CAVIUM NETWORKS, INC.
Form 10-Q
November 12, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from __________ to __________

Commission file number: 001-33435
CAVIUM NETWORKS, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	77-0558625
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
805 E. Middlefield Road Mountain View, California	94043
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (650) 623-7000

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

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

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

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

The number of shares of the Registrant s Common Stock, $.001 par value, outstanding at November 7, 2008 was: 40,831,252

CAVIUM NETWORKS, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2008
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PART I. FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

CAVIUM NETWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

	September 30, 2008	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 91,918	$ 98,462
Accounts receivable, net of allowance of $200 and $177, respectively	13,483	9,768
Inventories	15,301	9,573
Prepaid expenses and other current assets	1,276	946
Total current assets	121,978	118,749
Property and equipment, net	10,836	11,608
Intangible assets, net	8,212	4,096
Goodwill	4,186	
Other assets	385	157
Total assets	$ 145,597	$ 134,610
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 7,116	$ 5,311
Accrued expenses and other current liabilities	3,447	2,253
Deferred revenue	1,685	1,666
Capital lease and technology license obligations, current portion	2,666	4,471
Total current liabilities	14,914	13,701
Capital lease and technology license obligations, net of current portion	2,255	4,059
Other non-current liabilities	616	
Total liabilities	17,785	17,760
Commitments and contingencies (Note 13)		
Stockholders equity		
Preferred stock, par value $0.001: 10,000,000 shares authorized, no shares issued and outstanding as of September 30, 2008 and December 31, 2007		
Common stock, par value $0.001:		
	41	40

200,000,000 shares authorized; 40,810,284 and 40,307,361 shares issued and outstanding as of September 30, 2008 and December 31, 2007, respectively				
Additional paid-in capital		180,637		175,540
Accumulated deficit		(52,866)		(58,730)
Total stockholders equity		127,812		116,850
Total liabilities and stockholders equity	$	145,597	$	134,610

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

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CAVIUM NETWORKS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net revenue	$ 24,525	$ 14,165	$ 64,429	$ 37,972
Cost of revenue	10,099	5,207	24,494	14,087
Gross profit	14,426	8,958	39,935	23,885
Operating expenses:				
Research and development	6,593	4,796	18,874	13,843
Sales, general and administrative	5,944	3,976	15,953	10,667
Total operating expenses	12,537	8,772	34,827	24,510
Income (loss) from operations	1,889	186	5,108	(625)
Other income, net:				
Interest expense	(115)	(73)	(403)	(572)
Warrant revaluation expense				(574)
Interest income and other	499	1,307	2,100	2,193
Total other income, net	384	1,234	1,697	1,047
Income before income tax expense	2,273	1,420	6,805	422
Income tax expense	454	110	941	201
Net income	$ 1,819	$ 1,310	$ 5,864	$ 221
Net income, per common share, basic	$ 0.04	$ 0.03	$ 0.15	$ 0.01
Shares used in computing basic net income per common share	40,578	39,046	40,283	25,498
Net income, per common share, diluted	$ 0.04	$ 0.03	$ 0.14	$ 0.01
Shares used in computing diluted net income per common share	42,628	42,737	42,617	28,786

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

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CAVIUM NETWORKS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended September 30, 2008	2007
Cash flows from operating activities		
Net income	$ 5,864	$ 221
Adjustments to reconcile net income to net cash provided by operating activities		
Stock-based compensation expense	4,115	1,302
Amortization of warrant costs to interest expense		149
Revaluation of warrants to fair value		574
Depreciation and amortization	7,873	4,285
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	(3,338)	(513)
Inventories	(4,923)	(1,790)
Prepaid expenses and other current assets	(325)	(170)
Other assets	(227)	(176)
Accounts payable	2,723	935
Accrued expenses and other current and non-current liabilities	689	(520)
Deferred revenue	19	1,957
Net cash provided by operating activities	12,470	6,254
Cash flows used in investing activities		
Purchases of property and equipment	(6,398)	(2,713)
Purchases of IP licenses and intangible assets		(369)
Purchase of Parallogic and Star	(9,811)	
Net cash (used in) investing activities	(16,209)	(3,082)
Cash flows (used in) provided by financing activities		
Repayment for term loan financing		(4,000)
Proceeds from initial public offering, net of costs		97,458
Payments of initial public offering costs		(2,740)
Proceeds from issuance of common stock upon exercise of options	808	177
Principal payment of capital lease and technology license obligations	(3,609)	(2,707)
Repurchases of shares of unvested common stock	(4)	(10)
Net cash (used in) provided by financing activities	(2,805)	88,178
Net (decrease) increase in cash and cash equivalents	(6,544)	91,350
Cash and cash equivalents, beginning of period	98,462	10,154

Cash and cash equivalents, end of period	$ 91,918	$ 101,504
Supplemental disclosure of cash flow information		
Cash paid for interest	$ 403	$ 422
Supplemental disclosure of non-cash activities		
Capital lease and technology license obligations	$	$ 3,342
Vesting of early exercised options	$ 58	$ 88
Additions to property and equipment included in accounts payable and accrued expenses	$	$ 389
Accrual for Parallogic and Star acquisition	$ 1,095	$
Net exercise of common stock warrant	$	$ 249
Conversion of mandatorily redeemable convertible preferred stock to common stock	$	$ 72,437

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

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CAVIUM NETWORKS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Organization and Significant Accounting Policies

Organization

Cavium Networks, Inc., or the Company, was incorporated in the State of California on November 21, 2000 and was reincorporated in the State of Delaware on February 6, 2007. The Company designs, develops and markets semiconductor processors for intelligent and secure networks.

Initial Public Offering

In May 2007, the Company completed its initial public offering, or IPO, of common stock in which it sold and issued 7,762,500 shares of common stock, including 1,012,500 shares of underwriters over-allotment, at an issue price of $13.50 per share. A total of $104.8 million in gross proceeds was raised from the IPO, or approximately $94.7 million in net proceeds after deducting underwriting discounts and commissions of $7.3 million and other offering costs of $2.8 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into 22,364,378 shares of common stock, and 102,619 warrants to purchase mandatorily redeemable convertible preferred stock were converted into warrants to purchase common stock.

Summary of Significant Accounting Policies

Basis of Presentation

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

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. For further information, these financial statements should be read in conjunction with the Company s Annual Report on Form 10-K (File No. 001-33435) on file with the SEC for the year ended December 31, 2007.

The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly the Company s condensed consolidated financial position at September 30, 2008, and the condensed consolidated results of its operations for the three months and nine months ended September 30, 2008 and 2007, and the condensed consolidated cash flows for the nine months ended September 30, 2008 and 2007. The results of operations for the three months and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at December 31, 2007 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP.

Use of Estimates

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

Cash & Cash Equivalents

The Company considers all highly liquid investments with an original or remaining maturity of 90 days or less at the date of purchase to be cash equivalents. Cash equivalents consist primarily of an investment in a money market fund. Historically, we have not experienced any losses due to such concentration of credit risk.

Allowance for Doubtful Accounts

The Company reviews its allowance for doubtful accounts quarterly by assessing individual accounts receivable over a specific age and amount. The Company s allowance for doubtful accounts was $35,000 and $38,000 as of September 30, 2008 and December 31, 2007, respectively.

Inventories

Inventories consist of work-in-process and finished goods. Inventories are stated at the lower of cost (determined using the first-in, first-out method), or market value (estimated net realizable value). The Company writes down inventory by establishing inventory reserves based on aging and forecasted demand. These factors are impacted by market and economic conditions, technology changes new product introductions and changes in strategic direction and require estimates that may include uncertain elements. Actual demand may differ from forecasted demand and such differences may have a material effect on recorded inventory values. Inventory reserves, once established, are not released until the related inventories have been sold or scrapped.

Property and Equipment

Property and equipment are stated at cost and depreciated over their estimated useful lives using the straight-line method. Leasehold improvements are amortized over the shorter of estimated useful lives or unexpired lease term. Additions and improvements that increase the value or extend the life of an asset are capitalized. Upon retirement or sale, the cost of assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to income. Repairs and maintenance costs are expensed as incurred.

	Estimated Useful Lives
Software, computer and other equipment	1 to 5 years
Mask costs and test equipment	1 to 3 years
Furniture, office equipment and leasehold improvements	1 to 5 years

The Company capitalizes the cost of fabrication masks that are reasonably expected to be used during production manufacturing. Such amounts are included within property and equipment and depreciated to cost of revenue generally over a period of twelve months. If the Company does not reasonably expect to use the fabrication mask during production manufacturing, the related mask costs are expensed to research and development in the period in which the costs are incurred. The Company has capitalized mask costs of $1.0 million and $0.1 million for the three months ended September 30, 2008 and 2007, respectively, and $3.3 million and $1.8 million for the nine months ended September 30, 2008 and 2007, respectively.

Impairment of Long-Lived Assets

The Company reviews long-lived assets, including property and equipment, for impairment whenever events or changes in business circumstances indicate that the carrying value of the assets may not be fully recoverable. According to the Company s accounting policy, when such indicators are present, and the undiscounted cash flows expected to be generated from operations from those long-lived assets are less than the carrying value of those long-lived assets, the Company compares the fair value of the assets (estimated using discounted future net cash flows to be generated from the lowest common level of operations utilizing the assets) to the carrying value of the long-lived assets to determine any impairment charges. The Company reduces the carrying value of the long-lived assets if the carrying value of the long-lived assets is greater than their fair value.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company s financial instruments, including cash and cash equivalents, accounts receivable, other assets, accounts payable, accrued expenses and liabilities, approximate their fair values due to their short-term nature.

Concentration of Risk

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

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and accounts receivable. The Company deposits cash and cash equivalents with credit worthy financial institutions. The Company has not experienced any losses on its deposits of cash and cash equivalents. Management believes that the cash and cash equivalents are in quality money market funds, and, accordingly, minimal credit risk exists.

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A majority of the Company s accounts receivable are derived from revenue earned from customers primarily headquartered in the United States. The Company performs ongoing credit evaluations of its customers financial condition and, generally, requires no collateral from its customers. The Company provides an allowance for doubtful accounts receivable based upon the expected collectibility of accounts receivable. Summarized below are individual customers whose accounts receivable balances or revenues were 10% or higher of respective total consolidated amounts.

	Three months ended September 30,		**Nine months ended September 30,**	
	2008	**2007**	**2008**	**2007**
Percentage of total net revenue				
Customer A	24%	24%	29%	24%
Customer B	12%	18%	10%	19%
Customer C	13%	*	11%	*

* Represents less than 10% of the consolidated net revenue for the respective period end.

	As of September 30, 2008	**As of December 31, 2007**
Percentage of gross accounts receivable		
Customer D	18%	23%
Customer E	*	13%
Customer F	12%	*

* Represents less than 10% of the consolidated accounts receivable for the respective period end.

Intangible Assets

Prepaid technology licenses and acquired technologies, which includes technologies acquired from other companies either as a result of acquisitions or licensing, are capitalized and amortized on the straight-line method over the estimated useful life of the technologies, which generally does not exceed five years. Technology license obligations payable in installments are capitalized using the present value of the payments.

Revenue Recognition

The Company derives its revenue primarily from sales of semiconductor products. The Company applies the provisions of Staff Accounting Bulletin No. 104 *Revenue Recognition,* (SAB 104) for product revenue derived by the sale of semiconductor products. Under SAB 104, the Company recognizes revenue when all of the following criteria have been met: (i) persuasive evidence of a binding arrangement exists, (ii) delivery has occurred, (iii) the price is deemed fixed or determinable and free of contingencies and significant uncertainties, and (iv) collection is probable. The price is considered fixed or determinable at the execution of an agreement, based on specific products and quantities to be delivered at specified prices, which is often memorialized with a customer purchase order. Agreements with non-distributor customers do not include rights of return or acceptance provisions. The Company assesses the ability to collect from the Company s customers based on a number of factors, including credit worthiness and any past transaction history of the customer. If the customer is not deemed credit worthy, or the price is not considered fixed or determinable, the Company defers all revenue from the arrangement until payment is received and all other revenue recognition criteria are met.

Shipping charges billed to customers are included in product revenue and the related shipping costs are included in cost of revenue. The Company generally recognizes revenue at the time of shipment to the Company s customers. Revenue consists primarily of sales of the Company s products to networking original equipment manufacturers, or OEMs, their contract manufacturers or its distributors.

Initial sales of the Company s products for a new design are usually made directly to networking OEMs as they design and develop their product. Once their design enters production, they often outsource their manufacturing to contract manufacturers that purchase the Company s products directly from the Company or from the Company s distributors.

Revenue is recognized upon shipment for sales to distributors with limited rights of returns and price protection if the Company concludes it can reasonably estimate the credits for returns and price adjustments issuable. The Company records an estimated allowance, at the time of shipment, based on the Company s historical patterns of returns and pricing credits of sales recognized upon shipment. The credits issued to distributors or other customers were not material in the three and nine months ended September 30, 2008 and 2007.

Revenue and costs relating to sales to distributors are deferred if the Company grants more than limited rights of returns and price credits or if it cannot reasonably estimate the level of returns and credits issuable. During the quarter ended June 30, 2007, the Company signed a distribution agreement with Avnet, Inc. to distribute the Company s products primarily in the United States. Given the terms of the distribution agreement, for sales to Avnet revenue and costs are being deferred until products are sold by Avnet to its end customers. For the three months and nine months ended September 30, 2008, 3.7% and 3.6% of the Company s net revenues were from products sold by Avnet. For the three and nine months ended September 30, 2007, less than 1% of the Company s net revenues were from products sold by Avnet. Revenue recognition depends on notification from the distributor that product has been sold to Avnet s end customers. Avnet reports to the Company, on at least a monthly basis, the product resale price, quantity and end customer shipment information, as well as inventory on hand. Reported distributor inventory on hand is reconciled monthly to the Company s deferred revenue and cost balances. Deferred income on shipments to Avnet is included in deferred revenue. Accounts receivable from Avnet is recognized and inventory is relieved when title to inventories transfers, which typically takes place at the time of shipment, which is the point in time at which the Company has a legal enforceable right to collection under normal payment terms.

The Company also derives revenue in the form of license and maintenance fees through licensing its software products. Revenue from such arrangements is recorded by applying the provisions of Statement of Position, or SOP No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Revenue Recognition with Respect to Certain Transactions.* Revenue from such arrangements totaled $1.2 million and $0.2 million for the three months ended September 30, 2008 and 2007, respectively, and $1.7 million and $0.8 million for the nine months ended September 30, 2008 and 2007, respectively. The value of any support services is recognized as services revenue on a straight-line basis over the term of the related support period, which is typically one year.

The Company also enters into development agreements with some of its customers. Development revenue is recognized under the proportional performance method, with the associated costs included in cost of revenue. The Company estimates the proportional performance of the development contracts based on an analysis of progress toward completion. The Company periodically evaluates the actual status of each project to ensure that the estimates to complete each contract remain accurate. If the amount billed exceeds the amount of revenue recognized, the excess amount is recorded as deferred revenue. Revenue recognized in any period is dependent on progress toward completion of projects in progress. To the extent the Company is unable to estimate the proportional performance then the revenue is recognized on a completed performance basis. Revenue from such arrangements totaled $0.7 million and $1.0 million for the three months ended September 30, 2008 and 2007, respectively, and $1.7 million and $2.2 million for the nine months ended September 30, 2008 and 2007, respectively.

Total deferred revenue was $1.7 million as of September 30, 2008 and December 31, 2007, which includes deferred revenue associated with license and maintenance fees, development revenue and deferred income on shipments to Avnet.

Warranty Accrual

The Company s products are subject to a one-year warranty period. The Company provides for the estimated future costs of replacement upon shipment of the product as cost of revenue. The warranty accrual is estimated based on historical claims compared to historical revenue. The following table presents a reconciliation of the Company s product warranty liability, which is included within accrued expenses and other current liabilities in the consolidated balance sheets:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(in thousands)			
Beginning balance	$ 260	$ 183	$ 261	$ 161
Accruals for warranties issued	35	113	159	211
Settlements made	(35)	(32)	(160)	(108)
Ending balance	$ 260	$ 264	$ 260	$ 264

Indemnities

In the ordinary course of business the Company enters into agreements with customers that include indemnity provisions. Based on historical experience and other available information the Company believes its exposure related to the indemnity provisions was immaterial for each of the periods presented.

Research and Development

Research and development costs are expensed as incurred and primarily include personnel costs, prototype expenses, which include the cost of fabrication mask costs not reasonably expected to be used in production manufacturing, and allocated facilities costs as well as depreciation of equipment used in research and development.

Advertising

The Company expenses advertising costs as incurred. Advertising costs were $34,000 and $53,000 for the three months ended September 30, 2008 and 2007, respectively, and $0.3 million for each of the nine months ended September 30, 2008 and 2007.

Operating Leases

The Company recognizes rent expense on a straight-line basis over the term of the lease. The difference between rent expense and rent paid is recorded as accrued rent in accrued expenses and other current and non-current liabilities components of the consolidated balance sheets.

Income Taxes

The Company provides for deferred income taxes under the asset and liability method. Under this method, deferred tax assets, including those related to tax loss carryforwards and credits, and liabilities are determined based on the differences between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is recorded to reduce deferred tax assets when it is more likely than not that the net deferred tax asset will not be recovered. The Company monitors the status of the deferred tax assets on a regular basis. Once sustained profitability has been achieved in certain tax jurisdictions, the Company will release the valuation allowance per Statement of Financial Accounting Standards No. 109.

Accounting for Stock-Based Compensation

The Company recognizes stock-based compensation for options granted to employees in accordance with FAS 123(R). The Company estimates the grant date fair value of stock option awards under the provisions of SFAS 123(R) using the Black-Scholes option valuation model. The Company recorded stock-based compensation expense of $1.8 million and $0.5 million for the three months ended September 30, 2008 and 2007, respectively, and $4.1 million and $1.3 million for the nine months ended September 30, 2008 and 2007, respectively. In future periods, stock-based compensation expense may increase as the Company issues additional stock-based awards to continue to attract and retain key employees. SFAS 123(R) also requires that the Company recognize stock-based compensation expense only for the portion of stock options that are expected to vest, based on the Company s estimated forfeiture rate. If the actual number of future forfeitures differs from that estimated by management, the Company will be required to record adjustments to stock-based compensation expense in future periods.

The Company accounts for stock-based compensation arrangements with non-employees in accordance with SFAS 123(R) and Emerging Issues Task Force, or EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, using a fair value approach. The fair value of the stock options granted to non-employees was estimated using the Black-Scholes option valuation model. This model utilizes the value of the Company s common stock on the date of grant, the contractual term of the option, the expected volatility of the price of the Company s common stock, risk-free interest rates and the expected dividend yields of the Company s common stock. Stock-based compensation expense related to non-employees was $20,000 and $19,000 for the three months ended September 30, 2008 and 2007, respectively, and $20,000 and $0.1 million for the nine months ended September 30, 2008 and 2007, respectively.

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The following table presents the detail of stock-based compensation expense amounts included in the consolidated statement of operations for each of the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(in thousands)			
Cost of revenue	$ 20	$ 16	$ 103	$ 36
Research and development	805	222	1,792	537
Sales, general and administrative	1,012	287	2,220	729
	$ 1,837	$ 525	$ 4,115	$ 1,302

The total stock-based compensation cost capitalized as part of inventory as of September 30, 2008 and 2007 was $0.2 million and $19,000, respectively.

Other Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity that are not the result of transactions with stockholders. For the three and nine months ended September 30, 2008 and 2007, there are no components of comprehensive income (loss) which are excluded from the net income (loss) and, therefore, no separate statement of comprehensive income (loss) has been presented.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*, or SFAS No. 141R, which replaces SFAS No 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008 and will apply prospectively to business combinations completed on or after that date. The Company will assess the impact of SFAS 141R if and when a future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements,* or SFAS No. 160. SFAS No. 160 clarifies that a noncontrolling or minority interest in a subsidiary is considered an ownership interest and, accordingly, requires all entities to report such interests in subsidiaries as equity in the consolidated financial statements. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The Company will assess the impact of SFAS 160 if and when a future event occurs.

In April 2008, the FASB issued FSP 142-3, *Determination of the Useful Life of Intangible Assets*, or 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 No. 142, *Goodwill and Other Intangible Asset.* FSP 142-3 is intended to improve the consistency between the useful life of a recognized intangible asset under FAS 142 and the period of expected cash flows used to measure the fair value of the asset under FAS 141(R), *Business Combinations*, and other guidance under U.S. GAAP. FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impact, if any, of the adoption of FSP 142-3 on its consolidated financial statements.

In October 2008, the FASB issued FASB Staff Position FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP 157-3). FSP 157-3 clarified the application of SFAS 157. FSP 157-3 demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have an impact on our condensed consolidated financial statements.

2. Net Income Per Common Share

The Company calculates net income per share in accordance with SFAS No. 128, *Earnings per Share*, or SFAS 128. Under SFAS 128, basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period (excluding shares subject to repurchase). Diluted net income per common share is computed by dividing net income by the weighted-average number of common and potentially dilutive common equivalent shares outstanding during the period. Potentially dilutive securities, composed of incremental common shares issuable upon the exercise of stock options, restricted stock units, and common stock subject to repurchase, are included in diluted net income per share for the three months and nine months ended September 30, 2008 and 2007, respectively.

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

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands, except per share data)	2008	2007	2008	2007
Net income	$ 1,819	$ 1,310	$ 5,864	$ 221
Weighted average common shares outstanding basic	40,578	39,046	40,283	25,498
Dilutive effect of employee stock plans	2,050	3,691	2,334	3,288
Weighted average common shares outstanding diluted	42,628	42,737	42,617	28,786
Basic net income per share	$ 0.04	$ 0.03	$ 0.15	$ 0.01
Diluted net income per share	$ 0.04	$ 0.03	$ 0.14	$ 0.01

3. Fair Value

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements,* or SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework and provides guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 was effective for the Company as of January 1, 2008. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provisions of SFAS 157 with respect to its financial assets and liabilities only.

Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The adoption of this statement did not have a material impact on the Company s consolidated results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* or SFAS No. 159, which permits entities to choose to measure eligible financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Effective January 1, 2008, the Company adopted SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159).

SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. The Company did not elect to adopt the fair value option for assets or liabilities under this Statement.

At September 30, 2008, the Company s investment was classified as cash equivalents and was comprised of an investment in a money market fund. In accordance with SFAS 157, the Company determined the fair value hierarchy of its financial assets (cash equivalents) in the money market fund as Level 1, which approximated $87.1 million as of September 30, 2008.

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4. Inventories

Inventories are stated at the lower of cost (determined using the first-in, first-out method), or market value (estimated net realizable value) and are comprised of the following:

	As of September 30, 2008	As of December 31, 2007
	(in thousands)	
Work-in-process	$ 12,859	$ 8,092
Finished goods	2,442	1,481
	$ 15,301	$ 9,573

5. Property and Equipment, net

	As of September 30, 2008	As of December 31, 2007
	(in thousands)	
Mask costs and test equipment	$ 9,778	$ 5,587
Software, computer and other equipment	13,955	12,738
Furniture, office equipment and leasehold improvements	120	57
	23,853	18,382
Less: accumulated depreciation and amortization	(13,017)	(6,774)
	$ 10,836	$ 11,608

Depreciation and amortization expense was $2.2 million and $1.3 million for the three months ended September 30, 2008 and 2007, respectively, and $6.2 million and $3.1 million for the nine months ended September 30, 2008 and 2007, respectively.

Assets under capital leases included in property and equipment were $8.1 million at September 30, 2008 and $7.9 million at December 31, 2007. Amortization expense related to assets recorded under capital lease was $0.7 million and $0.4 million for the three months ended September 30, 2008 and 2007, respectively, and $2.0 million and $1.0 million for the nine months ended September 30, 2008 and 2007, respectively.

6. Acquisition

Star Semiconductor Corporation

On August 1, 2008, the Company and two of its subsidiaries (the Purchasers) acquired substantially all of the intangible assets and inventory and certain other tangible assets of Star Semiconductor Corporation (Star), a Taiwan-based design house in Hsinchu that builds highly integrated ARM-based SOC processors for the broadband, connected home and SOHO market segments. The Purchasers paid approximately $9.6 million in cash, including acquisition related expenses of approximately $0.8 million. Included in the purchase price was $1.0 million that was placed in escrow for 60 days after the close in order to indemnify the Company for certain matters, including breaches of representations and warranties and covenants made by Star. The acquisition will provide the Company with a highly experienced stand-alone SOC processor team based in Taiwan. The results of operations from Star have been included in the Company s consolidated statements of operations only since the date of acquisition.

The acquisition was accounted for using the purchase method of accounting in accordance with SFAS No. 141, Business Combinations. Under the purchase method of accounting, the total estimated purchase price was allocated to the tangible and identifiable intangible assets and liabilities assumed based on their relative fair values. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill. In accordance with SFAS No. 142, goodwill will not be amortized, but instead will be tested for impairment at least annually and more frequently if certain indicators are present. All of the $3.4 million allocated to goodwill is expected to be deductible for state income tax purposes but not for federal purposes. The final purchase price allocation may differ based upon the final purchase price. While the Company has accrued all acquisition costs that it is aware of, any adjustments to these costs will be adjusted to goodwill. The purchase price allocation will be finalized in the year ending December 31, 2009. The total purchase price was as follows:

Total purchase price of the acquisition of Star is as follows:		**Amount** (in thousands)
Cash consideration	$	8,790
Acquisition related expenses [1]		849
Total purchase price	$	9,639

(1) Acquisition related expenses include legal and accounting fees and other external costs directly related to the acquisition.

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The purchase price allocation was as follows (in thousands):

Net tangible assets	$ 973
Identifiable intangible assets:	
Existing and core technology	4,823
Customer contracts and relationships	307
Trade name	82
Order backlog	83
Goodwill	3,371
Total purchase price	$ 9,639

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

Intangible Assets	**Estimated useful life (in years)**	**Amount**
Existing technology product	4.0	$ 3,849
Core technology product	4.0	467
Existing technology licensed	0.2	507
Customer contracts and relationships	7.0	307
Trade name	2.0	82
Order backlog	0.2	83
Total		$ 5,295

The fair value of the existing technology- product, existing technology-licensed and the customer contracts and relationships was determined based on an income approach using the discounted cash flow method. The discount rate of 18.0% used to value the existing technology - product and discount rate of 20.0% used to value the customer contracts and relationships was estimated using a discount rate based on implied rate of return of the transaction, adjusted for the specific risk profile of each asset. The discount rate of 4.5% used to value the existing technology-licensed was based on a short-term risk free interest rate. The remaining useful life was estimated based on historical product development cycles, the projected rate of technology attrition, and the patterns of project economic benefit of the assets.

The fair value of core technology and trade name was determined using a variation of income approach known as the profit allocation method. The estimated savings in profit were determined using a 3.0% profit allocation rate and a discount rate of 18.0%. The estimated useful life was determined based on the future economic benefit expected to be received from the asset.

The fair value of order backlog was determined using cost approach where the fair value was based on estimated sales and marketing expenses expected to be incurred to regenerate the order backlog. The estimated useful life was determined based on the future economic benefit expected to be received from the asset.

Pro forma financial information

The unaudited financial information in the table below summarizes the combined results of operations of the Company and Star, on a pro forma basis, as though the companies had been combined as of the beginning of each of the periods presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of each of the periods presented. The pro forma financial information for all periods presented includes the purchase accounting adjustments on historical Star inventory, amortization charges from acquired intangible assets and related tax effects.

The unaudited pro forma financial information for the three months ended September 30, 2008 combines the results for the Company for the three months ended September 30, 2008, which include the results of Star subsequent to August 1, 2008 (the acquisition date), and the historical results for Star for the one month ended July 31, 2008. The unaudited pro forma financial information for the nine months ended September 30, 2008 combines the results of the Company for the nine months ended September 30, 2008, which include the results of Star subsequent to August 1, 2008, and the historical results of Star for the seven months ended July 31, 2008. The unaudited pro forma financial information for the three and nine months ended September 30, 2007 combines the historical results of the Company and Star for the three and nine months ended September 30, 2007. The following table summarizes the pro forma financial information (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenue	$24,596	$14,593	$65,784	$39,247
Net income (loss)	$ 1,171	$ (114)	$ 3,576	$ (2,664)
Net income (loss) per common share, basic	$ 0.03	$ (0.00)	$ 0.09	$ (0.10)
Net income (loss) per common share, diluted	$ 0.03	$ (0.00)	$ 0.08	$ (0.10)

Parallogic Corporation

On May 20, 2008, the Company acquired Parallogic Corporation (Parallogic), a privately held company. The aggregate purchase price consisted of cash consideration of $1.3 million, including direct acquisition costs of approximately $61,000. To date the Company has paid $0.8 million in cash associated with the acquisition. The remaining two subsequent payments of $0.2 million each are due at the completion of certain milestones or 18 th and 36 th month anniversaries of the acquisition date, whichever comes first.

Identifiable intangible assets of approximately $0.5 million consist of intellectual property related to the developed technology as well as incremental value associated with existing customer relationships. The developed technology acquired from Parallogic is the multi-core software focused on gigabit packet processing and security applications.

The total purchase price was allocated to tangible and identifiable intangible assets based on their estimated fair value as of May 20, 2008. The excess of the purchase price over the tangible and identifiable intangible assets were recorded as goodwill. The purchase price allocation was as follows (in thousands):

Net tangible assets	$
Identifiable intangible assets:	
Customer relationships	76
Developed technology	374
Goodwill	816
Total purchase price	$ 1,266

The fair value assigned to developed technology and customer relationships were based upon future discounted cash flows related to the assets projected income streams using a discount rate of 20% and 15% respectively. Factors considered in estimating the discounted cash flows to be derived from developed technology and customer relationships include risk 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. The Company is amortizing the purchased intangible assets to cost of revenue on a straight-line basis over its estimated useful life of 1 to 5 years.

Beginning on the acquisition date, May 20, 2008, the results of operations of Parallogic are included in our condensed consolidated statements of operations. Pro forma results of operations for the acquisition have not been presented as the effect has not been significant.

Of the total purchase price, approximately $0.8 million was allocated to goodwill, which represents the excess of the purchase price over the estimated fair value of the underlying net tangible and identifiable intangible assets acquired. The goodwill was attributed to the premium paid for the opportunity to expand and better serve the addressable market and achieve greater long-term growth opportunities. All of the $0.8 million allocated to the goodwill is expected to be deductible for tax purposes. Management believes with the acquisition the Company will be better positioned to deliver professional services for customers to help reduce the time-to-market for design wins and provide high-performance tuning. In accordance with SFAS No. 142, goodwill will not be amortized, but instead will be tested for impairment at least annually and more frequently if certain indicators are present.

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7. Intangible Assets, net

Intangible assets consisted of the following:

	As of September 30, 2008	As of December 31, 2007
	(in thousands)	
Developed technology	$ 8,540	$ 3,343
Customer contracts and relationships	383	
Technology license	9,205	9,205
Trade name	82	
Order backlog	83	
	18,293	12,548
Less: accumulated amortization		
Developed technology	(4,055)	(3,235)
Customer contracts and relationships	(32)	
Technology license	(5,904)	(5,217)
Trade name	(7)	
Order backlog	(83)	
	$ 8,212	$ 4,096

Amortization expense was $1.0 million and $0.4 million for the three months ended September 30, 2008 and 2007, respectively, and $1.6 million and $1.2 million for the nine months ended September 30, 2008 and 2007, respectively. The weighted-average remaining estimated lives for intangible assets are approximately 3.2 years for developed technology and 1.7 years for technology license. The weighted average remaining estimated life of intangible assets in total is approximately 2.4 years. Future amortization expenses are estimated to be $0.5 million for 2008, $2.8 million for 2009, $2.5 million for 2010, $1.4 million for 2011, $0.9 million for 2012 and $0.1 million thereafter.

8. Accrued Expenses and Other Current Liabilities

	As of September 30, 2008	As of December 31, 2007
	(in thousands)	
Accrued compensation and related benefit	$ 911	$ 1,010
Accrued warranty	260	261
Refundable deposits related to unvested employee stock option exercises	12	70
Professional fees	1,005	285
Income tax payable	870	231
Other	389	396
	$ 3,447	$ 2,253

9. Common Stock

Stock Options and Unvested Common Stock

Upon completion of its IPO in May 2007, the Company adopted the 2007 Stock Incentive Plan, or the 2007 Plan, which reserved 5,000,000 shares of the Company s common stock. The number of shares of the common stock reserved for issuance increased in January 2008 by 2,015,368 shares, pursuant to the automatic provision of the 2007 Plan. The 2007 Plan provides for the grant of incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance stock awards, and other forms of equity compensation, or collectively, the stock awards, and performance cash awards, all of which may be granted to employees (including officers), directors, and consultants or affiliates. Awards granted under the 2007 Plan vest at the rate specified by the plan administrator, typically with 1/8th of the shares vesting six months after the date of grant and 1/48th of the shares vesting monthly thereafter over the next three and one half years. The term of awards expires seven to ten years from the date of grant. As of September 30, 2008, 2,518,495 shares have been granted under the 2007 Plan.

Prior to the IPO, the Company issued stock options pursuant to the 2001 Stock Incentive Plan, or the 2001 Plan. As of September 30, 2008, 409,243 shares of the Company s common stock were reserved for issuance to employees, officers, directors, consultants and advisors of the Company pursuant to outstanding options. Options granted under the 2001 Plan were either incentive stock options or non-statutory stock options as determined by the Company s board of directors. Options granted under the 2001 Plan

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vest at the rate specified by the plan administrator, typically with 1/8th of the shares vesting six months after the date of grant and 1/48th of the shares vesting monthly thereafter over the next three and one half years to four and one half years. The term of option expires ten years from the date of grant. No options to purchase shares have been granted under the 2001 Plan in the three months and nine months ended September 30, 2008.

Under the Company s 2001 Plan, certain employees have the right to early-exercise unvested stock options, subject to rights held

by the Company to repurchase unvested shares in the event of voluntary or involuntary termination. For options granted prior to March 2005, the Company has the right to repurchase any such shares at the shares original purchase price. For options granted after March 2005, the Company has the right to repurchase such shares at the lower of market value or the original purchase price.

For those options granted prior to March 2005, in accordance with EITF 00-23, *Working Group Work Plan Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees, and FASB Interpretation No. 44 Accounting for Certain Transactions involving Stock Compensation*, the Company accounts for cash received in consideration for the early-exercise of unvested stock options as a current liability, included as a component of accrued liabilities in the Company s consolidated balance sheets. For those shares issued in connection with options granted prior to March 2005, there were 16,201 and 123,895 unvested shares outstanding as of September 30, 2008 and December 31, 2007, respectively, and $13,000 and $70,000 related liabilities, respectively.

Detail related to activity of early-exercise unvested shares of common stock is as follows:

	Number of Unvested Shares Outstanding	Weighted-Average Exercise/ Purchase Price
Balance as of December 31, 2007	436,662	$ 2.45
Issued		
Vested	(87,125)	1.89
Cancelled and forfeited		
Balance as of March 31, 2008	349,537	$ 2.59
Issued		
Vested	(85,654)	1.98
Cancelled and forfeited	(4,480)	0.88
Balance as of June 30, 2008	259,403	$ 2.82
Issued		
Vested	(61,089)	1.85
Cancelled and forfeited		
Balance as of September 30, 2008	198,314	$ 3.12

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Detail related to stock option activity is as follows:

	Number of Shares Outstanding	Weighted Average Exercise Price per Share
Balance at December 31, 2007	3,920,001	$ 3.86
Options granted	1,476,975	15.24
Options exercised	(81,395)	1.61
Options cancelled and forfeited	(20,754)	7.34
Balance as of March 31, 2008	5,294,827	$ 7.06
Options granted	404,800	20.53
Options exercised	(402,901)	1.47
Options cancelled and forfeited	(22,068)	7.00
Balance as of June 30, 2008	5,274,658	$ 8.52
Options granted	144,200	16.74
Options exercised	(17,232)	2.58
Options cancelled and forfeited	(75,227)	13.88
Balance as of September 30, 2008	5,326,399	$ 8.68

The total intrinsic value for options exercised amounted to $0.3 million and $3,000 for the three months ended September 30, 2008 and 2007, respectively, and $9.1 million and $1.2 million for the nine months ended September 30, 2008 and 2007, respectively, representing the difference between the closing price of the Company s common stock at the date of exercise and the exercise price.

The following table summarizes information about stock options outstanding as of September 30, 2008:

	Outstanding Options			Exercisable Options		
Exercise Prices	Number Outstanding As of 9/30/08	Weighted Average Remaining Contractual Term	Weighted Average Exercise Price	Number Exercisasble As of 9/30/08	Weighted Average Exercise Price	Aggregate Intrinsic Value
$0.20 - 0.80	281,556	5.69	$ 0.31	280,253	$ 0.30	
1.02 - 1.50	966,086	6.86	1.05	743,745	1.03	
3.04 - 3.04	1,440,926	7.47	3.04	710,091	3.04	
3.74 - 8.52	489,140	8.20	6.96	166,063	6.59	
14.80 - 14.80	1,316,075	6.46	14.80	160,826	14.80	
16.32 - 20.98	615,916	6.56	19.17	48,583	19.89	
23.92 - 31.54	216,700	8.53	28.09	53,046	28.40	
0.20 - 31.54	5,326,399	7.02	$ 8.68	2,162,607	$ 4.14	$ 35,861,728
Exercisable	2,162,607		$ 4.14			$ 22,646,137

Vested and expected to vest	4,921,995	$ 8.53	$ 33,773,257

The fair value of each employee option grant for the three months and nine months ended September 30, 2008 and 2007 under SFAS 123(R) was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
Risk-free interest rate	2.70%	4.13%	2.33% to 3.32%	4.13%-4.72%
Expected life	4.53 - 4.75 years	4 years	4.53 - 4.75 years	4.0 to 5.0 years
Dividend yield	None	None	None	None
Volatility	58.50%	45.00%	55.40% to 58.50%	45-55%

The Company determined that it was not practical to calculate the historical volatility of its share price since the Company has limited information on its past volatility as its securities were not publicly traded prior to May 2007, before which there was no readily

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determinable market value for its stock. Further, the Company is a high-growth technology company whose future operating results are not comparable to its prior operating results. Therefore, the Company estimated its expected volatility based on reported market value data for a group of publicly traded companies, which it selected from certain market indices, that the Company believed was relatively comparable after consideration of their size, stage of life cycle, profitability, growth, and risk and return on investment. The expected term represents the period that stock-based awards are expected to be outstanding, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of our stock-based awards. For the nine months ended September 30, 2008, the Company used the simplified method of determining the expected term as permitted by the provisions of Staff Accounting Bulletin No. 110, Year-End Help for Expensing Employee Stock Options.

The estimated weighted-average grant date fair value of options granted were $8.36 and $11.04 for the three months ended September 30, 2008 and 2007, respectively, and $7.89 and $7.16 for the nine months ended September 30, 2008 and 2007, respectively.

As of September 30, 2008, there was $17.7 million of unrecognized compensation costs related to stock options granted under the company s 2001 Plan and 2007 Plan. The unrecognized compensation cost is expected to be recognized over a weighted average period of 2.81 years.

Restricted Stock Unit Awards

The company began issuing restricted stock units, or RSUs, in the fourth quarter of 2007. Shares are issued on the date the restricted stock units vest, and the fair value of the underlying stock on the dates of grant is recognized as stock-based compensation over the vesting periods. Below is the information as of September 30, 2008:

	Number of Shares	**Weighted-Average Grant Date Fair Value Per**	**Weighted-Average Remaining Contractual Term (years)**	**Aggregate Intrinsic Value (1)**
Balance as of December 31, 2007	12,000	$ 31.54		
Granted	18,400	14.80		
Issued and released	(2,375)	31.54		
Cancelled and forfeited				
Balance as of March 31, 2008	28,025	$ 20.55	1.06	$ 459,610
Vested and expected to vest as of March 31, 2008	26,312	20.55	1.05	$ 431,519
Granted	28,000	19.65		
Issued and released	(875)	31.54		
Cancelled and forfeited				
Balance as of June 30, 2008	55,150	$ 19.92	1.41	$ 1,158,150
Expected to vest as of June 30, 2008	50,597	19.92	1.36	$ 1,062,539
Granted	248,420	16.70		
Issued and released	(2,625)	16.14		
Cancelled and forfeited	(500)	14.80		
Balance as of September 30, 2008	300,445	$ 17.30	1.82	$ 4,230,266

Expected to vest as of September 30, 2008	271,638	$ 17.30	1.75	$ 3,824,658

(1) Aggregate intrinsic value for RSUs represents the closing price per share of the Company s stock on September 30, 2008, multiplied by the number of unvested RSUs expected to vest as of September 30, 2008.

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

During the three months ended September 30, 2008, the Company issued 248,420 restricted stock units which will vest over four years. As of September 30, 2008, there was $4.4 million of unrecognized compensation costs related to restricted stock units granted under the Company s 2007 Equity Incentive Plan. The unrecognized compensation cost is expected to be recognized over a weighted average period of 1.82 years.

10. Current and Deferred Income Taxes

For the three months ended September 30, 2008 and 2007, the provision for income taxes was based on the estimated annual effective tax rate in compliance with SFAS 109 and other related guidance. The Company updates its estimate of its annual effective tax rate at the end of each quarterly period. The estimate takes into account estimations of annual pre-tax income, the geographic mix of pre-tax income and interpretations of tax laws and the possible outcomes of current and future audits.

The following table presents the provision and benefit for income taxes and the effective tax rates for the three months and nine months ended September 30, 2008 and 2007:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(in thousands)			
Income before income taxes	$2,273	$1,420	$6,805	$ 422
Income tax provision	$ 454	$ 110	$ 941	$ 201
Effective tax rate	20.0%	7.7%	13.8%	47.6%

The provision for income taxes was $0.5 million and $0.1 million for the three months ended September 30, 2008 and 2007, respectively, and $0.9 million and $0.2 million for the nine months ended September 30, 2008 and 2007, respectively. The income tax expense was primarily related to the federal alternative minimum tax on profits in the United States adjusted by certain non-deductible items, international taxes and state income taxes.

A valuation allowance is recorded to reduce any deferred tax asset that is more likely than not to be not realized. The Company performed assessments of the realization of the deferred tax assets considering all available evidence, both positive and negative. These assessments require that management makes significant judgments about many factors, including the amount and likelihood of future taxable income. As a result of this assessment, the Company concluded that it was more likely than not that the deferred tax assets would not be realized and recorded a full valuation allowance against its deferred tax assets. The Company will continue to evaluate the need for a valuation allowance. The Company may determine that some, or all, of its deferred tax assets will be realized, in which case it will reduce the valuation allowance in the quarter in which such determination is made. If a determination is made to reduce the valuation allowance the impact to the net income could be material. If the valuation allowance is reduced, the Company may recognize a benefit from income taxes on its income statement in that period. If such a benefit is recognized, then subsequent periods are likely to have significantly higher tax provision expenses.

The difference between the provision for income that would be derived by applying the statutory rate to income before tax for the three months and nine months ended September 30, 2008 and the provision actually recorded was due to the impact of non-deductible SFAS 123R stock option compensation expenses offset by the benefit from net operating loss carryforwards and utilization of research credits carryforwards.

As a result of the implementation of FIN 48, the Company did not recognize any adjustment to the liability for uncertain tax positions and therefore did not record any adjustment to the beginning balance of retained earnings. As of December 31, 2007 the Company had $3.6 million of unrecognized tax benefits, which is netted against deferred tax assets and is fully offset by a valuation allowance. There were no significant changes to the unrecognized tax benefit during the nine months ended September 30, 2008.

The Company s major tax jurisdictions are the United States federal government and the State of California. The Company files income tax returns in the United States federal jurisdiction, the State of California and various state and foreign tax jurisdictions in which it has a subsidiary or branch operation. The United States federal corporation income tax returns beginning with the 2000 tax year remain subject to examination by the Internal Revenue Service, or IRS. The California corporation income tax returns beginning with the 2000 tax year remain subject to examination by the California Franchise Tax Board. There are no on-going income tax audits in the major tax jurisdictions.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (Act) was enacted. The Act retroactively extended the federal research credits that expired on January 1, 2008. The Company is currently evaluating the impact of this Act for the year-end December 31, 2008 tax provision.

11. Retirement Plan

The Company has established a defined contribution savings plan under Section 401(k) of the Internal Revenue Code. This plan covers substantially all employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pre-tax basis. Company contributions to the plan may be made at the discretion of the board of directors. For the year ending December 31, 2008 the Company matches 50% of the employees contribution up to $2,000 per year per employee.

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12. Segment Information

SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company is organized as, and operates in, one reportable segment: the development and sale of semiconductor processor solutions for next-generation intelligent networking equipment. The chief operating decision-maker is the Chief Executive Officer. The Company s Chief Executive Officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by customer and geographic region, for purposes of evaluating financial performance and allocating resources. The Company and its Chief Executive Officer evaluate performance based primarily on revenue to the customers and in the geographic locations in which the Company operates. Revenue is attributed by geographic location based on the ship-to location of customers. The Company s assets are primarily located in the United States of America and not allocated to any specific region. Therefore, geographic information is presented only for total revenue. Substantially all of the Company s long-lived assets are located in the United States of America.

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
	(in thousands)			
United States	$ 12,252	$ 8,435	$ 32,803	$ 23,163
Taiwan	3,786	2,567	9,419	7,162
Japan	3,675	516	8,515	2,030
China	1,732	1,128	4,686	2,296
Other countries	3,080	1,519	9,006	3,321
Total	$ 24,525	$ 14,165	$ 64,429	$ 37,972

13. Commitments and Contingencies

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

The Company leases its facilities under non-cancelable operating leases, which contain renewal options and escalation clauses, and expires in May 2012. The Company also acquires certain assets under capital leases.

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Minimum commitments under non-cancelable capital and operating lease agreements as of September 30, 2008 were as follows:

	Capital lease and technology license obligations	Operating leases	Total
		(in thousands)	
Remainder of 2008	$ 957	$ 402	$ 1,359
2009	2,595	1,103	3,698
2010	1,774	1,113	2,887
2011		844	844
2012		199	199
thereafter			
	$ 5,326	$ 3,661	$ 8,987
Less: Interest component	(405)		
Present value of minimum lease payment	4,921		
Less: current portion	(2,666)		
Long-term portion of obligations	$ 2,255		

Rent expense incurred under operating leases was $0.5 million and $0.3 million for the three months ended September 30, 2008 and 2007, and $1.2 million and $0.7 million for the nine months ended September 30, 2008 and 2007, respectively.

The Company also has a purchase agreement with Synopsys Inc., or Synopsys, to purchase certain intellectual property which is to be used for the Company s future products. The Company has an agreement to pay $1.15 million over the two-year period for various intellectual properties. The agreement will expire in October 2008. As of September 30, 2008, $1.0 million has been paid to purchase certain intellectual property.

The technology license obligations include future cash payments payable primarily for license agreements with outside vendors. One of the license agreements is with Cadence Design Systems for its electronic design automation software which is used in the design of the Company s products. The term of the license is two years and will expire in June 2009. The second license agreement is with MIPS Technologies, Inc. which includes a non-exclusive, non-transferable right to develop multiple licensed MIPS cores that implement the MIPS architecture. This second license agreement required the Company to pay $1.9 million after the completion of its IPO for an automatic two-year extension of the license. The term of the license after the two-year extension is seven years and will expire in December 2010. As of September 30, 2008, $1.7 million was paid, and the balance is accrued within capital lease and technology license obligations on the consolidated balance sheets.

In October 2007, the Company signed a license agreement with Synopsys for certain design tools totaling $7.0 million, with 12 installment payments. The term of the license is three years and will expire in October 2010. The present value of the installment payments has been capitalized and is amortized over three years, and included within capital lease and technology license obligations on the consolidated balance sheets. As of September 30, 2008, $2.3 million was paid.

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

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

Overview

We are a provider of highly integrated semiconductor products that enable intelligent processing for networking, communications, storage, wireless and security applications. We market and sell our products to providers of networking equipment that sell their products into the enterprise network, data center, broadband and consumer, and access and service provider markets. Our products are used in a broad array of networking equipment, including routers, switches, content-aware switches, unified threat management, or UTM and other security appliances, application-aware gateways, voice/video/data, or triple-play, gateways, wireless local area network, or WLAN and third-generation, or 3G access and aggregation devices, storage networking equipment, servers and intelligent network interface cards. We focus our resources on the design, sales and marketing of our products, and outsource the manufacturing of our products.

From our incorporation in 2000 through 2003, we were primarily engaged in the design and development of our first processor family, NITROX, which we began shipping commercially in 2003. In 2004, we introduced and commenced commercial shipments of NITROX Soho. In 2006, we commenced our first commercial shipments of our OCTEON family of multi-core MIPS64 processors. We introduced a number of new products within all three of these product families in 2006. In 2007 we introduced our new line of OCTEON based storage services processors designed to address the specific needs in the storage market, as well as other new products in the OCTEON and NITROX families. In 2008, we expanded our OCTEON and NITROX product families with new products including wireless services processors to address the needs for wireless infrastructure equipment. Through the acquisition of substantially all of the assets of Star Semiconductor in the third quarter of 2008 for a purchase price of $9.6 million, we also added the Star ARM-based processors to our portfolio to address connected home and office applications. Since inception, we have invested heavily in new product development and achieved our first quarter of profitability during the quarter ended September 30, 2007. Our net revenue has grown from $19.4 million in 2005 to $34.2 million in 2006, $54.2 million in 2007, and $64.4 million for the nine months ended September 30, 2008, driven primarily by demand in the enterprise network and data center markets, and more recently by increased demand in the broadband and consumer markets. We expect sales of our products for use in the enterprise network and data center markets to continue to represent a substantial portion of our revenue in the foreseeable future. However, we expect sales into those markets to decline as a percentage of overall sales as sales in the broadband and consumer and the access and service provider markets are expected to increase at a faster rate than the expected increase in sales into the enterprise network and data center markets.

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

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Key Business Metrics

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

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

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

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

Results of Operations

Three and Nine months ended September 30, 2008 and 2007

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

We also derive revenue in the form of license and maintenance fees through licensing our software products which help our customers build products around our systems-on-a-chip, or SoCs in a more time and cost efficient manner. Revenue from such arrangements totaled $1.2 million and $0.2 million for the three months ended September 30, 2008 and 2007, respectively, and $1.7 million and $0.8 million for the nine months ended September 30, 2008 and 2007, respectively.

Our customers representing greater than 10% of net revenue for each of the periods were:

	For the three months ended September 30,		**For the nine months ended September 30,**	
	2008	**2007**	**2008**	**2007**
Percentage of total net revenue				
Cisco	24%	24%	29%	24%
F5 Networks	12%	18%	10%	19%

Sumitomo	13%	*	11%	*

* Represents less than 10% of the net revenue for the respective period end.

Our distributors are used primarily to support international sale logistics in Asia, including importation and credit management. Total net revenue through distributors was $9.5 million and $2.9 million for the three months ended September 30, 2008 and 2007, or

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38.9% and 20.6% of net revenue, respectively, and $22.8 million and $8.6 million for the nine months ended September 30, 2008 and 2007, or 35.4% and 22.7% of net revenue, respectively. While we have purchase agreements with our distributors, the distributors do not have long-term contracts with any of the equipment providers. Our distributor agreements limit the distributor s ability to return product up to a portion of purchases in the preceding quarter. Given our experience, along with our distributors limited contractual return rights, we believe we can reasonably estimate expected returns from our distributors. Accordingly, we recognize sales through distributors at the time of shipment, reduced by our estimate of expected returns.

Net revenue and costs relating to sales to distributors are deferred if we grant more than limited rights of returns and price credits or if we cannot reasonably estimate the level of returns and credits issuable. During the quarter ended June 30, 2007, we signed a distribution agreement with Avnet, Inc. to distribute our products primarily in the United States. Given the terms of the distribution agreement, for sales to Avnet, revenue and costs are being deferred until products are sold by Avnet to their end customers. For the three months and nine months ended September 30, 2008, 3.7% and 3.6%, respectively, of our net revenues were from products sold by Avnet. For the three and nine months ended September 30, 2007, less than 1% of our net revenues were from products sold by Avnet. Revenue recognition depends on notification from Avnet that product has been sold to Avnet s end customers.

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
	(in thousands)			
United States	$ 12,252	$ 8,435	$ 32,803	$ 23,163
Taiwan	3,786	2,567	9,419	7,162
Japan	3,675	516	8,515	2,030
China	1,732	1,128	4,686	2,296
Other countries	3,080	1,519	9,006	3,321
Total	$ 24,525	$ 14,165	$ 64,429	$ 37,972

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

We use third-party foundries and assembly and test contractors, which are primarily located in Asia, to manufacture, assemble and test our semiconductor products. We purchase processed wafers on a per wafer basis from our fabrication suppliers, which are currently TSMC and UMC. We also outsource the sort, assembly, final testing and other processing of our product to third-party contractors, primarily ASE and ISE. We negotiate wafer fabrication on a purchase order basis and do not have long-term agreements with any of our third-party contractors. A significant disruption in the operations of one or more of these contractors would impact the production of our products which could have a material adverse effect on our business, financial condition and results of operations.

Cost of revenue also includes amortized costs related to certain acquired technology assets in 2004 and 2005, and our most recent acquisitions of Parallogic in May 2008 and substantially all of the assets of Star Semiconductor Corporation (Star) in August 2008. In August 2004, we acquired certain assets of Brecis Communications Corporation, which included the purchase of its secure communication processor product line. We capitalized a total of $2.3 million of developed technology and amortized that amount on a straight-line basis over the expected useful life of three years. In April 2005, we acquired Menlo Logic, LLC, which included the purchase of technology used for secure communication. We capitalized a total of $1.1 million of developed technology and amortized that amount on a straight-line basis over the expected useful life of three years. In May 2008, we acquired Parallogic. The purchase included identifiable intangible assets of approximately $0.5 million, which consisted of intellectual property related to the developed technology as well as incremental value associated with existing customer relationships. We capitalized identifiable intangibles and are amortizing the amount on a straight-line basis over the expected useful life of one to five years. In August 2008, we acquired certain assets of Star, which included the purchase of identifiable intangible assets of $5.3 million. We capitalized the intangible assets and are amortizing the amount of $5.3 million on a straight-line basis over the expected useful lives of less than a year to seven years. The total intangible assets amortization expense included in cost of revenue was $0.8 million and $0.2 million for the three months September 30, 2008 and 2007, respectively, and $0.9 million and $0.8 million for the nine months September 30, 2008 and

2007, respectively. In addition, in the three and nine months ended September 30, 2008, we incurred a $0.2 million expense related to the fair value adjustment of Star inventory.

In addition, we incur costs for the fabrication of masks used by our contract manufacturers to manufacture wafers that incorporate our products. The cost of fabrication mask sets has increased as we began transitioning from a 130-nanometer to a 90-nanometer process in our next-generation products in 2007. During the three months ended September 30, 2008 and 2007, we capitalized $1.0 million and $0.1 million, respectively, and during the nine months ended September 30, 2008 and 2007, we capitalized $3.3 million and $1.8 million of mask costs, respectively. As our product processes continue to mature and as we develop more history and experience, we expect that, in the future, a large percentage of mask costs will be used directly for production manufacturing and will be capitalized. We amortize the cost of fabrication masks that we reasonably expect to use for production manufacturing over a 12-month period and include them in cost of revenue. Total amortized expenses for the masks included in the cost of revenue was $1.0 million and $0.6 million for the three months ended September 30, 2008 and 2007, respectively, and $2.3 million and $1.2 million for the nine months ended September 30, 2008 and 2007, respectively. The unamortized balance of capitalized mask costs at September 30, 2008 and December 31, 2007 was $2.4 million and $2.2 million, respectively. We anticipate that a large percentage of our total mask costs will be capitalized and amortized to cost of revenue.

Our net revenue, cost of revenue, gross profit and gross margin for the three months and nine months ended September 30, 2008 and 2007 were:

	For the three months ended September 30,				For the nine months ended September 30,			
	2008	2007	$ change	% change	2008	2007	$ change	% change
		(in thousands)				(in thousands)		
Net revenue	$ 24,525	$ 14,165	$ 10,360	73.1%	$ 64,429	$ 37,972	$ 26,457	69.7%
Cost of revenue	10,099	5,207	4,892	94.0%	24,494	14,087	10,407	73.9%
Gross Profit	$ 14,426	$ 8,958	$ 5,468	61.0%	$ 39,935	$ 23,885	$ 16,050	67.2%
Gross Margin	58.8%	63.2%	-4.4%	-7.0%	62.0%	62.9%	-0.9%	-1.5%

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

Three Months and Nine months ended September 30, 2008 Compared to the Three Months and Nine months ended September 30, 2007: Net Revenue. Our net revenue was $24.5 and $64.4 million in the three months and nine months ended September 30, 2008, as compared to $14.2 million and $38.0 million in the three months and nine months ended September 30, 2007, an increase of 73.1% and 69.7%, respectively. The majority of the increase is related to an increase in sales of $18.1 million and $49.3 million in the three months and nine months ended September 30, 2008, to existing customers, which was primarily a result of design wins reaching commercial production. In the three months and nine months ended September 30, 2008 and 2007, a substantial majority of our sales were to customers that sell into the enterprise network and data center markets as well as broadband and consumer markets. In the three months and nine months ended September 30, 2008 we derived 38.9% and 35.4% of our net revenue from distributors compared to 20.6% and 22.7% in the three months and nine months ended September 30, 2007, due to increased sales to top five customers through distributors.

Three Months and Nine months ended September 30, 2008 Compared to the Three Months and Nine months ended September 30, 2007: Gross Margin. Gross margin declined by 4.4 percentage points and 0.9 percentage points to 58.8 % and 62.0% in the three months and nine months ended September 30, 2008 from 63.2% and 62.9% in the three months and nine months ended September 30, 2007. The decline in gross margin in the three months and nine months ended September 30, 2008 compared to the three months and nine months ended September 30, 2007 was primarily due to higher amortization costs related to acquired intangible assets and amortization of fair value of Star s acquired inventory. In addition, to a lesser extent, the gross margin decline in the three months and nine months ended September 30, 2008 was due to a sales mix shift towards increased sales of lower performance, lower margin products.

Research and Development Expenses

Research and development expenses primarily include personnel costs, engineering design development software and hardware tools, allocated facilities expenses and depreciation of equipment used in research and development, and stock-based compensation under SFAS 123(R).

We expect research and development expenses to continue to increase in total dollars although we expect these expenses to generally decrease as a percentage of revenue. Additionally, as a percentage of revenue, these costs fluctuate from one period to another. Total research and development expenses for the three months and nine months ended September 30, 2008 and 2007 were:

	For the three months ended September 30,				For the nine months ended September 30,			
	2008	2007 (in thousands)	$ change	% change	2008	2007 (in thousands)	$ change	% change
Research and development expenses	$6,593	$4,796	$1,797	37.5%	$18,874	$13,843	$5,031	36.3%
Percent of total net revenue	26.9%	33.9%	-7.0%	-20.6%	29.3%	36.5%	-7.2%	-19.6%

Three Months and Nine months ended September 30, 2008 Compared to the Three Months and Nine months ended September 30, 2007: Research and development expenses increased by $1.8 million and $5.0 million, or 37.5% and 36.3% to $6.6 million and $18.9 million in the three months and nine months ended September 30, 2008 from $4.8 million and $13.8 million in the three months and nine months ended September 30, 2007. Of the $1.8 million and $5.0 million increase, salaries, benefits and commissions accounted for $0.9 million and $2.2 million, and stock-based compensation expense accounted for $0.6 million and $1.5 million, for the three months and nine months ended September 30, 2008. Design tools accounted for $0.1 million and $0.6 million of the increase in the three months and nine months ended September 30, 2008 and professional services and other miscellaneous expenses accounted for $0.2 million and $0.7 million of the increase, for the three months and nine months ended September 30, 2008. Research and development headcount increased to 191 at the end of September 2008 from 122 at the end of September 2007.

Sales, General and Administrative Expenses

Sales, general and administrative expenses primarily include personnel costs, accounting and legal fees, information systems, sales commissions, trade shows, marketing programs, depreciation, allocated facilities expenses and stock-based compensation under SFAS 123(R). We plan to continue to increase hiring of our sales and marketing organization to enable us to expand into existing and new markets. We also plan to continue to invest in expanding our domestic and international sales and marketing activities and building brand awareness. We incurred significant additional, accounting and legal compliance costs as well as additional insurance, and investor relations and other costs associated with being a public company. We expect sales, general and administrative expenses to increase significantly in absolute dollars and to generally decrease as a percentage of revenue in the future due to our expected growth and economies of scale. Total sales, general and administrative costs for the three months and nine months ended September 30, 2008 and 2007 were:

	For the three months ended September 30,				For the nine months ended September 30,			
	2008	2007 (in thousands)	$ change	% change	2008	2007 (in thousands)	$ change	% change
Sales , general and	$5,944	$3,976	$1,968	49.5%	$15,953	$10,667	$5,286	49.6%

administrative								
Percent of total net revenue	24.2%	28.1%	-3.8%	-13.7%	24.8%	28.1%	-3.3%	-11.9%

Three Months and Nine months ended September 30, 2008 Compared to the Three Months and Nine months ended September 30, 2007: Sales, general and administrative expenses increased \$2.0 million and \$5.3 million, or 49.5% and 49.6% to \$6.0 million and \$16.0 million in the three months and nine months ended September 30, 2008 from \$4.0 million and \$10.7 million in the three months and nine months ended September 30, 2007. Of the \$2.0 million and \$5.3 million increase, salaries, benefits and commissions accounted for \$0.7 million and \$1.6 million, and stock-based compensation expense accounted for \$0.7 million and \$1.7 million, for the three months and nine months ended September 30, 2008. Marketing programs, accounting, legal fees and other services accounted for \$0.3 million and \$1.1 of the increase in the three months and nine months ended September 30, 2008 due to the implementation of internal systems and other costs associated with being a public company. Other miscellaneous expenses accounted for \$0.3 million and \$0.9 million of the increase, for the three months and nine months ended September 30, 2008. Sales, general and administrative headcount increased to 84 at the end of September 2008 from 57 at the end of September 2007.

Other Income, Net. Other income, net, primarily includes interest income on cash and cash equivalents and interest expense on capitalized licenses. For 2007, it also includes adjustments we made to record our preferred stock warrants at fair value in accordance with FSP 150-5. These warrants have converted into warrants to purchase shares of our common stock in May 2007. As a result, there were no warrant revaluation expenses in the three months and nine months ended September 30, 2008.

	For the three months ended September 30,				For the nine months ended September 30,			
	2008	2007 (in thousands)	$ change	% change	2008	2007 (in thousands)	$ change	% change
Interest income and other	$ 499	$ 1,307	$ (808)	-61.8%	$ 2,100	$ 2,193	$ (93)	-4.2%
Interest expense	(115)	(73)	(42)	57.5%	(403)	(572)	169	-29.5%
Warrant revaluation expense				0.0%		(574)	574	-100.0%
Total other income, net	$ 384	$ 1,234	$ (850)	-68.9%	$ 1,697	$ 1,047	$ 650	62.1%

Three Months and Nine months ended September 30, 2008 Compared to the Three Months and Nine months ended September 30, 2007: Other income, net decreased in the three months ended September 30, 2008 due primarily the result of lower short-term U.S. interest rates, which decreased the interest income from our cash balances. Other income, net increased in the nine months ended September 30, 2008 due primarily the result of warrant revaluation expenses and, to a lesser extent, from the lower interest expense associated with the capital leases.

Income Tax Expense. For the three months ended September 30, 2008 and 2007, the provision for income taxes was based on our estimated annual effective tax rate in compliance with SFAS 109 and other related guidance. We update our estimate of our annual effective tax rate at the end of each quarterly period. Our estimate takes into account estimations of annual pre-tax income, the geographic mix of pre-tax income and our interpretations of tax laws and the possible outcomes of current and future audits.

The following table presents the provision and benefit for income taxes and the effective tax rates for the three months and nine months ended September 30, 2008 and 2007:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(in thousands)			
Income before income taxes	$2,273	$1,420	$6,805	$ 422
Income tax provision	$ 454	$ 110	$ 941	$ 201
Effective tax rate	20.0%	7.7%	13.8%	47.6%

The provision for income taxes of $0.5 million and $0.9 million for the three months and nine months ended September 30, 2008 related to alternative minimum tax on the Company s United States profits adjusted by certain non-deductible items, international taxes and state income taxes. The difference between the provision for income that would be derived by applying the statutory rate to income before tax for the three months and nine months ended September 30, 2008 and the provision actually recorded was due to the impact of non-deductible SFAS 123(R) stock-based compensation expenses offset by the benefit from net operating loss carryforwards and utilization of research credits carryforwards.

A valuation allowance is recorded to reduce any deferred tax asset that is more likely than not to be not realized. We perform assessments of the realization of our deferred tax assets considering all available evidence, both positive and negative. These assessments require that management make significant judgments about many factors, including the amount and likelihood of future taxable income. As a result of this assessment, we have concluded that it was more likely than not that our deferred tax assets would not be realized and have recorded a full valuation allowance against our deferred tax assets. We will continue to evaluate the need for a valuation allowance. We may determine that some, or all, of our deferred tax assets will be realized, in which case we will reduce our valuation allowance in the quarter in which such determination is made. If a determination is made to reduce the valuation allowance the impact to the net income could be material. If the valuation allowance is reduced, we may recognize a benefit from income taxes on our income statement in that period. If such a benefit is recognized, then subsequent periods are likely to have significantly higher tax provision expenses.

As a result of the implementation of FIN 48, we did not recognize any adjustment to the liability for uncertain tax positions and therefore did not record any adjustment to the beginning balance of retained earnings. As of December 31, 2007 we had $3.6 million of unrecognized tax benefits, which is netted against deferred tax assets and is fully offset by a valuation allowance. There were no significant changes to the unrecognized tax benefit during the three months and nine months ended September 30, 2008.

Our major tax jurisdictions are the United States federal government and the State of California. We file income tax returns in the United States federal jurisdiction, the State of California and various state and foreign tax jurisdictions in which we have a subsidiary

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or branch operation. The United States federal corporation income tax returns beginning with the 2000 tax year remain subject to examination by the Internal Revenue Service, or IRS. The California corporation income tax returns beginning with the 2000 tax year remain subject to examination by the California Franchise Tax Board. There are no on-going income tax audits in the major tax jurisdictions.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (Act) was enacted. The Act retroactively extended the federal research credits that expired on January 1, 2008. The Company is currently evaluating the impact of this Act for the year-end December 31, 2008 tax provision.

Liquidity and Capital Resources

In May 2007, we received net proceeds of approximately $94.7 million (after deducting underwriting discounts and commissions of $7.3 million and other offering related costs of approximately $2.8 million). Our other primary sources of cash historically have been proceeds from issuances of convertible preferred stock, cash collections from customers, a working capital line of credit and term loan and cash received from the exercise of employee stock options. As of September 30, 2008, we had cash and cash equivalents of $91.9 million and net accounts receivable of $13.5 million.

Following is a summary of our working capital and cash and cash equivalents as of September 30, 2008 and December 31, 2007:

	As of	
	September 30, 2008	**December 31, 2007**
	(in thousands)	
Working capital	$107,064	$105,048
Cash and cash equivalents	91,918	98,462

Cash Flows from Operating Activities

Net cash provided by operating activities was $12.5 million for the nine months ended September 30, 2008. Net cash provided by operating activities primarily consisted of $5.9 million of net income and $12.0 million in non-cash operating expenses, offset in part by $5.4 million in changes in working capital. Non-cash items in the nine months ended September 30, 2008 included depreciation and amortization expense of $7.9 million and stock-based compensation of $4.1 million. Net cash provided by operating activities was $6.3 million for the nine months ended September 30, 2007. This primarily consisted of our net income of $0.2 million, $6.3 million in non-cash operating expenses and offset by $0.3 million in changes in operating assets and liabilities. Non-cash items in the nine months ended September 30, 2007 included depreciation and amortization expense of $4.3 million, stock-based compensation of $1.3 million, warrant revaluation and amortization of $0.7 million. Changes in operating activities in the nine months of 2008 in comparison to 2007 were primarily driven by increases of $3.1 million in inventory and $2.8 million in accounts receivable, offset by increase in payables and accrued expenses of $0.9 million.

Cash Flows used in Investing Activities

Net cash used in investing activities was $16.2 million and $3.1 million for the nine months ended September 30, 2008 and 2007, respectively. In the nine months ended September 30, 2008 net cash of $9.8 million was used to purchase certain assets of Star in August 2008 and Parallogic in May 2008. In addition, in the nine months ended September 30, 2008, $3.3 million and $3.1 million of net cash were used for mask costs and capital expenditures, respectively, compared to $1.8 million and $1.3 million, respectively in the nine months ended September 30, 2007.

Cash Flows (used in) provided by Financing Activities

Net cash used in financing activities was $2.8 million for the nine months ended September 30, 2008, which was primarily due to principal payments of capital lease and technology license obligations of $3.6 million, offset by proceeds from stock option exercises. Net cash provided by financing activities was $88.2 million in the nine months ended September 30, 2007, which was primarily due to net proceeds of $94.7 million initial public offering, offset by $2.7 million in principal payments of capital lease and technology license obligations and $4.0 million in repayment of the term loan.

We believe that our $91.9 million of cash and cash equivalents at September 30, 2008 and expected cash flow from operations will be sufficient to fund our projected operating requirements for at least the next twelve months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our engineering, sales and marketing activities, the timing and extent of our expansion into new territories, the timing of introductions of new products and enhancements to existing products and the continuing market acceptance of our products. In addition, we may also enter into other types of arrangements in the future, which could require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Indemnities

In the ordinary course of business, we have entered into agreements with customers that include indemnity provisions. Based on historical experience and information known as of September 30, 2008, we believe our exposure related to the indemnities at September 30, 2008 is not material. We also enter into indemnification agreements with our officers and directors and our certificate of incorporation and bylaws include similar indemnification obligations to our officers and directors. It is not possible to determine the amount of our liability related to these indemnification agreements and obligations to our officers and directors due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

Off-Balance Sheet Arrangements

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

Contractual Obligations

The following table describes our commitments to settle contractual obligations in cash as of September 30, 2008:

	Payments Due By Period				
	Less Than 1 Year	1 to 2 Years	3 to 5 Years	More Than 5 Years	Total
			(in thousands)		
Operating lease obligations	$ 402	$ 2,216	$ 1,043	$	$ 3,661
Capital lease obligations	957	4,369			5,326
Purchase obligations	185				185
Total	$ 1,544	$ 6,585	$ 1,043	$	$ 9,172

We adopted FIN 48 on January 1, 2007. As of September 30, 2008, we had $3.6 million of total gross unrecognized tax benefits and related interest. The timing of any payments which could result from these unrecognized tax benefits will depend upon a number of factors. Accordingly, the timing of payment cannot be estimated. We do not expect a significant tax payment related to these obligations to occur within the next 12 months.

Critical Accounting Policies and Estimates

The preparation of our financial statements and accompanying disclosures in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and the accompanying notes. The SEC has defined a company s critical accounting policies as policies that are most important to the portrayal of a company s financial condition and results of operations, and which require a company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have identified our most critical accounting policies and estimates to be as follows: (1) revenue recognition; (2) product warranty accrual; (3) stock-based compensation; (4) inventory valuation; (5) accounting for income tax; (6) mask costs and (7) business combinations. Although we believe that our estimates, assumptions and judgments are reasonable, they are based upon information not presently available. Actual results may differ significantly from these estimates if the assumptions, judgments and conditions upon which they are based turn out to be inaccurate. During the three months ended September 30, 2008, we have identified business combinations as critical accounting policy and estimate. Except for the business combination critical accounting policy as described in detail below, management believes that there have been no significant changes during the nine months ended September 30, 2008 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations, in our Annual Report on Form 10-K for the year ended December 31, 2007 filed on March 10, 2008.

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Business Combinations

We account for business combinations in accordance with SFAS No. 141, Business Combinations (SFAS 141), which requires the purchase method of accounting for business combinations. In accordance with SFAS 141, we determine the recognition of intangible assets based on the following criteria: (i) the intangible asset arises from contractual or other rights; or (ii) the intangible is separable or divisible from the acquired entity and capable of being sold, transferred, licensed, returned or exchanged. In accordance with SFAS 141, we allocate the purchase price of business combinations to the tangible assets, liabilities and intangible assets acquired, including in-process research and development (IPR&D), based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. Management makes valuation assumptions that require significant estimates, especially with respect to intangible assets. Critical estimates in valuing certain intangible assets include, but are not limited to future expected cash flows from customer contracts, customer lists, distribution agreements and acquired developed technologies, expected costs to develop IPR&D into commercially viable products, estimated cash flows from projects when completed and discount rates. We estimate fair value based upon assumptions we believe to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. Other estimates associated with the accounting for acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed.

Recent Accounting Pronouncements

Please refer to the recent accounting pronouncements listed in the footnote 1 of the financial statements.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

During the three months ended September 30, 2008, there were no material changes to our quantitative and qualitative disclosures about market risk related to our investment activities as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the SEC on March 10, 2008.

Item 4T. *Controls and Procedures*

Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer evaluated with the participation of our management, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of September 30, 2008. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to management as appropriately to allow for timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the third quarter of 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

From time to time, we may become involved in legal proceedings arising in the ordinary course of our business. We are not presently a party to any legal proceedings the outcome of which, if determined adversely against us, would individually or in the aggregate have a material adverse effect on our business, operating results, financial condition or cash flows.

Item 1A. *Risk Factors*

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

We have marked with an asterisk(*) those risks described below that reflect substantive changes from the risks described under Item 1A. Risk Factors included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 10, 2008.

Risks Related to Our Business and Industry

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

We were established in 2000 and were not profitable in any fiscal period until the quarter ended September 30, 2007. We experienced net income of $1.8 million and $1.3 million for the three months ended September 30, 2008 and 2007, respectively, and $5.9 million and $0.2 million for the nine months ended September 30, 2008 and 2007, respectively. As of September 30, 2008, our accumulated deficit was $52.9 million. We expect to make significant expenditures related to the development of our products and expansion of our business, including research and development and sales and administrative expenses. As a public company, we also incur significant legal, accounting and other expenses that we did not incur as a private company. Additionally, we may encounter unforeseen difficulties, complications, product delays and other unknown factors that require additional expenditures. As a result of these increased expenditures, we may have to generate and sustain substantially increased revenue to achieve profitability. Our revenue growth trends in prior periods may not be sustainable. Accordingly, we may not be able to achieve or maintain profitability and we may continue to incur significant losses in the future.

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

The market for our products is highly competitive and we expect competition to intensify in the future. This competition could make it more difficult for us to sell our products, and result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses and failure to increase, or the loss of, market share or expected market share, any of which would likely seriously harm our business, operating results and financial condition. For instance, semiconductor products have a history of declining prices as the cost of production is reduced. However, if market prices decrease faster than product costs, gross and operating margins can be adversely affected. Currently, we face competition from a number of established companies, including Broadcom Corporation, Freescale Semiconductor, Inc., Intel Corporation, Marvell Technology Group Ltd., PMC-Sierra, Inc., Hifn, Inc., and others. We also face competition from a number of private companies, including Raza Microelectronics, Inc. and others. A few of our current competitors operate their own fabrication facilities and have, and some of our potential competitors could have, longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we have. Potential customers may prefer to purchase from their existing suppliers rather than a new supplier regardless of product performance or features.

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

- our success in identifying new and emerging markets, applications and technologies;
- our products performance and cost effectiveness relative to that of our competitors products;
- our ability to deliver products in large volume on a timely basis at a competitive price;
- our success in utilizing new and proprietary technologies to offer products and features previously not available in the marketplace;
- our ability to recruit design and application engineers and sales and marketing personnel; and

our ability to protect our intellectual property.

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

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

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

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

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

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

We receive a substantial portion of our revenues from a limited number of customers. We received an aggregate of approximately 57.3% and 61.0% of our revenues from our top five customers for the three months ended September 30, 2008 and 2007, respectively. We anticipate that we will continue to be dependent on a limited number of customers for a significant portion of our revenues in the immediate future and in some cases the portion of our revenues attributable to certain customers may increase in the future. However, we may not be able to maintain or increase sales to certain of our top customers for a variety of reasons, including the following:

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

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

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

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

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

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We expect our operating results to fluctuate.

We expect our revenues and expense levels to vary in the future, making it difficult to predict our future operating results. In particular, we experience variability in demand for our products as our customers manage their product introduction dates and their inventories.

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

- fluctuations in demand, sales cycles, product mix and prices for our products;
- the timing of our product introductions, and the variability in lead time between the time when a customer begins to design in one of our products and the time when the customer s end system goes into production and they begin purchasing our products;
- the forecasting, scheduling, rescheduling or cancellation of orders by our customers;
- our ability to successfully define, design and release new products in a timely manner that meet our customers needs;
- changes in manufacturing costs, including wafer, test and assembly costs, mask costs, manufacturing yields and product quality and reliability;
- the timing and availability of adequate manufacturing capacity from our manufacturing suppliers;
- the timing of announcements by our competitors or us;
- future accounting pronouncements and changes in accounting policies;
- volatility in our stock price, which may lead to higher stock compensation expenses;
- general economic and political conditions in the countries where we operate or our products are sold or used;
- costs associated with litigation, especially related to intellectual property; and
- productivity and growth of our sales and marketing force.

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

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

We have experienced significant growth in a short period of time. Our revenues increased from approximately $7.4 million in 2004 to approximately $34.2 million in 2006, $54.2 million in 2007 and $64.4 million in the first nine months of 2008. We may not achieve similar growth rates in future periods. You should not rely on our operating results for any prior quarterly or annual periods as an indication of our future operating performance. If we are unable to maintain adequate revenue growth, our financial results could suffer and our stock price could decline.

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

- recruit, hire, train and manage additional qualified engineers for our research and development activities, especially in the positions of design engineering, product and test engineering, and applications engineering;
- add additional sales personnel and expand sales offices;
- implement and improve our administrative, financial and operational systems, procedures and controls; and

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

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

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

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

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

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

- timely and efficient completion of process design and transfer to manufacturing, assembly and test processes;

- the quality, performance and reliability of the product; and

- effective marketing, sales and service.

If we fail to introduce new products that meet the demand of our customers or penetrate new markets that we target our resources on, our revenues will likely decrease over time and our financial condition could suffer.

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

Because of the wide price differences among our processors, the mix and types of performance capabilities of processors sold affect the average selling price of our products and have a substantial impact on our revenue. Generally, sales of higher performance products have higher gross margins than sales of lower performance products. We currently offer both higher and lower performance products within each of our NITROX and OCTEON product families. To the extent our sales mix shifts toward increased sales of lower performance products, our overall gross margins will be negatively affected. Fluctuations in the mix and types of our products may also affect the extent to which we are able to recover our fixed costs and investments that are associated with a particular product, and as a result can negatively impact our financial results.

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

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

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

expenses which may adversely affect our financial results.

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

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

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

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

- it can take from nine months to three years from the time our products are selected to commence commercial shipments; and our customers may experience changed market conditions or product development issues. The resources devoted to product development and sales and marketing may not generate material revenue for us, and from time to time, we may need to write off excess and obsolete inventory if we have produced product in anticipation of expected demand. We may spend resources on the development of products that our customers may not adopt. If we incur significant expenses and investments in inventory in the future that we are not able to recover, and we are not able to compensate for those expenses, our operating results could be adversely affected. In addition, if we sell our products at reduced prices in anticipation of cost reductions but still hold higher cost products in inventory, our operating results would be harmed.

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

If customers do not believe our products solve a critical need, our revenues will decline.

Our products are used in networking and security equipment including routers, switches, UTM appliances, intelligent switches, application-aware gateways, triple-play gateways, WLAN and 3G access and aggregation devices, storage networking equipment, servers, and intelligent network interface cards.

In order to meet our growth and strategic objectives, providers of networking equipment must continue to incorporate our products into their systems and the demands for their systems must grow as well. Our future depends in large part on factors outside our control, and the sale of next-generation networks may not meet our revenue growth and strategic objectives.

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

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

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

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

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

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

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

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

Stock options generally comprise a significant portion of our compensation packages for all employees. The FASB requirement to expense the fair value of stock options awarded to employees beginning in the first quarter of our fiscal 2006 has increased our operating expenses and may cause us to reevaluate our compensation structure for our employees. Our inability to attract, retain and motivate additional key employees could have an adverse effect on our business, financial condition and results of operations.

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

We were established in 2000. We have not been profitable in any fiscal period until the quarter ended September 30, 2007. We experienced net income of $1.8 million and $5.9 million for the three months and nine months ended September 30, 2008. Since we have only five quarters of operating profitability, we do not have an extended history from which to predict and manage profitability. Our limited operating experience, a dynamic and rapidly evolving market in which we sell our products, our dependence on a limited number of customers, as well as numerous other factors beyond our control, impede our ability to forecast quarterly and annual revenues accurately. As a result, we could experience budgeting and cash flow management problems, unexpected fluctuations in our results of operations and other difficulties, any of which could make it difficult for us to gain and maintain profitability and could increase the volatility of the market price of our common stock.

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

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

increased complexity and costs of managing international operations;

longer and more difficult collection of receivables;

difficulties in enforcing contracts generally;

geopolitical and economic instability and military conflicts;

limited protection of our intellectual property and other assets;

compliance with local laws and regulations and unanticipated changes in local laws and regulations, including tax laws and regulations;

trade and foreign exchange restrictions and higher tariffs;

travel restrictions;

timing and availability of import and export licenses and other governmental approvals, permits and licenses, including export classification requirements;

foreign currency exchange fluctuations relating to our international operating activities;

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

difficulties in staffing international operations;

heightened risk of terrorism;

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

differing employment practices and labor issues;

regional health issues (e.g., SARS) and natural disasters; and

work stoppages.

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

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

The fabrication of integrated circuits is a complex and technically demanding process. Our foundries could, from time to time, experience manufacturing defects and reduced manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. Poor yields from our foundries, or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems, harm our financial results and result in financial or other damages to our customers. Our customers could also seek damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly to defend.

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

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

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

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

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

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

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

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. Any inability to provide reliable financial reports or prevent fraud could harm our business. The Sarbanes-Oxley Act of 2002 requires management and our auditors to evaluate and assess the effectiveness of our internal control over financial reporting. We will be required to adhere to these requirements by the end of 2008. These Sarbanes-Oxley Act requirements may be modified, supplemented or amended from time to time. Implementing these changes may take a significant amount of time and may require specific compliance training of our personnel. In the future, we may discover areas of our internal controls that need improvement. If our auditors or we discover a material weakness, the disclosure of that fact, even if quickly remedied, could reduce the market s confidence in our financial statements and harm our stock price. We may not be able to effectively and timely implement necessary control changes and employee training to ensure continued compliance with the Sarbanes-Oxley Act and other regulatory and reporting requirements. Our rapid growth in recent periods, and our possible future expansion through acquisitions, present challenges to maintain the internal control and disclosure control standards applicable to public companies. If we fail to maintain effective internal controls, we could be subject to regulatory scrutiny and sanctions and investors could lose confidence in the accuracy and completeness of our financial reports. We cannot assure you that we will be able to fully comply with the requirements of the Sarbanes-Oxley Act or that management or our auditors will conclude that our internal controls are effective in future periods.

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

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

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

We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality and nondisclosure agreements and other methods, to protect our proprietary technologies and know-how. We have been issued 14 patents in the United States and two patents in foreign countries and have an additional 27 patent applications pending in the United States and 26 patent applications pending in foreign countries. Even if the pending patent applications are granted, the rights granted to us may not be meaningful or provide us with any commercial advantage. For example, these patents could be opposed, contested, circumvented or designed around by our competitors or be declared invalid or unenforceable in judicial or administrative proceedings. The failure of our patents to adequately protect our technology might make it easier for our competitors to offer similar products or technologies. Our foreign patent protection is generally not as comprehensive as our U.S. patent protection and may not protect our intellectual property in some countries where our products are sold or may be sold in the future. Many U.S.-based companies have encountered substantial intellectual property infringement in foreign countries, including countries where we sell products. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

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

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

Some of the software used with our products, as well as that of some of our customers, may be derived from so called open source software that is generally made available to the public by its authors and/or other third parties. Such open source software is often made available to us under licenses, such as the GNU General Public License, which impose certain obligations on us in the event we were to make available derivative works of the open source software. These obligations may require us to make source code for the derivative works available to the public, and/or license such derivative works under a particular type of license, rather than the forms of license customarily used to protect our intellectual property. In addition, there is little or no legal precedent for interpreting the terms of certain of these open source licenses, including the determination of which works are subject to the terms of such licenses. While we believe we have complied with our obligations under the various applicable licenses for open source software, in the event the copyright holder of any open source software were to successfully establish in court that we had not complied with the terms of a license for a particular work, we could be required to release the source code of that work to the public and/or stop distribution of that work.

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

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights and positions, which has resulted in protracted and expensive litigation for many companies. We expect that in the future we may receive, particularly as a public company, communications from various industry participants alleging our infringement of their patents, trade secrets or other intellectual property rights. Any lawsuits resulting from such allegations could subject us to significant liability for damages and invalidate our proprietary rights. Any potential intellectual property litigation also could force us to do one or more of the following:

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

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

- pay substantial damages to the party whose intellectual property rights we may be found to be infringing;

- redesign those products that contain the allegedly infringing intellectual property; or

- attempt to obtain a license to the relevant intellectual property from third parties, which may not be available on reasonable terms or at all.

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

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

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

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

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

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

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

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

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

Any acquisitions we make could disrupt our business and harm our financial condition.*

In May 2008 we acquired certain assets of Parallogic Corporation, in August 2008 we acquired substantially all of the assets of Star Semiconductor Corporation and we may in the future acquire companies or assets that we believe to be complementary to our business, including for the purpose of expanding our new product design capacity, introducing new design, market or application skills or enhancing and expanding our existing product lines. In connection with any such future acquisitions, we may need to use a significant portion of our available cash, issue additional equity securities that would dilute current stockholders percentage ownership and incur substantial debt or contingent liabilities. Such actions could adversely impact our operating results and the market price of our common stock. In addition, difficulties in assimilating any acquired workforce, merging operations or avoiding unplanned attrition in connection with such acquisitions could disrupt or harm our business. Furthermore, the purchase price of any acquired businesses may exceed the current fair values of the net tangible assets of such acquired businesses. As a result, we would be required to record material amounts of goodwill, and acquired in-process research and development charges and other intangible assets, which could result in significant impairment and acquired in-process research and development charges and amortization expense in future periods. These charges, in addition to the results of operations of such acquired businesses, could have a material adverse effect on our business, financial condition and results of operations. We cannot forecast the number, timing or size of future acquisitions, or the effect that any such acquisitions might have on our operating or financial results.

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

Our cash equivalents as of September 30, 2008 consisted primarily of money market instruments, which are invested primarily in US treasury securities, bonds of government agencies, and corporate bonds. We follow an established investment policy and set of guidelines to monitor, manage and limit our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes.

As a result of current adverse financial market conditions, investments in some financial instruments, such as structured investment vehicles, sub-prime mortgage-backed securities and collateralized debt obligations, may pose risks arising from liquidity and credit concerns. As of September 30, 2008, we had no direct holdings in these categories of investments and our indirect exposure to these financial instruments through our holdings in money market instruments was immaterial. As of September 30, 2008, we had no impairment charge associated with our cash equivalents relating to such adverse financial market conditions. Although we believe our current investment portfolio has very little risk of impairment, we cannot predict future market conditions or market liquidity and can provide no assurance that our investment portfolio will remain unimpaired.

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

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

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

We are in the process of expanding our international operations and staff to better support our expansion into international markets. This expansion includes the implementation of an international structure that includes, among other things, a research and development cost-sharing arrangement, certain licenses and other contractual arrangements between us and our wholly-owned domestic and foreign subsidiaries. As a result of these changes, we anticipate that our consolidated pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the U.S. federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the U.S. federal statutory rate. Our future effective income tax rates could be adversely affected if tax authorities challenge our international tax structure or if the relative mix of U.S. and international income changes for any reason. Accordingly, there can be no assurance that our income tax rate will be less than the U.S. federal statutory rate.

Risks Related to our Common Stock

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

The trading prices of the securities of technology companies have been highly volatile. Further, our common stock has a limited trading history. Since our initial public offering in May 2007 through September 30, 2008, our stock price has fluctuated from a low of $12.33 to a high of $34.29. We cannot predict the extent to which the trading market will continue to develop or how liquid the market may become. The trading price of our common stock is therefore likely to be highly volatile and could be subject to wide fluctuations in price in response to various factors, some of which are beyond our control. These factors include:

- quarterly variations in our results of operations or those of our competitors;
- general economic conditions and slow or negative growth of related markets;
- announcements by us or our competitors of design wins, acquisitions, new products, significant contracts, commercial relationships or capital commitments;
- our ability to develop and market new and enhanced products on a timely basis;

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commencement of, or our involvement in, litigation;

disruption to our operations;

the emergence of new sales channels in which we are unable to compete effectively;

any major change in our board of directors or management;

changes in financial estimates including our ability to meet our future revenue and operating profit or loss projections;

changes in governmental regulations; and

changes in earnings estimates or recommendations by securities analysts.

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

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

Our directors, executive officers and principal stockholders and their affiliates beneficially own approximately 40% of our outstanding common stock as of September 30, 2008. These stockholders, if they acted together, could exert substantial influence over matters requiring approval by our stockholders, including electing directors, adopting new compensation plans and approving mergers, acquisitions or other business combination transactions. This concentration of ownership may discourage, delay or prevent a change of control of our company, which could deprive our stockholders of an opportunity to receive a premium for their stock as part of a sale of our company and might reduce our stock price. These actions may be taken even if they are opposed by our other stockholders.

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

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

the division of our board of directors into three classes;

the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or due to the resignation or departure of an existing board member;

the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;

the requirement for the advance notice of nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders meeting;

the ability of our board of directors to alter our bylaws without obtaining stockholder approval;

the ability of the board of directors to issue, without stockholder approval, up to 10,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of our common stock;

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

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

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

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

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

Unregistered Sale of Equity Securities

None.

Use of Proceeds from Sale of Registered Securities

Our initial public offering of common stock was effected through a Registration Statement on Form S-1 (File No. 333-140660), that was declared effective by the SEC on May 1, 2007. We registered 7,762,500 shares of our common stock with a proposed maximum aggregate offering price of $104.8 million, all of which we sold. The offering was completed after the sale of all 7,762,500 shares. Morgan Stanley & Co. Incorporated and Lehman Brothers Inc. were the joint book-running managing underwriters of our initial public offering and Thomas Weisel Partners LLC, Needham & Company, LLC and JMP Securities LLC acted as co-managers. As of September 30, 2008, $78.6 million of the approximately $94.7 million in net proceeds received by us in the offering, after deducting approximately $7.3 million in underwriting discounts, commissions, and $2.8 million in other offering costs, were invested in various interest-bearing instruments, and $16.1 million of the net proceeds had been used for acquisitions, general corporate purposes, including the repayment of the outstanding balances under the term loan with Silicon Valley Bank, general and administrative and manufacturing expenses. None of the expenses were paid, directly or indirectly, to directors, officers or persons owning 10% or more of our common stock, or to our affiliates other than payments in the ordinary course of business to officers for salaries and to non-employee directors as compensation for board or board committee service.

Item 3. *Defaults Upon Senior Securities*

None.

Item 4. *Submission of Matters to a Vote of Security Holders*

None.

Item 5. *Other Information*

On August 1, 2008, we and two of our subsidiaries, (the Purchasers) completed the acquisition of substantially all of the intangible assets, inventory and certain other tangible assets of Star Semiconductor Corporation (Star) pursuant to an asset purchase agreement dated July 15, 2008 (the Acquisition). The Purchasers paid approximately $9.6 million in cash, including acquisition related expenses of approximately $0.8 million. Included in the purchase price was $1.0 million that was placed in escrow for 60 days after the close in order to indemnify the Purchasers for certain matters, including breaches of representations and warranties and covenants made by Star in the Asset Purchase Agreement.

Item 6. *Exhibits*

Exhibit Number	Description
2.1	Asset Purchase Agreement by and between Cavium Networks, Inc., Cavium International, Cavium (Taiwan) Ltd., and Star Semiconductor Corporation, dated July 15, 2008 (1)
3.1	Amended and Restated Certificate of Incorporation of the Registrant (2)
3.2	Amended and Restated Bylaws (3)
4.1	Reference is made to Exhibits 3.1 and 3.2

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Exhibit Number	Description
4.2	Specimen of Common Stock Certificate (4)
31.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer
31.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Arthur D. Chadwick, Chief Financial Officer
32.1*	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer and Arthur D. Chadwick, Chief Financial Officer
(1)	Filed as Exhibit 10.1 to the Registrant s report on Form 8-K (No. 001-33435), filed with the SEC on July 16, 2008, and incorporated herein by reference.
(2)	Filed as Exhibit 3.3 to the Registrant s registration statement on Form S-1 (No. 333-140660), filed with the SEC on February 13, 2007, as amended, and incorporated herein by reference.
(3)	Filed as Exhibit 3.5 to the Registrant s registration statement on Form S-1 (No. 333-140660), filed with the SEC on February 13, 2007, as amended, and incorporated herein by reference.
(4)	Filed as Exhibit 4.2 to the Registrant s registration statement on Form S-1 (No. 333-140660), filed with the SEC on February 13, 2007, as amended, and incorporated herein by reference.

* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Registrant under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as

amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

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SIGNATURES

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

	CAVIUM NETWORKS, INC.
Date: November 12, 2008	By: /s/ ARTHUR D. CHADWICK Arthur D. Chadwick Chief Financial Officer

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incorporated by reference into any filing of the Registrant under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.