analysis, adjusted to reflect additional risks related to the products' development and success, as well as the products' stage of completion.

Of the total estimated purchase price, approximately $37.1 million has been allocated to goodwill. Goodwill represents the excess of the purchase price of an acquired business over the fair value of the underlying net tangible and intangible assets, and is deductible for tax purposes. In accordance with the Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," goodwill is not amortized but instead is tested for impairment at least annually, and more frequently if certain indicators are present. In the event we determine that the value of goodwill has become impaired, it will incur an accounting charge for the amount of impairment during the fiscal quarter in which such determination is made.

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TCAM2 Assets Purchase

In August 2007, we purchased the TCAM2 and TCAM2-CR network search engine products (collectively, the "TCAM2 Products") and certain related assets from Cypress for a total cash purchase price of approximately $14.6 million, which was determined as follows (in thousands):

Cash	$	14,448
Direct transaction costs		188
Total purchase price	$	14,636

The acquisition was accounted for as an asset purchase transaction and the total purchase price was allocated to the TCAM2 Products' net tangible and intangible assets based on their fair values as of the date of the completion of the acquisition. Based on management's estimates of the fair values, the estimated purchase price was allocated as follows (in thousands):

Inventory	$	3,090
Backlog		300
Composite intangible asset		11,246
Total	$	14,636

The composite intangible asset consisted of the existing technology related to the TCAM2 Products and a customer relationship with Cisco, who is the sole customer for the TCAM2 Products. On the acquisition date, there was no active research and development in process on the TCAM2 Products and therefore, no IPRD was identified. The value assigned to the composite intangible asset was based upon future discounted cash flows related to the TCAM2 Products' projected income streams. Factors considered in estimating the discounted cash flows to be derived from the existing technology included risks related to the characteristics and applications of the technology, existing and future markets and an assessment of the age of the technology within its life span. We are amortizing the composite intangible asset on a straight-line basis over an estimated life of four years.

The backlog intangible asset represented the value of the sales and marketing costs required to establish the order backlog and was valued using the discounted cash flow method. We estimated those orders would be delivered and billed within four months from the acquisition date, which is the period over which the asset was amortized. As of December 31, 2007, the orders had been delivered and billed and the backlog intangible asset had been fully amortized.

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NOTE 3—Goodwill and Other Intangible Assets

The following table summarizes the components of goodwill, other intangible assets and related accumulated amortization balances, which were recorded as a result of prior business combinations (in thousands):

	December 31, 2008			December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 68,712	$ -	$ 68,712	$ 55,422	$ -	$ 55,422
Other intangible assets:						
Developed technology	$ 34,180	$ (11,668)	$ 22,512	$ 34,180	$ (3,679)	$ 30,501
Composite intangible asset	11,246	(3,749)	7,497	11,246	(937)	10,309
Patents and core technology	5,590	(1,325)	4,265	5,590	(207)	5,383
Customer relationships	6,900	(1,636)	5,264	6,900	(256)	6,644
Backlog	2,106	(2,106)	-	2,106	(2,106)	-
Total	$ 60,022	$ (20,484)	$ 39,538	$ 60,022	$ (7,185)	$ 52,837

The goodwill balance increased from December 31, 2007, due to additional purchase price allocation adjustments related to the Aeluros Acquisition, arising primarily from the payable of $15.5 million to the former Aeluros stockholders upon our attainment of post acquisition revenue milestones, subject to certain adjustment as provided in the Aeluros acquisition agreement. For the year ended December 31, 2008 and 2007, goodwill represented approximately 28% and 27%, respectively, of our total assets.

For the years ended December 31, 2008, 2007 and 2006, amortization expense related to intangible assets was $13.3 million, $5.2 million, and $2.0 million, respectively. The amortization expense related to intangible assets is included in cost of sales because it related to products sold during such periods, except for the amortization of customer relationships of $1.4 million, $0.3 million, and zero for the years ended December 31, 2008, 2007, and 2006, respectively, which was included in selling, general and administrative expenses.

As of December 31, 2008, the estimated future amortization expense of intangible assets in the table above is as follows (in thousands):

Fiscal Year Ending	Estimated Amortization
2009	$ 13,299
2010	13,299
2011	10,154
2012	2,786
Total	$ 39,538

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NOTE 4—BALANCE SHEET COMPONENTS:

	December 31, 2008	2007
	(in thousands)	
Accounts receivables:		
Trade accounts receivables	$ 8,450	$ 14,857
Less: Allowance for doubtful accounts and customer returns	(68)	(19)
	$ 8,382	$ 14,838
Inventories:		
Finished goods	$ 8,170	$ 3,363
Work-in-progress	5,537	9,575
	$ 13,707	$ 12,938
Property and equipment, net:		
Machinery and equipment	$ 6,097	$ 6,428
Software	11,249	14,918
Furniture and fixtures	270	341
Leasehold improvements	199	180
	17,815	21,867
Less: Accumulated depreciation and amortization	(12,302)	(16,122)
	$ 5,513	$ 5,745

Property and equipment includes $1.7 million of machinery and equipment under capital lease arrangements that were fully depreciated at December 31, 2008 and 2007.

Depreciation and amortization expense related to property and equipment for the years ended December 31, 2008, 2007, and 2006 was $3.9 million, $3.8 million, and $3.0 million, respectively.

	December 31, 2008	2007
	(in thousands)	
Accrued Liabilities:		
Acrrued payroll and related expenses	$ 4,784	$ 4,295
Accrued accounts payable	131	2,038
Accrued inventory purchases	729	1,774
Accrued warranty	1,445	1,512
Accrual for Aeluros earn-out based on post-acquisition revenue milestone	15,501	-
Other accrued expenses	3,330	3,667
	$ 25,920	$ 13,286

The following table summarizes the activity related to the product warranty liability during the years