

AXT INC  
Form 10-Q  
May 10, 2011

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended March 31, 2011

Or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-24085

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AXT, INC.

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of  
Incorporation or organization)

94-3031310  
(I.R.S. Employer  
Identification No.)

4281 Technology Drive, Fremont, California 94538  
(Address of principal executive offices) (Zip code)

(510) 683-5900  
(Registrant's telephone number, including area code)

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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 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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this

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chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                           | Outstanding at April 29, 2011 |
|---------------------------------|-------------------------------|
| Common Stock, \$0.001 par value | 31,973,288                    |

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

AXT, INC.  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (Unaudited, in thousands, except per share data)

|  | March 31,<br>2011 | December 31,<br>2010 (1) |
|--|-------------------|--------------------------|
| Assets:  |                   |                          |
| Current assets:  |                   |                          |
| Cash and cash equivalents  | \$23,273          | \$ 23,724                |
| Short-term investments   | 4,756             | 10,079                   |
| Accounts receivable, net of allowances of \$403 and \$561 as of March 31, 2011 and December 31, 2010, respectively   | 19,154            | 23,076                   |
| Inventories  | 39,747            | 35,986                   |
| Prepaid expenses and other current assets  | 7,009             | 4,090                    |
| Total current assets   | 93,939            | 96,955                   |
| Long-term investments  | 10,425            | 7,172                    |
| Property, plant and equipment, net   | 26,173            | 24,240                   |
| Other assets   | 11,950            | 11,884                   |
| <b>Total assets</b>  | <b>\$142,487</b>  | <b>\$ 140,251</b>        |
| Liabilities and stockholders' equity:  |                   |                          |
| Current liabilities:   |                   |                          |
| Accounts payable   | \$6,076           | \$ 7,094                 |
| Accrued liabilities  | 7,116             | 7,745                    |
| Total current liabilities  | 13,192            | 14,839                   |
| Long-term portion of royalty payments  | 5,063             | 5,500                    |
| Other long-term liabilities  | 102               | 108                      |
| Total liabilities  | 18,357            | 20,447                   |
| Commitments and contingencies (Note 10)  |                   |                          |
| Stockholders' equity:  |                   |                          |
| Preferred stock, \$0.001 par value; 2,000 shares authorized; 883 shares issued and outstanding as of March 31, 2011 and December 31, 2010 (Liquidation preference of \$5.6 million as of March 31, 2011 and December 31, 2010) | 3,532             | 3,532                    |
| Common stock, \$0.001 par value per share; 70,000 shares authorized; 31,973 and 31,877 shares issued and outstanding as of March 31, 2011 and December 31, 2010, respectively  | 32                | 32                       |
| Additional paid-in capital   | 190,585           | 190,021                  |
| Accumulated deficit  | (78,269 )         | (82,477 )                |
| Accumulated other comprehensive income   | 4,720             | 4,652                    |
| AXT, Inc. stockholders' equity   | 120,600           | 115,760                  |
| Noncontrolling interests   | 3,530             | 4,044                    |
| Total stockholders' equity   | 124,130           | 119,804                  |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$142,487</b>  | <b>\$ 140,251</b>        |

See accompanying notes to condensed consolidated financial statements.

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(1) The condensed consolidated balance sheet at December 31, 2010 has been derived from the audited consolidated financial statements at that date.

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AXT, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (Unaudited, in thousands, except per share data)

|  | Three Months Ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2011                            | 2010     |
| Revenue  | \$24,566                        | \$18,641 |
| Cost of revenue  | 13,906                          | 11,909   |
| Gross profit   | 10,660                          | 6,732    |
| Operating expenses:                                      |                                 |          |
| Selling, general and administrative                      | 3,690                           | 3,419    |
| Research and development                                 | 505                             | 451      |
| Total operating expenses                                 | 4,195                           | 3,870    |
| Income from operations                                   | 6,465                           | 2,862    |
| Interest income, net                                     | 87                              | 15       |
| Other income (expense), net                              | (363 )                          | 79       |
| Income before provision for income taxes                 | 6,189                           | 2,956    |
| Provision for income taxes                               | (902 )                          | (246 )   |
| Net income   | 5,287                           | 2,710    |
| Less: Net income attributable to noncontrolling interest | (1,079 )                        | (130 )   |
| Net income attributable to AXT, Inc.                     | \$4,208                         | \$2,580  |
| Net income attributable to AXT, Inc. per common share:   |                                 |          |
| Basic  | \$0.13                          | \$0.08   |
| Diluted  | \$0.13                          | \$0.08   |
| Weighted average number of common shares outstanding:    |                                 |          |
| Basic  | 31,718                          | 30,743   |
| Diluted  | 33,199                          | 31,792   |

See accompanying notes to condensed consolidated financial statements.

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AXT, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (Unaudited, in thousands)

|   | Three Months Ended<br>March 30, |          |
|---|---------------------------------|----------|
|   | 2011                            | 2010     |
| Cash flows from operating activities:   |                                 |          |
| Net income  | \$5,287                         | \$2,710  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |          |
| Depreciation and amortization   | 815                             | 752      |
| Amortization of marketable securities premium                                     | 98                              | —        |
| Stock-based compensation  | 207                             | 114      |
| Realized loss (gain) on sale of investments                                       | 4                               | (120)    |
| Loss on disposal of property, plant and equipment                                 | —                               | 1        |
| Changes in assets and liabilities:  |                                 |          |
| Accounts receivable, net  | 3,916                           | 196      |
| Inventories   | (3,773)                         | (505)    |
| Prepaid expenses and other current assets   | (2,926)                         | (655)    |
| Other assets  | (69)                            | 38       |
| Accounts payable  | (1,014)                         | 1,366    |
| Accrued liabilities   | (624)                           | 325      |
| Other long-term liabilities   | (395)                           | 9        |
| Net cash provided by operating activities   | 1,526                           | 4,231    |
| Cash flows from investing activities:   |                                 |          |
| Purchases of property, plant and equipment  | (2,787)                         | (320)    |
| Proceeds from disposal of property, plant and equipment                           | —                               | 4        |
| Purchases of available for sale securities  | (10,002)                        | (6,284)  |
| Proceeds from available for sale securities                                       | 11,923                          | 6,120    |
| Net cash used in investing activities   | (866)                           | (480)    |
| Cash flows from financing activities:   |                                 |          |
| Proceeds from common stock options exercised                                      | 357                             | 132      |
| Dividends paid by joint ventures  | (1,636)                         | (192)    |
| Long-term debt payments   | —                               | (18)     |
| Net cash used in financing activities   | (1,279)                         | (78)     |
| Effect of exchange rate changes on cash and cash equivalents                      | 168                             | —        |
| Net increase (decrease) in cash and cash equivalents                              | (451)                           | 3,673    |
| Cash and cash equivalents at the beginning of the period                          | 23,724                          | 16,934   |
| Cash and cash equivalents at the end of the period                                | \$23,273                        | \$20,607 |

See accompanying notes to condensed consolidated financial statements.





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AXT, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Basis of Presentation

The accompanying condensed consolidated financial statements of AXT, Inc. (“AXT,” the “Company,” “we,” “us,” and “our” refer to AXT, Inc. and all of its consolidated subsidiaries) are unaudited, and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the year-end condensed consolidated balance sheet data was derived from our audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of our management, the unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, considered necessary to present fairly the financial position, results of operations and cash flows of AXT and our consolidated subsidiaries for all periods presented.

Our management has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ materially from those estimates.

The results of operations are not necessarily indicative of the results to be expected in the future or for the full fiscal year. It is recommended that these condensed consolidated financial statements be read in conjunction with our consolidated financial statements and the notes thereto included in our 2010 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the “SEC”) on March 16, 2011.

The condensed consolidated financial statements include the accounts of AXT and our majority-owned subsidiaries. All significant inter-company accounts and transactions have been eliminated. Investments in business entities in which we do not have control, but have the ability to exercise significant influence over operating and financial policies (generally 20-50% ownership), are accounted for by the equity method. For majority-owned subsidiaries, we reflect the noncontrolling interest of the portion we do not own on our Condensed Consolidated Balance Sheets in Equity and in our Condensed Consolidated Statements of Operations.

Note 2. Accounting for Stock-Based Compensation

We account for stock-based compensation in accordance with the provisions of FASB Accounting Standards Codification (“ASC”) topic 718, Compensation-Stock Compensation (“ASC 718”), which established accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at each grant date, based on the fair value of the award, and is recognized as expense over the employee’s requisite service period of the award. All of the Company’s stock compensation is accounted for as an equity instrument. The provisions of ASC 718 apply to all awards granted or modified after the date of adoption which was January 1, 2006. The unrecognized expense of awards not yet vested at the date of adoption will be recognized in net income (loss) in the periods after the date of adoption using the same Black-Scholes valuation method and assumptions determined under the original provisions of ASC 718.

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We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted both before and after the adoption of ASC 718. The following table summarizes compensation costs related to our stock-based compensation awards (in thousands, except per share data):

|  | Three Months Ended |            |
|--|--------------------|------------|
|  | March 31,          |            |
|  | 2011               | 2010       |
| Stock-based compensation in the form of employee stock options, included in: |                    |            |
| Cost of revenue  | \$ 20              | \$ 10      |
| Selling, general and administrative  | 176                | 97         |
| Research and development   | 11                 | 7          |
| <b>Total stock-based compensation</b>  | <b>207</b>         | <b>114</b> |
| Tax effect on stock-based compensation                                       | —                  | —          |
| Net effect on net income   | \$ 207             | \$ 114     |
| Effect on net income attributable to AXT, Inc. per common share:             |                    |            |
| Basic  | \$ 0.01            | \$ 0.00    |
| Diluted  | \$ 0.01            | \$ 0.00    |

The amortization of stock compensation under ASC 718 for the period after our January 1, 2006 adoption is based on the single-option approach.

As of March 31, 2011, the compensation costs related to unvested stock options granted to employees under our stock option plan but not yet recognized was approximately \$1.4 million, net of estimated forfeitures of \$159,000. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 2.7 years and will be adjusted for subsequent changes in estimated forfeitures. We elected not to capitalize any stock-based compensation to inventory as of March 31, 2011 due to the immateriality of the amount.

We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of ASC 718. There were no stock option grants made in the three months ended March 31, 2011 and 2010.

The following table summarizes the stock option transactions during the three months ended March 31, 2011 (in thousands, except per share data):

| Stock Options                 | Shares | Weighted-average Exercise Price | Weighted-average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|-------------------------------|--------|---------------------------------|--|---------------------------|
| Balance as of January 1, 2011 | 2,280  | \$3.10                          |  |                           |
| Granted                       | —      | —                               |  |                           |

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|  |       |        |      |         |
|--|-------|--------|------|---------|
| Exercised  | (100  | )      | 3.57 |         |
| Canceled and expired                                     | —     |        | —    |         |
| Balance as of March 31, 2011                             | 2,180 | \$3.08 | 6.37 | \$9,348 |
| Options vested and expected to vest as of March 31, 2011 | 2,097 | \$3.05 | 6.27 | \$9,066 |
| Options exercisable as of March 31, 2011                 | 1,259 | \$2.68 | 4.62 | \$6,077 |

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The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing price of \$7.17 on March 31, 2011, which would have been received by the option holder had all option holders exercised their options on that date. The total number of in-the-money options exercisable as of March 31, 2011 was 1,215,459.

The options outstanding and exercisable as of March 31, 2011 were in the following exercise price ranges:

| Options Outstanding as of March 31, 2011 |           |                                 |   | Options Exercisable as of March 31, 2011 |                                 |
|--|-----------|---------------------------------|---|--|---------------------------------|
| Range of Exercise Price                  | Shares    | Weighted-average Exercise Price | Weighted-average Remaining Contractual Life | Shares                                   | Weighted-Average Exercise Price |
| \$1.18 - \$1.33                          | 231,174   | \$ 1.26                         | 3.90  | 231,174                                  | \$ 1.26                         |
| \$1.34 - \$1.40                          | 191,494   | \$ 1.38                         | 2.41  | 191,494                                  | \$ 1.38                         |
| \$1.59 - \$1.59                          | 421,508   | \$ 1.59                         | 8.09  | 206,889                                  | \$ 1.59                         |
| \$1.88 - \$1.98                          | 15,000    | \$ 1.93                         | 4.09  | 15,000                                   | \$ 1.93                         |
| \$2.04 - \$2.04                          | 459,900   | \$ 2.04                         | 8.57  | 153,969                                  | \$ 2.04                         |
| \$2.19 - \$3.11                          | 273,109   | \$ 2.39                         | 1.89  | 273,109                                  | \$ 2.39                         |
| \$3.14 - \$5.09                          | 84,418    | \$ 4.49                         | 5.37  | 83,012                                   | \$ 4.48                         |
| \$5.83 - \$5.83                          | 365,750   | \$ 5.83                         | 9.34  | 0  | \$ 0.00                         |
| \$6.31 - \$12.12                         | 127,730   | \$ 7.53                         | 5.59  | 94,812                                   | \$ 7.62                         |
| \$39.80 - \$39.80                        | 10,000    | \$ 39.80                        | 0.14  | 10,000                                   | \$ 39.80                        |
|  | 2,180,083 | \$ 3.08                         | 6.37  | 1,259,459                                | \$ 2.68                         |

There were 100,178 and 90,159 options exercised in the three months ended March 31, 2011 and 2010, respectively. The total intrinsic value of options exercised for the three months ended March 31, 2011 and 2010 was \$637,000 and \$165,000, respectively. Cash received from options exercised for the three months ended March 31, 2011 and 2010 was \$357,000 and \$132,000, respectively.

#### Restricted stock awards

A summary of activity related to restricted stock awards for the three months ended March 31, 2011 is presented below:

| Stock Awards                     | Shares  | Weighted-Average Grant Date Fair Value |
|----------------------------------|---------|--|
| Non-vested as of January 1, 2011 | 218,405 | \$ 3.30                                |
| Granted                          | —       | \$ —                                   |
| Vested                           | —       | \$ —                                   |
| Non-vested as of March 31, 2011  | 218,405 | \$ 3.30                                |

As of March 31, 2011, we had \$556,000 of unrecognized compensation expense related to restricted stock awards, which will be recognized over the weighted average period of 2.05 years. During the three months ended March 31, 2011, no shares of restricted stock awards vested.

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## Note 3. Investments and Fair Value Measurements

Our cash, cash equivalents and investments are classified as follows (in thousands):

|  | March 31, 2011    |                             |                               | December 31, 2010 |                   |                             |                               |               |
|--|-------------------|-----------------------------|-------------------------------|-------------------|-------------------|-----------------------------|-------------------------------|---------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>(Loss) | Fair<br>Value     | Amortized<br>Cost | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>(Loss) | Fair<br>Value |
| Classified as:                                     |                   |                             |                               |                   |                   |                             |                               |               |
| Cash   | \$19,777          | \$ —                        | \$ —                          | \$19,777          | \$22,736          | \$ —                        | \$ —                          | \$22,736      |
| Cash equivalents:                                  |                   |                             |                               |                   |                   |                             |                               |               |
| Money market fund                                  | 3,496             | —                           | —                             | 3,496             | 988               | —                           | —                             | 988           |
| Total cash<br>equivalents                          | 3,496             | —                           | —                             | 3,496             | 988               | —                           | —                             | 988           |
| Total cash and cash<br>equivalents                 | 23,273            | —                           | —                             | 23,273            | 23,724            | —                           | —                             | 23,724        |
| Investments:                                       |                   |                             |                               |                   |                   |                             |                               |               |
| Certificates of<br>deposit                         | 3,121             | 12                          | (3 )                          | 3,130             | 3,360             | 11                          | —                             | 3,371         |
| US Treasury and<br>agency securities               | 3,780             | —                           | (8 )                          | 3,772             | 4,903             | 8                           | (2 )                          | 4,909         |
| Corporate bonds                                    | 8,300             | 8                           | (29 )                         | 8,279             | 8,961             | 10                          | —                             | 8,971         |
| Total investments                                  | 15,201            | 20                          | (40 )                         | 15,181            | 17,224            | 29                          | (2 )                          | 17,251        |
| Total cash, cash<br>equivalents and<br>investments | \$38,474          | \$ 20                       | \$ (40 )                      | \$38,454          | \$40,948          | \$ 29                       | \$ (2 )                       | \$40,975      |
| Contractual<br>maturities on<br>investments:       |                   |                             |                               |                   |                   |                             |                               |               |
| Due within 1 year                                  | \$4,745           |                             |                               | \$4,756           | \$10,074          |                             |                               | \$10,079      |
| Due after 1 through 5<br>years                     | 10,456            |                             |                               | 10,425            | 7,150             |                             |                               | 7,172         |
|  | \$15,201          |                             |                               | \$15,181          | \$17,224          |                             |                               | \$17,251      |

We manage our investments as a single portfolio of highly marketable securities that is intended to be available to meet our current cash requirements. We have no investments in auction rate securities. For the three months ended March 31, 2011 and 2010, the proceeds from sales of available-for-sale securities were \$11.9 million and \$6.1 million, respectively and we had a gross realized loss of \$4,000 and a gross realized gain of \$120,000, respectively.

The gross unrealized losses related to our portfolio of available-for-sale securities were primarily due to changes in interest rates and market and credit conditions of the underlying securities. We have determined that the gross unrealized losses on some of our available-for-sale securities as of March 31, 2011 are temporary in nature. We periodically reviewed our investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.

The following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of March 31, 2011 (in thousands):

|                                      | In Loss Position<br>< 12 months |                               | In Loss Position<br>> 12 months |                               | Total In<br>Loss Position |                               |
|--------------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------|-------------------------------|
|                                      | Fair<br>Value                   | Gross<br>Unrealized<br>(Loss) | Fair<br>Value                   | Gross<br>Unrealized<br>(Loss) | Fair<br>Value             | Gross<br>Unrealized<br>(Loss) |
| Investments:                         |                                 |                               |                                 |                               |                           |                               |
| Certificates of deposit              | \$957                           | \$(3 )                        | \$—                             | \$—                           | \$957                     | \$(3 )                        |
| US Treasury and agency<br>securities | 3,772                           | (8 )                          | —                               | —                             | 3,772                     | (8 )                          |
| Corporate bonds                      | 6,711                           | (29 )                         | —                               | —                             | 6,711                     | (29 )                         |
| Total in loss position               | \$11,440                        | \$(40 )                       | \$—                             | \$—                           | \$11,440                  | \$(40 )                       |

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## Investments in Privately-held Companies

We have made strategic investments in private companies located in China in order to gain access at a competitive cost to raw materials that are critical to our substrate business (see Note 9). The investment balances for the two companies accounted for under the equity method are included in “other assets” in the condensed consolidated balance sheets and totaled \$4.6 million and \$4.5 million as of March 31, 2011 and December 31, 2010, respectively. We also maintain minority investments in four and three other unconsolidated privately-held companies as of March 31, 2011 and December 31, 2010, respectively. As of March 31, 2011 and December 31, 2010, our investments in these unconsolidated privately-held companies had a carrying value of \$1.2 million and \$733,000, respectively, and are included in “other assets” in the condensed consolidated balance sheets.

## Fair Value Measurements

On January 1, 2008, we adopted ASC topic 820, Fair Value Measurements and Disclosures (“ASC 820”) which defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. ASC 820 applies whenever other statements require or permit assets or liabilities to be measured at fair value. ASC 820 applies to all financial assets and financial liabilities that are being measured and reported on a fair value basis and requires disclosure that establishes a framework for measuring fair value and expands disclosure about fair value measurements.

Our financial assets and liabilities are valued using market prices on both active markets (Level 1) and less active markets (Level 2). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets. Level 2 instrument valuations are obtained from readily-available pricing sources for comparable instruments. Level 3 instrument valuations are obtained from unobservable inputs in which there is little or no market data, which require us to develop our own assumptions. As of March 31, 2011, we did not have any Level 3 assets or liabilities. This hierarchy requires us to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, we measure certain financial assets and liabilities at fair value, primarily including our marketable securities.

Our cash equivalents and investment instruments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The type of instrument valued based on quoted market prices in active markets include money market funds, which are generally classified within Level 1 of the fair value hierarchy.

The types of instruments valued based on other observable inputs include investment-grade corporate bonds and US Treasury and agency securities. Such instruments are generally classified within Level 2 of the fair value hierarchy.

The following table summarizes our financial assets and liabilities measured at fair value on a recurring basis in accordance with ASC 820 as of March 31, 2011 (in thousands):

|                                   | Balance as of<br>March 31, 2011 | Quoted Prices in<br>Active Markets of<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) |
|-----------------------------------|---------------------------------|--|--|
| Assets:                           |                                 |  |  |
| Cash equivalents and investments: |                                 |  |  |
| Money market fund                 | \$ 3,496                        | \$ 3,496   | \$ —   |
| Certificates of deposit           | 3,130                           | —  | 3,130  |
| US Treasury and agency securities | 3,772                           | —  | 3,772  |

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|                 |           |          |           |
|-----------------|-----------|----------|-----------|
| Corporate bonds | 8,279     | —        | 8,279     |
| Total           | \$ 18,677 | \$ 3,496 | \$ 15,181 |
| Liabilities     | \$ —      | \$ —     | \$ —      |

Items Measured at Fair Value on a Nonrecurring Basis

Certain assets that are subject to nonrecurring fair value measurements are not included in the table above. These assets include investments in privately-held companies accounted for by equity and cost method (See Note 9). We did not record other-than-temporary impairment charges for either of these investments during the three months ended March 31, 2011 and 2010.



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## Note 4. Inventories

The components of inventories are summarized below (in thousands):

|                 | March 31,<br>2011 | December 31,<br>2010 |
|-----------------|-------------------|----------------------|
| Inventories:    |                   |                      |
| Raw materials   | \$ 19,977         | \$ 16,477            |
| Work in process | 15,010            | 15,839               |
| Finished goods  | 4,760             | 3,670                |
|                 | \$ 39,747         | \$ 35,986            |

## Note 5. Accrued Liabilities

The components of accrued liabilities are summarized below (in thousands):

|  | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| Accrued compensation and related charges | \$ 1,244          | \$ 1,694             |
| Current portion of royalty payments      | 1,375             | 1,622                |
| Accrued product warranty                 | 798               | 740                  |
| Accrued income taxes                     | 846               | 516                  |
| Other accrued liabilities                | 2,853             | 3,173                |
|  | \$ 7,116          | \$ 7,745             |

## Note 6. Net Income Per Share

Basic net income per share is computed using the weighted average number of common shares outstanding during the periods less shares of common stock subject to repurchase and non-vested stock awards. Diluted net income per share is computed using the weighted average number of common shares outstanding and potentially dilutive common shares outstanding during the periods. The dilutive effect of outstanding stock options and restricted stock awards is reflected in diluted earnings per share by application of the treasury stock method. Potentially dilutive common shares consist of common shares issuable upon the exercise of stock options. Potentially dilutive common shares are excluded in net loss periods, as their effect would be anti-dilutive.

A reconciliation of the numerators and denominators of the basic and diluted net income per share calculations is as follows (in thousands, except per share data):

|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2011                            | 2010     |
| Numerator:                                  |                                 |          |
| Net income attributable to AXT, Inc.        | \$ 4,208                        | \$ 2,580 |
| Less: Preferred stock dividends             | (44 )                           | (44 )    |
| Net income available to common stockholders | \$ 4,164                        | \$ 2,536 |
| Denominator:                                |                                 |          |
|   | 31,718                          | 30,743   |

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Denominator for basic net income per share - weighted average common shares

Effect of dilutive securities:

|  |         |         |
|--|---------|---------|
| Common stock options   | 1,324   | 920     |
| Restricted stock awards  | 157     | 129     |
| Denominator for dilutive net income per common share                                       | 33,199  | 31,792  |
| Net income attributable to AXT, Inc. per common share:                                     |         |         |
| Basic  | \$ 0.13 | \$ 0.08 |
| Diluted  | \$ 0.13 | \$ 0.08 |
| Options excluded from diluted net income per share as the impact is anti-dilutive          | 65      | 366     |
| Restricted stock excluded from diluted net income per share as the impact is anti-dilutive | 218     | 171     |

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The 883,000 shares of \$0.001 par value Series A preferred stock issued and outstanding as of March 31, 2011 and December 31, 2010, valued at \$3,532,000 are non-voting and non-convertible preferred stock with a 5.0% cumulative annual dividend rate payable when declared by the board of directors and \$4 per share liquidation preference over common stock, and must be paid before any distribution is made to common stockholders. These preferred shares were issued to Lyte Optronics, Inc. stockholders in connection with the completion of our acquisition of Lyte Optronics, Inc. on May 28, 1999.

## Note 7. Stockholders' Equity and Other Comprehensive Income (Loss)

## Consolidated Statements of Changes in Equity

|   | Preferred Stock | Common Stock | Additional Paid In Capital | Accumulated Deficit | Other Comprehensive Income/(loss) | AXT, Inc. stockholders' equity | Noncontrolling interests | Total stockholders' equity |
|---|-----------------|--------------|----------------------------|---------------------|-----------------------------------|--------------------------------|--------------------------|----------------------------|
| Balance as of December 31, 2010                           | \$ 3,532        | \$ 32        | \$ 190,021                 | \$ (82,477)         | \$ 4,652                          | \$ 115,760                     | \$ 4,044                 | \$ 119,804                 |
| Common stock options exercised                            |                 |              | 357                        |                     |                                   | 357                            |                          | 357                        |
| Stock-based compensation                                  |                 |              | 207                        |                     |                                   | 207                            |                          | 207                        |
| Comprehensive income (loss):                              |                 |              |                            |                     |                                   |                                |                          |                            |
| Net income  |                 |              |                            | 4,208               |                                   | 4,208                          | 1,079                    | 5,287                      |
| Dividend declared by joint ventures                       |                 |              |                            |                     |                                   |                                | (1,636)                  | (1,636)                    |
| Change in unrealized (loss) gain on marketable securities |                 |              |                            |                     | (47)                              | (47)                           |                          | (47)                       |
| Currency translation adjustment                           |                 |              |                            |                     | 115                               | 115                            | 43                       | 158                        |
| Balance as of March 31, 2011                              | \$ 3,532        | \$ 32        | \$ 190,585                 | \$ (78,269)         | \$ 4,720                          | \$ 120,600                     | \$ 3,530                 | \$ 124,130                 |

The components of comprehensive income (loss) are as follows (in thousands):

|  | Three Months Ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2011                            | 2010     |
| Net income attributable to AXT, Inc  | \$ 4,208                        | \$ 2,580 |
| Other comprehensive income, net of tax:  |                                 |          |
| Change in foreign currency translation gain (loss), net of tax                 | 158                             | (205)    |
| Change in unrealized gain (loss) on available-for-sale investments, net of tax | (47)                            | (19)     |

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|  |          |          |
|--|----------|----------|
| Total other comprehensive income, net of tax                           | 111      | (224 )   |
| Comprehensive income   | 4,319    | 2,356    |
| Less: Comprehensive income attributable to the noncontrolling interest | (43 )    | —        |
| Comprehensive income attributable to AXT, Inc.                         | \$ 4,276 | \$ 2,356 |

Note 8. Segment Information and Foreign Operations

Segment Information

We operate in one segment for the design, development, manufacture and distribution of high-performance compound semiconductor substrates and sale of materials. In accordance with ASC topic 280, Segment Reporting, our chief operating decision-maker has been identified as the Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the Company. Since we operate in one segment, all financial segment and product line information can be found in the condensed consolidated financial statements.

Product Information

|                          | Three Months Ended |           |
|--------------------------|--------------------|-----------|
|                          | March 31,          |           |
|                          | 2011               | 2010      |
| Revenue by product type: |                    |           |
| GaAs substrates          | \$ 15,892          | \$ 13,434 |
| InP substrates           | 1,332              | 875       |
| Ge substrates            | 2,990              | 1,640     |
| Raw materials and other  | 4,352              | 2,692     |
| Total                    | \$ 24,566          | \$ 18,641 |

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## Geographical Information

The following table represents revenue amounts (in thousands) reported for products shipped to customers in the corresponding geographic region:

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2011                            | 2010      |
| Net revenues:                             |                                 |           |
| North America*                            | \$ 3,792                        | \$ 4,531  |
| Europe                                    | 5,184                           | 3,768     |
| Japan                                     | 3,028                           | 2,778     |
| Taiwan                                    | 2,864                           | 2,582     |
| Asia Pacific (excluding Japan and Taiwan) | 9,698                           | 4,982     |
| Total                                     | \$ 24,566                       | \$ 18,641 |

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\*Primarily the United States

Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Long-lived assets by geographic region were as follows (in thousands):

|   | As of             |                      |
|---|-------------------|----------------------|
|   | March 31,<br>2011 | December 31,<br>2010 |
| Long-lived assets by geographic region: |                   |                      |
| North America                           | \$ 594            | \$ 543               |
| China                                   | 25,579            | 23,697               |
|   | \$ 26,173         | \$ 24,240            |

## Significant Customers

One customer represented more than 10% of revenue at 15.9% for the three months ended March 31, 2011 while one customer represented more than 10% of revenue at 16.1% for the three months ended March 31, 2010. Our top five customers represented 36.5% and 39.6% of revenue for the three months ended March 31, 2011 and 2010, respectively.

We perform ongoing credit evaluations of our customers' financial condition, and limit the amount of credit extended when deemed necessary, but generally do not require collateral. Two customers accounted for 10% or more of our trade accounts receivable balance as of March 31, 2011 at 27.5% and 12.0%, respectively. One customer accounted for 10% or more of our trade accounts receivable balance as of December 31, 2010 at 30%.

## Note 9. Investments in Privately-held Companies

We have made strategic investments in private companies located in China in order to gain access to raw materials at a competitive cost that are critical to our substrate business.

Our investments are summarized below (in thousands):

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| Company   | Investment Balance as of |                   | Accounting Method | Ownership Percentage |   |
|---|--------------------------|-------------------|-------------------|----------------------|---|
|   | March 31, 2011           | December 31, 2010 |                   |                      |   |
| Beijing JiYa Semiconductor Material Co., Ltd                    | \$ 996                   | \$ 996            | Consolidated      | 46                   | % |
| Nanjing Jin Mei Gallium Co., Ltd                                | 592                      | 592               | Consolidated      | 83                   | % |
| Beijing BoYu Semiconductor Vessel Craftwork Technology Co., Ltd | 410                      | 410               | Consolidated      | 70                   | % |
| Xilingol Tongli Germanium Co. Ltd                               | 3,492                    | 3,437             | Equity            | 25                   | % |
| Emeishan Jia Mei High Purity Metals Co., Ltd                    | 1,073                    | 1,055             | Equity            | 25                   | % |

Our ownership of Beijing Ji Ya Semiconductor Material Co., Ltd. (JiYa) is 46%. We continue to consolidate JiYa as we have significant influence in management and have a majority control of the board. Our Chief Executive Officer is chairman of the JiYa board, while our president of China operations and our vice president of China administration and our vice president of wafer production are also members of the JiYa board.

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Our ownership of Nanjing Jin Mei Gallium Co., Ltd. (Jin Mei) is 83%. We continue to consolidate Jin Mei as we have significant influence in management and have a majority control of the board. Our Chief Executive Officer is chairman of the Jin Mei board, while our president of China operations and our vice president of China administration are also members of the Jin Mei board.

Our ownership of Beijing BoYu Semiconductor Vessel Craftwork Technology Co., Ltd (BoYu) is 70%. We continue to consolidate Bo Yu as we have a significant influence in management and have a majority control of the board. Our Chief Executive Officer is chairman of the BoYu board, while our president of China operations and our vice president of China administration are also members of the BoYu board.

Although we have representation on the boards of directors of each of these companies, the daily operations of each of these companies are managed by local management and not by us. Decisions concerning their respective short term strategy and operations, any capacity expansion and annual capital expenditures, and decisions concerning sales of finished product, are made by local management without input from us.

During the three months ended March 31, 2011 and 2010, the three consolidated joint ventures generated \$2.6 million and \$500,000 of income, respectively, of which \$1.1 million and \$130,000, respectively was allocated to minority interests, resulting in \$1.5 million and \$370,000, respectively to our net income.

The investment balances for the two companies accounted for under the equity method are included in “other assets” in the condensed consolidated balance sheets and totaled \$4.6 million and \$4.5 million as of March 31, 2011 and December 31, 2010, respectively. We own 25% of the ownership interests in each of these companies. These two companies are not considered variable interest entities because:

both companies have sustainable businesses of their own;

our voting power is proportionate to our ownership interests;

we only recognize our respective share of the losses and/or residual returns generated by the companies if they occur; and

we do not have controlling financial interest in, do not maintain operational or management control of, do not control the board of directors of, and are not required to provide additional investment or financial support to either company.

Our equity earnings from the two-minority owned joint ventures that are not consolidated are recorded as other income (loss), net and totaled \$73,000 and \$21,000 for the three months ended March 31, 2011 and 2010, respectively. Undistributed retained earnings relating to all our investments in these companies were \$17.9 million and \$16.3 million as of March 31, 2011 and December 31, 2010, respectively.

Our two minority-owned joint ventures that are not consolidated and accounted for under the equity method had the following summarized income information (in thousands) for the three months ended March 31, 2011 and 2010.

|              | Three Months Ended<br>March 31, |          |
|--------------|---------------------------------|----------|
|              | 2011                            | 2010     |
| Net Sales    | \$ 3,304                        | \$ 3,338 |
| Gross profit | 1,359                           | 895      |

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|                  |     |     |
|------------------|-----|-----|
| Operating income | 363 | 123 |
| Net income       | 292 | 82  |

We maintain minority investments directly in two privately-held companies accounted for under the cost method and we do not have the ability to exercise significant influence over their operations. As of March 31, 2011 and December 31, 2010, our investments in these two unconsolidated privately-held companies had a carrying value of \$392,000 and are included in “other assets” in the condensed consolidated balance sheets. We also maintain minority investments indirectly in privately-held companies through one of our consolidated joint ventures. As of March 31, 2011 and December 31, 2010, our consolidated joint venture included the minority investments in “other assets” in the condensed consolidated balance sheets with a carrying value of \$785,000 and \$341,000, respectively.



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## Note 10. Commitments and Contingencies

## Indemnification Agreements

We enter into standard indemnification arrangements in the ordinary course of business. Pursuant to these arrangements, we indemnify, hold harmless, and agree to reimburse the indemnified parties for losses suffered or incurred by the indemnified party, generally their business partners or customers, in connection with any U.S. patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual anytime after the execution of the agreement. The maximum potential amount of future payments we could be required to make under these agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal.

We have entered into indemnification agreements with our directors and officers that may require us to indemnify our directors and officers against liabilities that may arise by reason of their status or service as directors or officers, other than liabilities arising from willful misconduct of a culpable nature; to advance their expenses incurred as a result of any proceeding against them as to which they could be indemnified; and to obtain directors' and officers' insurance if available on reasonable terms, which we currently have in place.

## Product Warranty

We warrant our products for a specific period of time, generally twelve months, against material defects. We provide for the estimated future costs of warranty obligations in cost of sales when the related revenue is recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that we expect to incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. On a quarterly basis, we review the accrued balances and update these based on the historical warranty cost trends. The following table reflects the change in our warranty accrual which is included in "accrued liabilities" on the condensed consolidated balance sheets, during the three months ended March 31, 2011 and 2010 (in thousands):

|  | Three Months Ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2011                            | 2010     |
| Beginning accrued warranty and related costs | \$ 740                          | \$ 1,082 |
| Charged to cost of revenue                   | 58                              | 60       |
| Actual warranty expenditures                 | —                               | (56 )    |
| Ending accrued warranty and related costs    | \$ 798                          | \$ 1,086 |

## Contractual Obligations

We lease certain office space, manufacturing facilities and equipment under long-term operating leases expiring at various dates through February 2014. The lease agreement of the facility at Fremont, California with approximately 27,760 square feet commenced December 1, 2008 for a term of seven years, with an option by us to cancel the lease after five years, upon forfeiture of the security deposit and payment of one-half of the fifth year's rent

We have entered into a royalty agreement with a vendor effective December 3, 2010 with a term of eight years, terminating December 31, 2018. We and our related companies are granted a worldwide, nonexclusive, royalty bearing, irrevocable license to certain patents for the term on the agreement.

Outstanding contractual obligations as of March 31, 2011 are summarized as follows (in thousands):

| Contractual Obligations | Total   | Payments due by period |           |           |                   |
|-------------------------|---------|------------------------|-----------|-----------|-------------------|
|                         |         | Less than 1 year       | 1-3 years | 3-5 years | More than 5 years |
| Operating leases        | \$1,540 | \$ 339                 | \$689     | \$512     | \$—               |
| Royalty agreement       | 6,438   | 1,375                  | 1,938     | 1,544     | 1,581             |
| Total                   | \$7,978 | \$ 1,714               | \$2,627   | \$2,056   | \$1,581           |

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Purchase Obligations

Through the normal course of business, we purchase or place orders for the necessary materials of our products from various suppliers and we commit to purchase products where we may incur a penalty if the agreement was canceled. As of March 31, 2011, we do not have any outstanding material purchase obligations.

Legal Proceedings

From time to time we may be involved in judicial or administrative proceedings concerning matters arising in the ordinary course of business. We do not expect that any of these matters, individually or in the aggregate, will have a material adverse effect on our business, financial condition, cash flows or results of operation.

Note 11. Foreign Exchange Transaction Gains/Losses

We incurred foreign currency transaction exchange losses of \$196,000 and \$68,000 for the three months ended March 31, 2011, and 2010, respectively. These amounts are included in "Other income (expense), net" on the condensed consolidated statements of operations.

Note 12. Income Taxes

In July 2006, the Financial Accounting Standards Board ("FASB") issued ASC topic 740, Income Taxes ("ASC 740"). ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with ASC 740. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted ASC 740 effective January 1, 2007. We recognize interest and penalties related to uncertain tax positions in income tax expense. As of March 31, 2011, we do not have any gross unrecognized tax benefits, nor any accrued interest and penalties related to uncertain tax positions. As a result of the implementation of ASC 740, we identified \$16.4 million in the liability for unrecognized tax benefits. Of this amount, none was accounted for as a reduction to the January 1, 2007 balance of retained earnings. The amount decreased the tax loss carry-forwards in the U.S. which are fully offset by a valuation allowance. We file income tax returns in the U.S. federal, various states and foreign jurisdictions. We have substantially concluded all U.S. federal and state income tax matters through December 31, 2008. There was no Federal U.S. tax expense during three months ended March 31, 2011 due to the valuation allowance being utilized.

Note 13. Recent Accounting Pronouncements

There have been no new accounting pronouncements during the three months ended March 31, 2011, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2010, that are of material significance, or potential significance, to the Company.

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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, including the following sections, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, particularly statements relating to our expectations regarding results of operations, customer demand, our ability to expand our markets and increase sales, industry trends, customer qualifications of our products, gross margins, the impact of the adoption of certain accounting pronouncements, our investments in capital projects, and our belief that we have adequate cash and investments to meet our needs over the next 12 months. These forward-looking statements are based upon management's current views with respect to future events and financial performance, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated in such forward-looking statements. Such risks and uncertainties include those set forth under the section entitled "Risk Factors" below, which identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in this Form 10-Q and other filings we have made with the Securities and Exchange Commission. Forward-looking statements may be identified by the use of terms such as "anticipates," "believes," "estimates," "expects," "intends," and similar expressions. Statements concerning our future or expected financial results and condition, business strategy and plans or objectives for future operations are forward-looking statements.

These forward-looking statements are not guarantees of future performance. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. This discussion should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2010 and the condensed consolidated financial statements included elsewhere in this report.

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## Overview

We are a leading developer and producer of high-performance compound and single element semiconductor substrates comprising gallium arsenide (GaAs), indium phosphide (InP) and germanium (Ge). We currently sell the following substrate products in the sizes and for the applications indicated:

| Substrates             | Product | Diameter           | Applications  |
|------------------------|---------|--------------------|---|
| GaAs (semi-insulating) |         | 2", 3", 4", 5", 6" | Power amplifiers and radio frequency integrated circuits for wireless handsets (cell phones)<br>Direct broadcast television<br>High-performance transistors<br>Satellite communications |
| GaAs (semi-conducting) |         | 2", 3", 4"         | High brightness light emitting diodes<br>Lasers<br>Optical couplers   |
| InP                    |         | 2", 3", 4"         | Broadband and fiber optic communications  |
| Ge                     |         | 2", 4", 6"         | Satellite and terrestrial solar cells<br>Optical applications   |

We manufacture all of our semiconductor substrates using our proprietary vertical gradient freeze (VGF) technology. Most of our revenue is from sales of GaAs substrates. We manufacture all of our products in the People's Republic of China (PRC or China), which generally has favorable costs for facilities and labor compared to comparable facilities in the United States, Europe or Japan. We also have five joint ventures in China which provide us pricing advantages, reliable supply and enhanced sourcing lead-times for key raw materials which are central to our final manufactured products. These joint ventures produce products including 99.99% pure gallium (4N Ga), high purity gallium, arsenic, germanium, germanium dioxide, paralytic boron nitride (pBN) crucibles and boron oxide. AXT's ownership interest in these entities ranges from 25% to 83%. We consolidate, for accounting purposes, three of these joint ventures in which we own a majority or controlling financial interest and employ equity accounting for the two joint ventures in which we have a 25% interest in each. We purchase portions of the materials produced by these ventures for our own use and the joint ventures sell the remainder of their production to third parties. We use our direct sales force in the United States and independent sales representatives in Europe and Asia to market our substrates. We believe that, as the demand for compound semiconductor substrates is expected to increase, we are positioned to leverage our PRC-based manufacturing capabilities and access to favorably priced raw materials to increase our market share.

We believe positive industry trends in the wireless device, LED and solar cell markets, as well as increased demand worldwide in 2010, and continued advantages in our manufacturing and cost structure will allow us to continue to drive positive results in our business in 2011. Our qualification efforts to qualify as an approved supplier for our customers in both gallium arsenide and germanium substrates have been successful and we are pleased with our increasing diversification in these areas. While the volatile business and financial markets are prompting us to continue to take a conservative approach to our business, we remain optimistic about our business.

## Critical Accounting Policies and Estimates

We prepared our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. As such, we make estimates, assumptions and judgments that affect the amounts reported on our financial statements. These estimates, assumptions and judgments about future events and their effects on our results cannot be determined with certainty, and are made based upon our historical experience and on other assumptions that are believed to be reasonable under the circumstances. These estimates may change as new events occur or additional information is obtained, and we may periodically be faced with uncertainties, the outcomes of which are not within our control and may not be known for a prolonged period of time. The discussion and analysis of our results of operations and financial condition are based upon these condensed consolidated financial statements.

We have identified the policies below as critical to our business operations and understanding of our financial condition and results of operations. A critical accounting policy is one that is both material to the presentation of our financial statements and requires us to make difficult, subjective or complex judgments that could have a material effect on our financial condition and results of operations. They may require us to make assumptions about matters that are highly uncertain at the time of the estimate, and different estimates that we could have used, or changes in the estimate that are reasonably likely to occur, may have a material impact on our financial condition or results of operations.

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### Revenue Recognition

We manufacture and sell high-performance compound semiconductor substrates and sell certain raw materials including gallium, germanium dioxide, and pBN crucibles. After we ship our products, there are no remaining obligations or customer acceptance requirements that would preclude revenue recognition. Our products are typically sold pursuant to a purchase order placed by our customers, and our terms and conditions of sale do not require customer acceptance. We recognize revenue upon shipment and transfer of title of products to our customers, which is either upon shipment from our dock, receipt at the customer's dock, or removal from consignment inventory at the customer's location, provided that we have received a signed purchase order, the price is fixed or determinable, title and risk of ownership have transferred, collection of resulting receivables is probable, and product returns are reasonably estimable. We do not provide training, installation or commissioning services.

We provide for future returns based on historical experience, current economic trends and changes in customer demand at the time revenue is recognized.

### Accounts Receivable and Allowance for Doubtful Accounts

We periodically review the likelihood of collection on our accounts receivable balances and provide an allowance for doubtful accounts receivable primarily based upon the age of these accounts. We provide a 100% allowance for receivables from U.S. customers in excess of 90 days and for receivables from customers located outside the U.S. in excess of 120 days. We assess the probability of collection based on a number of factors, including the length of time a receivable balance has been outstanding, our past history with the customer and their creditworthiness.

As of March 31, 2011 and December 31, 2010, our accounts receivable, net, balance was \$19.2 million and \$23.1 million, respectively, which was net of an allowance for doubtful accounts of \$55,000 and \$99,000, respectively. During three months ended March 31, 2011, we decreased this allowance for doubtful accounts by \$44,000 primarily for improved collections worldwide. If actual uncollectible accounts differ substantially from our estimates, revisions to the estimated allowance for doubtful accounts would be required, which could have a material impact on our financial results for the affected period.

The allowance for sales returns is also deducted from gross accounts receivable. As of March 31, 2011 and December 31, 2010, our allowance for sales returns was \$348,000 and \$462,000, respectively.

### Warranty Reserve

We maintain a warranty reserve based upon our claims experience during the prior twelve months. Warranty costs are accrued at the time revenue is recognized. As of March 31, 2011 and December 31, 2010, accrued product warranties totaled \$798,000 and \$740,000, respectively. If actual warranty costs differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material impact on our financial condition and results of operations.

### Inventory Valuation

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average cost method. Our inventory consists of raw materials as well as finished goods and work-in-process that include material, labor and manufacturing overhead costs. Given the nature of our substrate products, and the materials used in the manufacturing process, the wafers and ingots comprising work-in-process may be held in inventory for up to two years and three years, respectively, as the risk of obsolescence for these materials is low. We routinely evaluate the levels of our inventory in light of current market conditions in order to identify excess and obsolete inventory, and we provide a

valuation allowance for certain inventories based upon the age and quality of the product and the projections for sale of the completed products. As of March 31, 2011 and December 31, 2010, we had an inventory reserve of \$11.8 million and \$11.5 million, respectively, for excess and obsolete inventory. If actual demand for our products were to be substantially lower than estimated, additional inventory adjustments for excess or obsolete inventory might be required, which could have a material impact on our business, financial condition and results of operations.

#### Impairment of Investments

We classify our investments in debt and equity securities as available-for-sale securities in accordance with ASC topic 320, Investments - Debt and Equity Securities ("ASC 320"). All available-for-sale securities with a quoted market value below cost (or adjusted cost) are reviewed in order to determine whether the decline is other-than-temporary. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.



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We invest in equity instruments of privately-held companies for business and strategic purposes. These investments are classified as other assets and are accounted for under the cost method as we do not have the ability to exercise significant influence over their operations. We monitor our investments for impairment and record reductions in carrying value when events or changes in circumstances indicate that the carrying value may not be recoverable. Determination of impairment is highly subjective and is based on a number of factors, including an assessment of the strength of investee's management, the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the investee, fundamental changes to the business prospects of the investee, share prices of subsequent offerings, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in our carrying value.

### Fair Value of Investments

In the current market environment, the assessment of the fair value of debt instruments can be difficult and subjective. Although volume of trading activity of certain debt instruments has increased since 2010, and the rapid changes occurring in today's financial markets can lead to changes in the fair value of financial instruments in relatively short periods of time. ASC 820 establishes three levels of inputs that may be used to measure fair value.

Level 1 instruments represent quoted prices in active markets. Therefore, determining fair value for Level 1 instruments does not require significant management judgment, and the estimation is not difficult.

Level 2 instruments include observable inputs other than Level 1 prices, such as quoted prices for identical instruments in markets with insufficient volume or infrequent transactions (less active markets), issuer credit ratings, non-binding market consensus prices that can be corroborated with observable market data, model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated with observable market data for substantially the full term of the assets or liabilities, or quoted prices for similar assets or liabilities. These Level 2 instruments require more management judgment and subjectivity compared to Level 1 instruments, including:

Determining which instruments are most similar to the instrument being priced requires management to identify a sample of similar securities based on the coupon rates, maturity, issuer, credit rating, and instrument type, and subjectively select an individual security or multiple securities that are deemed most similar to the security being priced.

Determining whether a market is considered active requires management judgment. Our assessment of an active market for our marketable debt instruments generally takes into consideration activity during each week of the one-month period prior to the valuation date of each individual instrument, including the number of days each individual instrument trades and the average weekly trading volume in relation to the total outstanding amount of the issued instrument.

Determining which model-derived valuations to use in determining fair value requires management judgment. When observable market prices for identical securities or similar securities are not available, we price our marketable debt instruments using non-binding market consensus prices that are corroborated with observable market data or pricing models, such as discounted cash flow models, with all significant inputs derived from or corroborated with observable market data.

Level 3 instruments include unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. The determination of fair value for Level 3 instruments requires the most management judgment and subjectivity. As of March 31, 2011, we did not have any assets or liabilities without observable market values that would require a high level of judgment to determine fair value (Level 3 assets).

### Impairment of Long-Lived Assets

We evaluate the recoverability of property, equipment and intangible assets in accordance with ASC topic 360, Impairment of Disposal of Long-Lived Assets (“ASC 360”). When events and circumstances indicate that long-lived assets may be impaired, we compare the carrying value of the long-lived assets to the projection of future undiscounted cash flows attributable to these assets. In the event that the carrying value exceeds the future undiscounted cash flows, we record an impairment charge against income equal to the excess of the carrying value over the assets’ fair value. Fair values are determined based on quoted market values, discounted cash flows or internal and external appraisals, as applicable.

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## Stock-based Compensation

We grant options to substantially all management employees and believe that this program helps us to attract, motivate and retain high quality employees, to the ultimate benefit of our stockholders. We account for stock-based compensation in accordance with ASC topic 718, Stock-based Compensation (“ASC 718”), using the modified prospective method. We utilize the Black-Scholes option pricing model to estimate the grant date fair value of employee stock compensation awards, which requires the input of highly subjective assumptions, including expected volatility and expected term. Historical volatility was used in estimating the fair value of our stock options awards, while the expected term for our options was estimated based on historical option exercise behavior and post-vesting forfeitures of options by our employees. Further, we estimate forfeitures for stock compensation awards that are not expected to vest. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our stock compensation.

We recognize the compensation costs net of an estimated forfeiture rate over the requisite service period of the options award, which is generally the vesting term of four years. The cost of restricted stock awards is determined using the fair value of our common stock on the date of grant. Compensation expense for restricted stock awards is recognized over the vesting period, which is generally three years or four years. Stock-based compensation expense is recorded in cost of revenue, research and development, and selling, general and administrative expenses.

## Income Taxes

We account for income taxes in accordance with ASC topic 740, Income Taxes (“ASC 740”) which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. ASC 740 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized.

We provide for income taxes based upon the geographic composition of worldwide earnings and tax regulations governing each region, particularly China. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws, particularly in foreign countries such as China.

See Note 12—“Income Taxes” in the notes to condensed financial statements for additional information.

## Results of Operations

## Revenue

|               | Three Months Ended |                   | Increase<br>(Decrease) | % Change |
|---------------|--------------------|-------------------|------------------------|----------|
|               | 2011               | March 31,<br>2010 |                        |          |
|               | (\$ in thousands)  |                   |                        |          |
| GaAs          | \$ 15,892          | \$ 13,434         | \$ 2,458               | 18.3 %   |
| InP           | 1,332              | 875               | 457                    | 52.2 %   |
| Ge            | 2,990              | 1,640             | 1,350                  | 82.3 %   |
| Raw materials | 4,352              | 2,692             | 1,660                  | 61.6 %   |
| Total revenue | \$ 24,566          | \$ 18,641         | \$ 5,925               | 31.8 %   |

Revenue increased \$5.9 million, or 31.8%, to \$24.6 million for the three months ended March 31, 2011 from \$18.6 million for the three months ended March 31, 2010. Total GaAs substrate revenue increased \$2.5 million, or 18.3%, to \$15.9 million for the three months ended March 31, 2011 from \$13.4 million for the three months ended March 31, 2010. The increase in revenue was primarily due to the stronger demand environment worldwide compared to the

prior year, particularly in the LED market from Asia and Europe.

Sales of 5 inch and 6 inch diameter GaAs substrates decreased \$731,000 to \$4.6 million for the three months ended March 31, 2011 from \$5.3 million for the three months ended March 31, 2010 primarily due to less than expected orders from a few customers who postponed orders while utilizing excessive inventory in the wireless devices market compared to the same period prior year.

Sales of 2 inch, 3 inch and 4 inch diameter GaAs substrates increased \$3.2 million to \$11.3 million for the three months ended March 31, 2011 from \$8.1 million for the three months ended March 31, 2010. The increase in revenue from smaller diameter substrates was primarily due to the increasing adoption and investment in LED technology in many applications, particularly in Asia and Europe.

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InP substrate revenue increased \$457,000, or 52.2%, to \$1.3 million for the three months ended March 31, 2011 from \$875,000 for the three months ended March 31, 2010 as demand from customers in the optical networking industry increased. We continued to see renewed demand for these substrates as investment in high-speed optical communications increased worldwide.

Ge substrate revenue increased \$1.4 million, or 82.3%, to \$3.0 million for the three months ended March 31, 2011 from \$1.6 million for the three months ended March 31, 2010 due to increased demand for concentrated photovoltaic solar applications from our German and Chinese customers.

Raw materials revenue increased \$1.7 million, or 61.6%, to \$4.4 million for the three months ended March 31, 2011 from \$2.7 million for the three months ended March 31, 2010 primarily due to demand from newly added customers for 4N raw gallium.

## Revenue by Geographic Region

|   | Three Months Ended |          | Increase<br>(Decrease) | % Change |
|---|--------------------|----------|------------------------|----------|
|   | March 31,<br>2011  | 2010     |                        |          |
|   | (\$ in thousands)  |          |                        |          |
| North America *                           | \$3,792            | \$4,531  | \$(739)                | (16.3)%  |
| % of total revenue                        | 15%                | 24%      |                        |          |
| Europe                                    | 5,184              | 3,768    | 1,416                  | 37.6%    |
| % of total revenue                        | 21%                | 20%      |                        |          |
| Japan                                     | 3,028              | 2,778    | 250                    | 9.0%     |
| % of total revenue                        | 12%                | 15%      |                        |          |
| Taiwan                                    | 2,864              | 2,582    | 282                    | 10.9%    |
| % of total revenue                        | 12%                | 14%      |                        |          |
| Asia Pacific (excluding Japan and Taiwan) | 9,698              | 4,982    | 4,716                  | 94.7%    |
| % of total revenue                        | 40%                | 27%      |                        |          |
| Total revenue                             | \$24,566           | \$18,641 | \$5,925                | 31.8%    |

\*Primarily the United States

Revenue from customers in North America decreased by \$739,000, or 16.3%, to \$3.8 million for the three months ended March 31, 2011 from \$4.5 million for the three months ended March 31, 2010 primarily due to less than expected orders from a few customers who postponed orders while utilizing excessive inventory in the wireless devices market compared to the same period prior year.

Revenue from customers in Europe increased by \$1.4 million, or 37.6%, to \$5.2 million for the three months ended March 31, 2011 from \$3.8 million for the three months ended March 31, 2010 primarily due to increased substrate sales to customers in Germany, United Kingdom and Italy. The demand for germanium substrates increased particularly due to increased demand from customers in Germany.

Revenue from customers in Japan increased by \$250,000 or 9.0%, to \$3.0 million for the three months ended March 31, 2011 from \$2.8 million for the three months ended March 31, 2010. The increase came primarily from increased substrate sales to new and existing customers in small diameter wafers, offset by decreased sales in large diameter wafers and raw material sales of 4N gallium to existing customers.

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Revenue from customers in Taiwan increased by \$282,000, or 10.9%, to \$2.9 million for the three months ended March 31, 2011 from \$2.6 million for the three months ended March 31, 2010. The increase came mainly from increased sales in 3” diameter wafers and in InP substrates sales to existing customers.

Revenue from customers in Asia Pacific (excluding Japan and Taiwan) increased by \$4.7 million, or 94.7%, to \$9.7 million for the three months ended March 31, 2011 from \$5.0 million for the three months ended March 31, 2010. The increase came from several new and existing customers in China for both raw materials and substrates, and from increased demand for large diameter wafer from one major customer in Singapore.

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## Gross Margin

|                     | Three Months Ended<br>March 31, |         | Increase<br>(Decrease) | % Change |
|---------------------|---------------------------------|---------|------------------------|----------|
|                     | 2011                            | 2010    |                        |          |
|                     | (\$ in thousands)               |         |                        |          |
| Gross profit (loss) | \$10,660                        | \$6,732 | \$3,928                | 58.3 %   |
| Gross Margin %      | 43.4                            | % 36.1  | %                      |          |

Gross margin increased to 43.4% of total revenue for the three months ended March 31, 2011 from 36.1% of total revenue for the three months ended March 31, 2010. Sales product mix, and process improvements in production such as longer ingots and first pass yield improvements in ingots continued to contribute a higher gross profit for the three months ended March 31, 2011. During the three months ended March 31, 2011, raw material sales increased compared to the same quarter last year and at higher gross margins due to higher selling prices of gallium.

## Selling, General and Administrative Expenses

|  | Three Months Ended<br>March 31, |         | Increase<br>(Decrease) | % Change |
|--|---------------------------------|---------|------------------------|----------|
|  | 2011                            | 2010    |                        |          |
|  | (\$ in thousands)               |         |                        |          |
| Selling, general and administrative expenses | \$3,690                         | \$3,419 | \$271                  | 7.9 %    |
| % of total revenue                           | 15.0                            | % 18.3  | %                      |          |

Selling, general and administrative expenses increased \$271,000, or 7.9% to \$3.7 million for the three months ended March 31, 2011 from \$3.4 million for the three months ended March 31, 2010. The increase was primarily due to higher legal fees associated with a royalty renegotiation and higher labor and related costs from annual increases including stock-based compensation expenses.

## Research and Development

|                          | Three Months Ended<br>March 31, |       | Increase<br>(Decrease) | % Change |
|--------------------------|---------------------------------|-------|------------------------|----------|
|                          | 2011                            | 2010  |                        |          |
|                          | (\$ in thousands)               |       |                        |          |
| Research and development | \$505                           | \$451 | \$54                   | 12.0 %   |
| % of total revenue       | 2.1                             | % 2.4 | %                      |          |

Research and development expenses increased \$54,000, or 12.0% to \$505,000 for the three months ended March 31, 2011 from \$451,000 for the three months ended March 31, 2010. The increase was primarily due to higher labor and relating costs from annual increases.

## Interest Income, net

|                      | Three Months Ended<br>March 31, |       | Increase<br>(Decrease) | % Change |
|----------------------|---------------------------------|-------|------------------------|----------|
|                      | 2011                            | 2010  |                        |          |
|                      | (\$ in thousands)               |       |                        |          |
| Interest income, net | \$87                            | \$15  | \$72                   | 480.0 %  |
| % of total revenue   | 0.4                             | % 0.1 | %                      |          |

Interest income, net increased \$72,000 to \$87,000 for the three months ended March 31, 2011 from \$15,000 for the three months ended March 31, 2010. Interest income, net for the three months ended March 31, 2011 was higher as a

result of interest earned on the different timing of notes maturing.

Other Income (Expense), net

|                             | Three Months Ended |       | Increase<br>(Decrease) | % Change |
|-----------------------------|--------------------|-------|------------------------|----------|
|                             | 2011               | 2010  |                        |          |
|                             | March 31,          |       |                        |          |
|                             | (\$ in thousands)  |       |                        |          |
| Other income (expense), net | \$(363 )           | \$79  | \$(442 )               | NM       |
| % of total revenue          | (1.5 %)            | 0.4 % |                        |          |

NM = % not meaningful



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Other income (expense), net was \$(363,000) for the three months ended March 31, 2011 primarily due to withholding tax on foreign dividends from joint ventures and unrealized foreign exchange losses on our Yen denominated accounts receivable. Other income, net was \$79,000 for the three months ended March 31, 2010 primarily due to a realized gain on the sale of short-term investments held by us partially offset by unrealized foreign exchange losses of \$80,000 on our Yen denominated accounts receivable.

## Provision for Income Taxes

|                            | Three Months Ended<br>March 31, |       | Increase<br>(Decrease) | % Change |   |
|----------------------------|---------------------------------|-------|------------------------|----------|---|
|                            | 2011                            | 2010  |                        |          |   |
|                            | (\$ in thousands)               |       |                        |          |   |
| Provision for income taxes | \$902                           | \$246 | \$656                  | 266.7    | % |
| % of total revenue         | 3.7                             | % 1.3 | %                      |          |   |

Provision for income taxes for three months ended March 31, 2011 and 2010 was mostly related to our foreign subsidiaries. The increase in tax provision was primarily due to increased sales and increased net income for our foreign subsidiaries in the first quarter of 2011 compared to the same period last year.

## Noncontrolling interest

|                         | Three Months Ended<br>March 31, |       | Increase<br>(Decrease) | % Change |   |
|-------------------------|---------------------------------|-------|------------------------|----------|---|
|                         | 2011                            | 2010  |                        |          |   |
|                         | (\$ in thousands)               |       |                        |          |   |
| Noncontrolling interest | \$1,079                         | \$130 | \$949                  | 730.0    | % |
| % of total revenue      | 4.4                             | % 0.7 | %                      |          |   |

Net income attributable to noncontrolling interest increased \$949,000 or 730.0% to \$1.1 million for the three months ended March 31, 2011 from \$130,000 for the three months ended March 31, 2010 as a result of higher profitability from our China joint venture operations as raw materials sales have increased due to increased demand compared to the same period last year.

## Liquidity and Capital Resources

As of March 31, 2011, our principal sources of liquidity were \$38.5 million, consisting of cash and cash equivalents of \$23.3 million, short-term investments of \$4.8 million and long-term investments of \$10.4 million. We consider cash and cash equivalents and short and long-term investments as liquid and available for use within two years in our current operations. Short and long-term investments are comprised of government bonds and high-grade commercial debt instruments.

Cash and cash equivalents of \$23.3 million decreased by \$451,000 in the first quarter of 2011 compared to the fourth quarter of 2010.

Net cash provided by operating activities of \$1.5 million for the three months ended March 31, 2011 was primarily comprised of our net income of \$5.3 million, adjusted for non-cash items of depreciation of \$815,000, stock-based compensation of \$207,000, amortization of marketable securities premium of \$98,000, realized loss on sale of investments of \$4,000 and a net increase of \$4.5 million in assets and liabilities. The \$4.5 million net increase in assets and liabilities primarily resulted from a \$3.8 million increase in inventories, a \$2.9 million increase in prepaid expenses and other current assets, a \$69,000 increase in other assets, a \$1.0 decrease in accounts payable, a \$624,000

decrease in accrued liabilities, and a \$395,000 decrease in other long-term liabilities, partially offset by a \$3.9 million decrease in accounts receivable.

Net cash provided by operating activities of \$4.2 million for the three months ended March 31, 2010 was primarily comprised of our net income of \$2.7 million, adjusted for non-cash items of depreciation of \$752,000, stock-based compensation of \$114,000, a net decrease of \$774,000 in assets and liabilities partially offset by a gain on sale of investments of \$120,000. The \$774,000 net decrease in assets and liabilities primarily resulted from a \$1.4 million increase in accounts payable, a \$325,000 increase in accrued liabilities, and a \$196,000 decrease in accounts receivable, partially offset by a \$655,000 increase in prepaid expenses, and a \$505,000 increase in inventories.

Net cash used in investing activities of \$866,000 for the three months ended March 31, 2011 was primarily from the purchase of property, plant and equipment of \$2.8 million partially offset by the net proceeds of marketable securities of \$1.9 million.

Net cash used in investing activities of \$480,000 for the three months ended March 31, 2010 was primarily from the purchase of property, plant and equipment of \$320,000 and partially offset by the net purchases of marketable securities of \$164,000.

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In 2011, we expect to invest up to approximately \$11.0 million in capital projects at our China facilities to expand the manufacturing capabilities to optimize the utilization of our resources.

Net cash used in financing activities of \$1.3 million for the three months ended March 31, 2011 consisted of \$1.6 million dividends paid by joint ventures partially offset by net proceeds of \$357,000 on the issuance of common stock.

Net cash used in financing activities of \$78,000 for the three months ended March 31, 2010 consisted of \$192,000 dividends paid, and payments of \$18,000 related to our tenant improvement loan, partially offset by net proceeds of \$132,000 on the issuance of common stock.

We believe that we have adequate cash and investments to meet our needs over the next 12 months. If our sales decrease, however, our ability to generate cash from operations will be adversely affected which could adversely affect our future liquidity, require us to use cash at a more rapid rate than expected, and require us to seek additional capital. There can be no assurance that such additional capital will be available or, if available it will be at terms acceptable to us. Cash from operations could be affected by various risks and uncertainties, including, but not limited to those set forth below under Item 1A “Risks Factors.”

We lease certain office space, manufacturing facilities and equipment under long-term operating leases expiring at various dates through February 2014. The lease agreement of the facility at Fremont, California with approximately 27,760 square feet commenced December 1, 2008 for a term of seven years, with an option by us to cancel the lease after five years, upon forfeiture of the security deposit and payment of one-half of the fifth year’s rent. Total rent expenses under these operating leases were approximately \$81,000 and \$77,000 for the three months ended March 31, 2011 and 2010, respectively.

We have entered into a royalty agreement with a vendor effective December 3, 2010 with a term of eight years, terminating December 31, 2018. We and our related companies are granted a worldwide, nonexclusive, royalty bearing, irrevocable license to certain patents for the term on the agreement.

Outstanding contractual obligations as of March 31, 2011 are summarized as follows (in thousands):

| Contractual Obligations | Total   | Payments due by period |           |           |                   |
|-------------------------|---------|------------------------|-----------|-----------|-------------------|
|                         |         | Less than 1 year       | 1-3 years | 3-5 years | More than 5 years |
| Operating leases        | \$1,540 | \$ 339                 | \$689     | \$512     | \$—               |
| Royalty agreement       | 6,438   | 1,375                  | 1,938     | 1,544     | 1,581             |
| Total                   | \$7,978 | \$ 1,714               | \$2,627   | \$2,056   | \$1,581           |

## Recent Accounting Pronouncements

There have been no new accounting pronouncements during the three months ended March 31, 2011, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2010, that are of material significance, or potential significance, to us.

In various areas, including revenue recognition, stock option accounting, accounting standards and practices continue to evolve. Additionally, the SEC and the FASB’s Emerging Issues Task Force continue to address revenues, stock option accounting related accounting issues. We believe that we are in compliance with all of the rules and related guidance as they currently exist. However, any changes to accounting principles generally accepted in the United States of America in these areas could impact the future accounting of our operations.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Foreign Currency Risk

A significant portion of our business is conducted in currencies other than the U.S. dollar. The functional currency for our foreign operations is the renminbi, the local currency of China, where our operating expenses are predominantly in the local currency. Since most of our operations are conducted in China, most of our costs are incurred in Chinese currency, which subjects us to fluctuations in the exchange rates between the U.S. dollar and the Chinese renminbi. We incur transaction gains or losses resulting from consolidation of expenses incurred in local currencies for these subsidiaries, as well as in translation of the assets and liabilities of these assets at each balance sheet date. Our financial results could be adversely affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets, including the revaluation by China of the renminbi, and any future adjustments that China may make to its currency such as any move it might make to a managed float systems with opportunistic interventions. In the future we may experience foreign exchange losses on our non-functional currency denominated receivables and payables to the extent that we have not mitigated our exposure utilizing foreign currency forward exchange contracts. Foreign exchange losses could have a material adverse effect on our operating results and cash flows. The U.S. is currently pressuring China to devalue the renminbi, which could adversely affect our operation costs and results of operations. If we do not effectively manage against these risks, our cash flows and financial condition may be adversely affected.

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We manage against these risks by actively monitoring the exchange rate exposure. Our foreign operations, however, in most instances act as a natural hedge since both operating expenses as well as revenues and both assets and liabilities are generally denominated in their respective local currency. In these instances, although an unfavorable change in the exchange rate of foreign currencies against the U.S. dollar will result in lower revenues when translated into U.S. dollars, the operating expenses will be lower as well. We do not use short-term forward exchange contracts for hedging purposes to reduce the effects of adverse foreign exchange rate movements. We had previously purchased foreign exchange contracts to hedge against certain trade accounts receivable denominated in Japanese yen. The change in the fair value of the forward contracts was recognized as part of the related foreign currency transactions as they occur. As of March 31, 2011 and December 31, 2010, we had no outstanding commitments with respect to foreign exchange contracts.

During the three months ended March 31, 2011, we recorded a net realized foreign exchange loss of \$51,000, included as part of other income in our condensed consolidated statements of operations. We incurred foreign currency transaction exchange gains and losses due to operations in general. It is uncertain whether these currency trends will continue. In the future we may experience foreign exchange losses on our non-functional currency denominated receivables and payables to the extent that we have not mitigated our exposure utilizing foreign currency forward exchange contracts. Foreign exchange losses could have a materially adverse effect on our operating results and cash flows. During the first quarter of 2011, we recorded an unrealized foreign currency loss of \$145,000, included in the balance of accumulated other comprehensive income on our condensed consolidated balance sheet.

In July 2005, China agreed to a shift in Chinese currency policy. It established a 2% revaluation of the renminbi and referenced the renminbi to a basket of currencies, with a daily trading band of +/-0.3%. Depending on market conditions and the state of the Chinese economy, it is possible that China will make more adjustments in the future. Over the next five to ten years, China may move to a managed float system, with opportunistic interventions. This reserve diversification may negatively impact the United States dollar and U.S. interest rates, which, in turn, could negatively impact our operating results and financial condition. The functional currency of our Chinese subsidiary, including our joint ventures, is the local currency; since most of our operations are conducted in China, most of our costs are incurred in Chinese currency, which subjects us to fluctuations in the exchange rates between the U.S. dollar and the Chinese renminbi. We incur transaction gains or losses resulting from consolidation of expenses incurred in local currencies for these subsidiaries, as well as in translation of the assets and liabilities of these assets at each balance sheet date. These risks may be increased by the fluctuation and revaluation of the Chinese renminbi. If we do not effectively manage the risks associated with this currency risk, our revenue, cash flows and financial condition could be adversely affected.

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## Interest Rate Risk

Cash and cash equivalents earning interest and certain variable rate debt instruments are subject to interest rate fluctuations. The following table sets forth the probable impact of a 10% change in interest rates (in thousands):

| Instrument                                   | Balance as of<br>March 31,<br>2011 | Current<br>Interest<br>Rate | Projected Annual<br>Interest<br>Income/(Expense) | Proforma 10%<br>Interest Rate<br>Decline<br>Income/(Expense) | Proforma 10%<br>Interest Rate<br>Increase<br>Income/(Expense) |
|--|------------------------------------|-----------------------------|--|--|---|
| Cash   | \$ 19,777                          | 0.20                        | % \$ 40  | \$ 36  | \$ 44   |
| Cash equivalents                             | 3,496                              | 0.20                        | 7  | 6  | 8   |
| Investment in debt and equity<br>instruments | 15,181                             | 3.03                        | 460  | 414  | 506   |
|  |                                    |                             | \$ 507   | \$ 456   | \$ 558  |

The primary objective of our investment activities is to preserve principal while maximizing income without significantly increasing risk. Financial instruments that potentially subject us to concentration of credit risk consist primarily of cash and cash equivalents, short-term investments, and trade accounts receivable. We invest primarily in money market accounts, commercial paper instruments, and investment grade securities. We are exposed to credit risks in the event of default by the issuers to the extent of the amount recorded on the condensed consolidated balance sheets. These securities are generally classified as available-for-sale and consequently are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income, net of estimated tax. Our cash, cash equivalents and short-term investments are in high-quality securities placed with major banks and financial institutions and commercial paper. We have no investments in auction rate securities.

## Accounts Receivable Risk

We perform periodic credit evaluations of our customers' financial condition and generally do not require collateral. Two customers each accounted for 10% or more of our trade accounts receivable balance as of March 31, 2011 at 27.5%, and 12.0%, respectively. One customer accounted for 10% or more of our trade accounts receivable balance at 30% as of December 31, 2010.

## Equity Risk

We maintain minority investments directly, and indirectly through our joint ventures in privately-held companies located in China. These minority investments are reviewed for other than temporary declines in value on a quarterly basis. These investments are classified as other assets in the condensed consolidated balance sheets and are either accounted for under the cost method or consolidated through joint ventures as we do not have the ability to exercise significant influence over their operations. We monitor our investments for impairment and record reductions in carrying value when events or changes in circumstances indicate that the carrying value may not be recoverable. Reasons for other than temporary declines in value include whether the related company would have insufficient cash flow to operate for the next twelve months, significant changes in the operating performance and changes in market conditions. As of March 31, 2011 and December 31, 2010, the direct minority investments totaled \$392,000, and the indirect minority investments totaled \$785,000 and \$341,000, respectively.

## ITEM 4. CONTROLS AND PROCEDURES

## Disclosure Controls and Procedures

Under the supervision and with the participation of our management, our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as such terms are defined under Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report in ensuring that information required to be disclosed on SEC reports is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

#### Changes in Internal Control Over Financial Reporting

No change in our internal control over financial reporting was made in the three months ended March 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time we may be involved in judicial or administrative proceedings concerning matters arising in the ordinary course of business. We do not expect that any of these matters, individually or in the aggregate, will have a material adverse effect on our business, financial condition, cash flows or results of operation.

Item 1A. Risk Factors

There are no material changes from the risk factors set forth under Part I, Item 1A. "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

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

None

Item 3. Defaults upon Senior Securities

None

Item 4. [Reserved]

Item 5. Other Information

None



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Item 6. Exhibits

a. Exhibits

| Exhibit<br>Number | Description  |
|-------------------|--|
| 31.1              | Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2              | Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1              | Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2              | Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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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.

AXT, INC.

Dated: May 10, 2011

By:

/s/ MORRIS S. YOUNG  
Morris S. Young  
Chief Executive Officer  
(Principal Executive Officer)

/s/ RAYMOND A. LOW  
Raymond A. Low  
Chief Financial Officer  
(Principal Financial Officer and Principal  
Accounting Officer)

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