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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2000

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:

SILICON LABORATORIES INC.

(Exact name of registrant as specified in its charter)

Delaware	74-2793174
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4635 Boston Lane, Austin, Texas	78735
(Address of principal executive offices)	(Zip Code)

(512) 416-8500

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. / / Yes / / No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of September 30, 2000, 47,745,621 shares of common stock of Silicon Laboratories Inc. were outstanding.

PART I: FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

SILICON LABORATORIES INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	SEPTEMBER 30, 2000 (Unaudited)	JANUARY 1, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 46,555	$ 8,197
Short-term investments	43,411	6,509
Accounts receivable, net of allowance for doubtful accounts of $758 at September 30, 2000 and $569 at January 1, 2000	16,458	10,322
Inventories	6,929	2,837
Deferred income taxes	1,585	963
Prepaid expenses and other	816	435
Total current assets	115,754	29,263
Property, equipment and software, net	21,737	12,350
Goodwill and other intangible assets	40,193	--
Other assets	418	345
Total assets	$ 178,102	$ 41,958
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 7,422	$ 7,374
Accrued expenses	5,082	1,083
Deferred revenue	2,510	1,006
Current portion of long-term obligations	2,030	2,697
Income taxes payable	873	2,822
Total current liabilities	17,917	14,982
Long-term debt and leases, net of current maturities	3,919	6,081
Other long-term obligations	1,288	142
Total liabilities	23,124	21,205
Redeemable convertible preferred stock	--	12,750
Stockholders' equity:		
Common stock--$.0001 par value; 250,000 and 52,000 shares authorized and 47,746 and 30,016 shares issued and outstanding at September 30, 2000 and January 1, 2000, respectively	5	3
Additional paid-in capital	154,883	19,014
Stockholder notes receivable	(1,472)	(1,472)
Deferred stock compensation	(15,377)	(15,330)
Retained earnings	16,939	5,788
Total stockholders' equity	154,978	8,003
Total liabilities and stockholders' equity	$ 178,102	$ 41,958

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SILICON LABORATORIES INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER 30, 2000	OCTOBER 2, 1999	SEPTEMBER 30, 2000	OCTOBER 2, 1999
Sales	$ 29,427	$ 14,574	$ 73,400	$ 28,437
Cost of goods sold	10,130	4,582	25,277	9,862
Gross profit	19,297	9,992	48,123	18,575
Operating expenses:				
Research and development	5,263	2,109	13,290	5,000
Selling, general and administrative	5,128	2,105	12,702	4,737
Write off of in-process research & development	394	--	394	--
Goodwill amortization	1,240	--	1,240	--
Amortization of deferred stock compensation	884	254	2,451	403
Operating expenses	12,909	4,468	30,077	10,140
Operating income	6,388	5,524	18,046	8,435
Other (income) and expenses:				
Interest income	(1,248)	(98)	(2,753)	(236)
Interest expense	339	217	957	477
Income before tax expense	7,297	5,405	19,842	8,194
Income tax expense	3,332	1,251	8,691	1,896
Net income	$ 3,965	$ 4,154	$ 11,151	$ 6,298
Net income per share:				
Basic	$ 0.09	$ 0.26	$ 0.31	$ 0.44
Diluted	$ 0.08	$ 0.09	$ 0.23	$ 0.14
Weighted average common shares outstanding:				
Basic	43,917	15,902	36,119	14,378
Diluted	49,987	44,377	48,584	43,867

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

SILICON LABORATORIES INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

	NINE MONTHS ENDED	
	SEPTEMBER 30, 2000	OCTOBER 2, 1999
OPERATING ACTIVITIES		
Net income	$ 11,151	$ 6,298
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization expense	5,963	1,293
Amortization of deferred stock compensation	2,451	403
Amortization of note/lease end-of-term interest payments	242	62
Compensation expense related to stock options, direct stock issuance, and warrants to non-employees	153	16
Investment interest receivable	(275)	19
Changes in operating assets and liabilities:		
Prepaid expenses and other	(252)	(96)
Accounts receivable	(5,947)	(5,290)
Inventories	(3,556)	(577)
Other assets	(61)	(18)
Accounts payable	(1,709)	2,612
Accrued expenses	3,806	904
Deferred revenue	1,504	271
Deferred income taxes	(535)	--
Income taxes payable	(47)	1,773
Net cash provided by operating activities	12,888	7,670
INVESTING ACTIVITIES		
Purchases of short-term investments	(60,278)	(6,390)
Maturities of short-term investments	23,651	2,891
Purchases of property and equipment	(13,395)	(4,993)
Payment for software license	(750)	--
Acquisition of Krypton, net of cash acquired	(13,285)	--
Net cash used in investing activities	(64,057)	(8,492)
FINANCING ACTIVITIES		
Proceeds from long-term debt	3,532	2,383
Payments on long-term debt	(5,997)	(458)
Proceeds from credit facility	--	1,100
Payments on credit facility	--	(1,100)
Proceeds from equipment lease financing	--	1,242
Payments on capital leases	(364)	(331)
Proceeds from exercise of warrants	100	--
Net proceeds from initial public offering of common stock	90,646	--
Net proceeds from exercises of stock options	1,610	57
Net cash provided by financing activities	89,527	2,893
Increase in cash and cash equivalents	38,358	2,071
Cash and cash equivalents at beginning of period	8,197	2,867
Cash and cash equivalents at end of period	$ 46,555	$ 4,938
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid	$ 706	$ 386
Income taxes paid	$ 9,170	$ 123

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF
THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

SILICON LABORATORIES INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
SEPTEMBER 30, 2000

1. Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the consolidated financial position of Silicon Laboratories Inc. and its subsidiary (collectively, the "Company") at September 30, 2000 and the consolidated results of its operations and cash flows for the three and nine months ended September 30, 2000 and October 2, 1999. All intercompany accounts and transactions have been eliminated. The results of operations for the three and nine months ended September 30, 2000 are not necessarily indicative of the results to be expected for the full year.

The accompanying unaudited condensed consolidated financial statements do not include footnotes and certain financial presentations normally required under accounting principles generally accepted in the United States. Therefore, these financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended January 1, 2000, included in the Company's Registration Statement on Form S-1 filed with the Securities and Exchange Commission.

Short-Term Investments

The Company's short-term investments have been classified as available-for-sale securities in accordance with Statement of Financial Accounting Standard (SFAS) No. 115, ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES. The carrying value of available-for-sale securities approximates fair value.

Inventories

Inventories are stated at the lower of cost, determined using the first-in, first-out method, or market. Inventories consist of the following (in thousands):

	SEPTEMBER 30, 2000	JANUARY 1, 2000
Work in progress	$4,775	$ 1,902
Finished goods	2,154	935
	$6,929	$ 2,837

Stock Based Compensation

On March 31, 2000, the Financial Accounting Standards Board issued FASB Interpretation No. 44, ACCOUNTING FOR CERTAIN TRANSACTIONS INVOLVING STOCK COMPENSATION, an interpretation of APB Opinion No. 25. The Interpretation clarifies guidance for certain issues that arose in the application of APB Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES. The interpretation has been applied prospectively to new awards, modifications to outstanding awards, and changes in employee status on or after July 1, 2000, except as follows: (i) requirements

related to the definition of an employee apply to new awards granted after December 15, 1998; (ii) modifications that directly or indirectly reduce the exercise price of an award apply to modifications made after December 15, 1998; and (iii) modifications to add a reload feature to an award apply to modifications made after January 12, 2000. The adoption of this pronouncement had no impact on the earnings or the financial condition of the Company.

Other Comprehensive Income

In June 1997, the FASB issued SFAS No. 130, REPORTING COMPREHENSIVE INCOME, which establishes standards for reporting and display of comprehensive income and its components in the financial statements. There were no material differences between net income and comprehensive income during any of the periods presented.

Earnings Per Share

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER 30, 2000	OCTOBER 2, 1999	SEPTEMBER 30, 2000	OCTOBER 2, 1999
Net income	$3,965	$4,154	$11,151	$6,298
Basic:				
Weighted-average shares of common stock outstanding	47,496	29,120	42,162	28,971
Weighted-average shares of common stock subject to repurchase	(3,579)	(13,218)	(6,043)	(14,593)
Shares used in computing basic net income per share	43,917	15,902	36,119	14,378
Effect of dilutive securities:				
Weighted-average shares of common stock subject to repurchase	3,506	13,111	5,932	14,425
Convertible preferred stock and warrants	115	13,967	4,281	13,957
Stock options	2,449	1,397	2,252	1,107
Shares used in computing diluted net income per share	49,987	44,377	48,584	43,867
Basic net income per share	$0.09	$0.26	$0.31	$0.44
Diluted net income per share	$0.08	$0.09	$0.23	$0.14

2. Acquisition of Krypton Isolation, Inc.

On August 9, 2000, the Company consummated a merger with Krypton Isolation, Inc. (Krypton), a company specializing in patented total solid state all-silicon Data Access Arrangement, or DAA, devices. The purchase price of $42.0 million consisted of $15.0 million in cash, 384,100 shares of the Company's common stock valued at $21.9 million, 90,449 options to purchase the Company's common stock valued at $4.8 million, and direct acquisition costs of $0.3 million. The direct acquisition costs consist primarily of legal, accounting, and appraisal fees incurred by the Company that are directly related to the merger. There can be no assurance that the Company and Krypton will not incur additional charges related to the merger or that management will be successful in its efforts to integrate the operations of the two companies. To determine the value associated with the stock and stock option portion of the consideration paid to Krypton shareholders, management used the average of the closing prices of the Company's common stock for the three days before and after the measurement date, August 4, 2000, in accordance with Emerging Issues Task Force (EITF) 99-12 ACCOUNTING FOR FORMULA ARRANGEMENTS UNDER EITF 95-19, DETERMINATION OF THE MEASUREMENT DATE FOR THE MARKET PRICE OF ACQUIRER SECURITIES ISSUED IN A PURCHASE BUSINESS COMBINATION. The average of these closing prices was $56.96. The number of shares tendered was based on the average of the closing prices of the Company's common stock in the ten trading days ending on August 4, 2000 in accordance with the terms of the agreement.

The acquisition of Krypton is being accounted for under the purchase method of accounting. The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed based on independent appraisals and management estimates as follows (in thousands):

		Amortization Period
Intangibles:		
Workforce	$ 214	3 years
Customer base	1,006	5 years
Acquired technology	952	4-7 years
Patents	120	3 years
Goodwill	37,229	5 years
	39,521	
Net fair value of tangible assets acquired and liabilities assumed	2,415	
Net deferred tax liabilities assumed	(373)	
Deferred stock compensation	35	
In-process research and development	394	
Total purchase price	$ 41,992	

Since this acquisition was accounted for using the purchase method, the results of operations of Krypton have been included with those of the Company subsequent to the acquisition date, August 9, 2000. The following presents the unaudited pro forma combined results of operations of the Company with Krypton for the nine month periods ended September 30, 2000 and October 2, 1999, after giving effect to certain pro forma adjustments, as if Krypton has been acquired as of the beginning of the respective fiscal years. The unaudited pro forma

financial information for the nine months ended September 30, 2000 combines the unaudited historical results of operations of the Company for the nine months ended September 30, 2000 and the unaudited historical results of operations of Krypton for the nine months ended July 31, 2000. The unaudited pro forma financial information for the nine months ended October 2, 1999 combines the unaudited results of operations for the nine months ended October 2, 1999 for the Company, and the unaudited results of operations for the nine months ended July 31, 1999 for Krypton. (in thousands, except per share data)

	NINE MONTHS ENDED SEPTEMBER 30, 2000	NINE MONTHS ENDED OCTOBER 2, 1999
Sales	$ 74,280	$ 29,852
Net income (loss)	(1,834)	258
Diluted net income (loss) per share	$ (0.04)	$ 0.01

The pro forma information is presented for illustrative purposes only and is not necessarily indicative of the operating results or financial position that would have occurred if the merger had been consummated at the beginning of the respective fiscal years, nor is it necessarily indicative of future operating results or financial position of the Company.

Approximately $394,000 of the purchase price was allocated to in-process research and development based upon an independent third party appraisal and expensed upon the consummation of the transaction. The proforma adjustments do not include a charge for this expense as it does not have a continuing impact on the operations of the Company. Further, the unaudited pro forma financial information does not include the realization of cost savings from operating efficiencies, synergies or other restructurings that may result from the merger.

3. Stockholders' Equity

During the quarter ended September 30, 2000, the Company recorded deferred stock compensation of $1,669,000 in connection with nonqualified stock options granted during the quarter at an exercise price lower than the fair market value of the common stock on the date of grant. The deferred stock compensation is being amortized over the vesting periods of the applicable options. Amortization of deferred stock compensation resulted in expense of $884,000 and $2,451,000 for the three and nine months ended September 30, 2000 related to options granted and direct issuances either in such quarter or in prior periods.

In March 2000, the Company completed its initial public offering (the "Offering") of 3,680,000 shares of its Common Stock. Of these shares, the Company sold 3,200,000 shares (including 480,000 shares issued in connection with the exercise of the underwriters' over-allotment option), and selling shareholders sold 480,000 shares, at a price of $31.00 per share. The Company received aggregate proceeds from the Offering of $90,646,000 in cash (net of underwriting discounts and commissions and estimated offering costs). Upon consummation of the Offering, all outstanding shares of the Company's Convertible Preferred Stock were automatically converted into an aggregate of 13,884,190 shares of Common Stock.

4. Commitments and Contingencies

The Company is involved in various legal proceedings that have arisen in the normal course of business. While the ultimate results of these matters cannot be predicted with certainty, management does not expect them to have a material adverse effect on the consolidated financial position and results of operations.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH THE CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES THERETO INCLUDED ELSEWHERE IN THIS QUARTERLY REPORT ON FORM 10-Q, THE PRIOR QUARTERLY REPORTS ON FORM 10-Q FILED JULY 17, 2000 AND APRIL 26, 2000,FORM 8-K FILED AUGUST 11, 2000 AND FORM 8-K/A FILED SEPTEMBER 8, 2000, AND THE SILICON LABORATORIES' PROSPECTUS DATED MARCH 23, 2000. EXCEPT FOR THE HISTORICAL FINANCIAL INFORMATION CONTAINED HEREIN, THE MATTERS DISCUSSED IN THIS QUARTERLY REPORT ON FORM 10-Q MAY BE CONSIDERED "FORWARD-LOOKING" STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. SUCH STATEMENTS INCLUDE DECLARATIONS REGARDING THE INTENT, BELIEF OR CURRENT EXPECTATIONS OF SILICON LABORATORIES AND ITS MANAGEMENT AND MAY BE SIGNIFIED BY THE WORDS "EXPECTS," "ANTICIPATES," "INTENDS," "BELIEVES" OR SIMILAR LANGUAGE. PROSPECTIVE INVESTORS ARE CAUTIONED THAT ANY SUCH FORWARD-LOOKING STATEMENTS ARE NOT GUARANTEES OF FUTURE PERFORMANCE AND INVOLVE A NUMBER OF RISKS AND UNCERTAINTIES. ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE INDICATED BY SUCH FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE OR CONTRIBUTE TO SUCH DIFFERENCES INCLUDE THOSE DISCUSSED BELOW, AS WELL AS THOSE DISCUSSED IN SILICON LABORATORIES' PROSPECTUS DATED MARCH 23, 2000, PRIOR QUARTERLY REPORTS ON FORM 10-Q FILED JULY 17, 2000 AND APRIL 26, 2000, AND PRIOR CURRENT REPORTS ON FORM 8-K AND 8-K/A FILED AUGUST 11, 2000 AND SEPTEMBER 8, 2000. OUR FISCAL YEAR-END FINANCIAL REPORTING PERIODS ARE A 52- OR 53- WEEK YEAR ENDING ON THE SATURDAY CLOSEST TO DECEMBER 31ST. OUR THIRD QUARTER OF FISCAL YEAR 2000 ENDED SEPTEMBER 30, 2000. OUR THIRD QUARTER OF FISCAL YEAR 1999 ENDED OCTOBER 2, 1999. ALL OF THE QUARTERLY PERIODS REPORTED IN THIS QUARTERLY REPORT ON FORM 10-Q HAD THIRTEEN WEEKS.

OVERVIEW

Silicon Laboratories designs and develops proprietary, analog-intensive, mixed-signal integrated circuits, or ICs, for the rapidly growing communications industry. Our innovative ICs can dramatically reduce the cost, size and system power requirements of the products that our customers sell to their end-user customers. We currently offer ICs that can be incorporated into communications devices, such as modems and cellular phones, as well as cable and satellite set-top boxes, credit card verification machines, automated teller machines, network access equipment, remote gaming devices and high speed optical networking equipment.

Our company was founded in 1996. Our business has grown rapidly since our inception, as reflected by our employee headcount, which increased to 240 employees at September 30, 2000 from 148 at the end of fiscal 1999, 42 at the end of fiscal 1998, and 17 at the end of fiscal 1997. As a "fabless" semiconductor company, we rely on third-party semiconductor fabricators to manufacture the silicon wafers that reflect our IC designs. Each wafer contains numerous die, which are cut from the wafer to create a chip for an IC. We also rely on third-party assemblers to assemble and package these die prior to final product testing and shipping.

Our first IC product, the direct access arrangement, or DAA, had its first commercial shipment in April 1998. Based on the success of our DAA products, we became profitable in the fourth quarter of fiscal 1998 and have been profitable in each succeeding quarter through the

quarter ended September 30, 2000. Substantially all of our sales to date have been derived from sales of our various DAA products and we expect to remain dependent on continued sales of DAA products for a majority of our sales until we are able to diversify sales with new products.

To date, a majority of our sales have been generated through our direct sales force. In fiscal 1998, we began to establish a network of independent sales representatives and distributors worldwide to support our sales and marketing activities. We anticipate that sales to these representatives and distributors will increase as a percentage of our sales in future periods. However, we expect to continue to experience significant customer concentration in direct sales to key customer accounts until we are able to diversify sales with new customers.

The sales cycle for the test and evaluation of our ICs can range from 1 to 12 months or more. An additional 3 to 6 months or more may be required before a customer ships a significant volume of devices that incorporate our ICs. Due to this lengthy sales cycle, we may experience a significant delay between incurring expenses for research and development and selling, general and administrative efforts, and the generation of corresponding sales, if any. We intend to continue to increase our investment in research and development, selling, general and administrative functions and inventory as we expand our operations in the future. Consequently, if sales in any quarter do not occur when expected, expenses and inventory levels could be disproportionately high, and our operating results for that quarter and, potentially, future quarters would be adversely affected.

Our limited operating history and rapid growth make it difficult for us to assess the impact of seasonal factors on our business. Because many of our ICs are designed for use in consumer products such as PCs and cellular telephones, we expect that the demand for our products will be subject to seasonal demand resulting in increased sales in the third and fourth quarters of each year when customers place orders to meet holiday demand. We expect to experience seasonal fluctuations in the demand for our products as customer demand increases in greater volume across our product offerings.

The following describes the line items set forth in our consolidated statements of income:

SALES. Sales consists of revenue generated principally by sales of our ICs. Generally, we recognize sales at the time of shipment to our customers. Sales are deferred on shipments to distributors until they are resold by such distributors. Our products typically carry a one-year warranty. Since our inception, product returns and warranty costs have not been significant. Our sales are subject to variation from period to period due to the volume of shipments made within a period and the prices we charge for our products. The vast majority of our sales were conducted at prices that reflect a discount from the list prices for our products. These discounts are made for a variety of reasons, including to establish a relationship with a new customer, as an incentive for customers to purchase products in larger volumes or in response to competition. In addition, as a product matures, we expect that the average selling price for that product will decline. Therefore, our ability to increase sales in the future is dependent on increased demand for our established products and our ability to ship larger volumes of products in response to such demand, as well as customer acceptance of newly introduced products.

COST OF GOODS SOLD. Cost of goods sold includes the cost of purchasing finished silicon wafers processed by independent foundries; costs associated with assembly, test and shipping of those products; costs of personnel and equipment associated with manufacturing support, logistics and quality assurance; an allocated portion of our occupancy costs; and allocable depreciation of testing equipment. Generally, we depreciate equipment over four years on a straight line basis. We also depreciate our leasehold improvements over the applicable lease term. Recently introduced products tend to have higher cost of goods sold per unit due to initially low production volumes required by our customers and higher costs associated with new package variations. Generally, as production volumes for a product increase, unit production costs tend to decrease as

our semiconductor fabricators and assemblers achieve greater economies of scale for that product. Additionally, the cost of wafer procurement, which is a significant component of cost of goods sold, varies cyclically with overall demand for semiconductors. The semiconductor industry has recently experienced a period of high demand, resulting in higher wafer procurement costs.

RESEARCH AND DEVELOPMENT. Research and development expense consists primarily of compensation and related costs of employees engaged in research and development activities, as well as an allocated portion of our occupancy costs for such operations. We depreciate our research and development equipment over four years and amortize our purchased software from computer-aided design tool vendors over four years. Development activities include the creation of test methodologies to assure compliance with required specifications. We have granted stock options or directly issued stock to patent attorneys and outside technical consultants for services previously rendered. We recognize stock-based compensation expense for these non-employees based on the deemed fair value of the options or stock at the date of grant. We have issued a warrant to a university's Electrical Engineering Department to support mixed signal analog intensive integrated circuit design activities. We recognized expense for this warrant based on the deemed fair value of the warrant at the date of grant.

SELLING, GENERAL AND ADMINISTRATIVE. Selling, general and administrative expense consists primarily of personnel-related expenses, related allocable portion of our occupancy costs, sales commissions to independent sales representatives, professional fees, other promotional and marketing expenses and reserves for bad debt. Write-offs of bad debt have been insignificant to date. We awarded stock to non-employee sales persons in connection with a sales incentive program that ended on January 1, 2000. We recognized stock-based compensation expense for these non-employees based on the deemed fair value of the stock at the date of grant.

AMORTIZATION OF DEFERRED STOCK COMPENSATION. In connection with the grant of stock options and direct issuances of stock to our employees prior to our initial public offering, we recorded deferred stock compensation of approximately $16.3 million, representing, for accounting purposes, the difference between the exercise price of option grants, or the issuance price of direct issuances of stock, and the deemed fair value of our common stock at the time of such grants or issuances. Since the initial public offering, we have recorded additional deferred stock compensation of $2.5 million on the same basis. The deferred stock compensation is amortized over the vesting period of the applicable options or shares, generally five to eight years. The amortization of deferred stock compensation is recorded as an operating expense.

INTEREST INCOME. Interest income reflects interest earned on average cash and cash equivalents and investment balances.

INTEREST EXPENSE. Interest expense consists of interest on our long-term debt and capital lease obligations.

INCOME TAX EXPENSE. We accrue a provision for federal and state income tax at the Company's estimated effective tax rate.

RESULTS OF OPERATIONS

The following table sets forth our statement of operations data as a percentage of sales for the periods indicated:

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER 30, 2000	OCTOBER 2, 1999	SEPTEMBER 30, 2000	OCTOBER 2, 1999
	(Unaudited)			
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	34.4	31.4	34.4	34.7
Gross profit	65.6	68.6	65.6	65.3
Operating expenses:				
Research and development	17.9	14.5	18.1	17.6
Selling, general and administrative	17.4	14.4	17.3	16.7
Write off of in-process research & development	1.3	--	0.5	--
Goodwill amortization	4.2	--	1.7	--
Amortization of deferred stock compensation	3.0	1.7	3.3	1.4
Operating expenses	43.9	30.7	41.0	35.7
Operating income	21.7	37.9	24.6	29.7
Interest income	(4.2)	(0.7)	(3.8)	(0.8)
Interest expense	1.2	1.5	1.3	1.7
Income before tax expense	24.8	37.1	27.0	28.8
Income tax expense	11.3	8.6	11.8	6.7
Net income	13.5%	28.5%	15.2%	22.1%

COMPARISON OF THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2000 TO THE THREE AND NINE MONTHS ENDED OCTOBER 2, 1999

SALES. Sales for the three months ended September 30, 2000 were $29.4 million, an increase of $14.9 million or 102% from sales of $14.6 million in the three months ended October 2, 1999. Sales for the nine months ended September 30, 2000 were $73.4 million, an increase of $44.9 million or 158% from sales of $28.4 million in the nine months ended October 2, 1999. The increases were principally attributable to the continued strong acceptance of our DAA family of products, including our international DAA products. Sales from other non-DAA products such as the ISOmodem, the ProSLIC and the RF Synthesizer contributed to more than 15% of sales revenue for the quarter ended September 30, 2000. The increases reflected both an increase in the number of customers that purchased our IC products and an increase in the volume that those customers bought.

GROSS PROFIT. Gross profit for the three months ended September 30, 2000 was $19.3 million or 65.6% of sales, an increase of $9.3 million as compared with gross profit of $10.0 million or 68.6% of sales in the three months ended October 2, 1999. Gross profit for the nine months ended September 30, 2000 was $48.1 million or 65.6% of sales, an increase of $29.6 million as compared with gross profit of $18.6 million or 65.3% of sales in the nine months ended October 2, 1999. The increases in gross profit in both cases were primarily due to the substantial increase in sales volume and the increased utilization of less expensive internal testing of product. These factors were partially offset by higher depreciation expense related to significantly higher internal test floor capacity. Our gross margins may decline due to the expected introduction of competitive products to the market and increased demand for silicon wafer capacity within the semiconductor industry generally. However, the impact of these factors on our gross margins may be offset by increased sales of newly introduced products. We expect many of our new products

will have larger gross margins than products which have been in the market for longer periods of time and that face greater competition as a result.

RESEARCH AND DEVELOPMENT. Research and development expense for the three months ended September 30, 2000 was $5.3 million or 17.9% of sales, an increase of $3.1 million or 150% as compared with research and development expense of $2.1 million or 14.5% of sales for the three months ended October 2, 1999. Research and development expense for the nine months ended September 30, 2000 was $13.3 million or 18.1% of sales, an increase of $8.3 million or 166% as compared with research and development expense of $5.0 million or 17.6% of sales for the nine months ended October 2, 1999. The increase in the dollar amount of research and development expense was principally due to continued product development activities, significant increases in new product development initiatives, and increased spending to develop test methodologies for new products. The decrease in research and development expense as a percentage of sales reflected our modest sales in the three and nine months ended October 2, 1999 as compared to substantial sales growth in the three and nine months ended September 30, 2000. We expect that research and development expense will increase in absolute dollars in future periods as we develop new ICs, and may fluctuate as a percentage of sales due to significant changes in our sales volume and new product development initiatives.

SELLING, GENERAL AND ADMINISTRATIVE. Selling, general and administrative expense increased $3.0 million or 144%, to $5.1 million in the quarter ended September 30, 2000 from $2.1 million in the quarter ended October 2, 1999, and represented 17.4% of sales in the quarter ended September 30, 2000 and 14.4% of sales in the quarter ended October 2, 1999. Selling, general and administrative expense for the nine months ended September 30, 2000 was $12.7 million or 17.3% of sales, an increase of $7.9 million or 168% as compared with selling, general and administrative expense of $4.7 million or 16.7% of sales for the nine months ended October 2, 1999. The increase in the dollar amount of selling, general and administrative expense was principally attributable to increased staffing. Additionally, we incurred $1.0 million and $2.3 million in patent litigation expenses in the three months and nine months ended September 30, 2000 related to a lawsuit we filed against Analog Devices and 3Com on January 12, 2000 (See "Part II, Other Information, Item 1. Legal Proceedings"). We expect that selling, general and administrative expense will increase in absolute dollars in future periods as we expand our sales channels, marketing efforts and administrative infrastructure. We also expect our legal expenses to continue as a result of our pending lawsuit against Analog Devices and 3Com. This lawsuit may also cause our sales to 3Com to decline. 3Com accounted for 8% of our sales in the nine months ended September 30, 2000. In addition, we expect selling, general and administrative expense to fluctuate as a percentage of sales because of (1) the likelihood that indirect distribution channels, which entail the payment of commissions, will account for a larger portion of our sales in future periods and, therefore, increase our selling, general and administrative expense relative to a direct sales force performing at satisfactory levels of productivity; (2) fluctuating usage of advertising to promote our products and, in particular, our newly introduced products; and (3) potential significant variability in our future sales volume.

AMORTIZATION OF DEFERRED STOCK COMPENSATION. We have recorded deferred stock compensation for the difference between the exercise price of option grants or the issuance price of direct issuances of stock, and the deemed fair value of our common stock at the time of such grants or issuances. We are amortizing this amount over the vesting periods of the applicable options or restricted stock, which resulted in amortization expense of $0.9 million and $2.5 million for the three and nine months ended September 30, 2000 as compared to $0.3 million and $0.4 million for the three and nine months ended October 2, 1999.

INTEREST INCOME. Interest income for the three and nine months ended September 30, 2000 was $1.2 million and $2.8 million as compared to $0.1 million and $0.2 million for the three and nine months ended October 2, 1999. The net proceeds from our initial public offering of our common stock, which were received on March 29, 2000, contributed to the increase in interest income.

INTEREST EXPENSE. Interest expense for the three and nine months ended September 30, 2000 was $0.3 million and $1.0 million as compared to $0.2 million and $0.5 million for the three and nine months ended October 2, 1999. The increase in interest expense was primarily due to higher levels of debt during the year and lease financing used to finance capital expenditures, particularly relating to the acquisition of IC testing equipment and leasehold improvements.

INCOME TAX EXPENSE. Our effective tax rate was 45.7% and 43.8% for the three and nine months ended September 30, 2000 as compared to 23.1% in both the three months and nine months ended October 2, 1999. Our pro forma tax rate after excluding the amortization of deferred stock compensation, write off of in-process research and development and goodwill amortization all of which are not tax deductible, would be 34.0% and 36.3% for the three and nine months ended September 30, 2000. The lower effective tax rate in 1999 also reflected net operating loss tax carryforwards that were available from our development stage operations which were used to offset a portion of our tax liability during the three and nine months ended October 2, 1999. These net operating loss tax carryforwards were fully utilized during fiscal 1999.

LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of liquidity as of September 30, 2000 consisted of $90 million in cash, cash equivalents and short-term investments and our bank credit facilities.

Our bank credit facilities include a revolving line of credit available for borrowings and letters of credit of up to the lesser of $5.0 million or 80.0% of eligible accounts receivable and a separate letter of credit facility for $0.4 million related to a building lease. At September 30, 2000, (1) a letter of credit for $0.5 million related to a building lease was outstanding under the revolving line of credit and (2) the separate letter of credit for $0.4 million was outstanding. At September 30, 2000, $4.5 million was available under the revolving line of credit.

Borrowings under the revolving line of credit bear interest at the bank's prime rate, which was 9.5% at September 30, 2000, and are payable at annual renewal of the line. All bank facilities are secured by our accounts receivable, inventories, capital equipment and all other unsecured assets (excluding intellectual property). The line of credit and the separate letter of credit facility contain provisions that prohibit the payment of cash dividends and require the maintenance of tangible net worth and compliance with financial ratios, which measure our immediate liquidity and our ongoing ability to pay back our outstanding obligations. Any default on one of the bank facilities will cause all of the bank facilities to be in default under these agreements.

We also have entered into agreements with three institutional lenders for equipment financing to purchase or lease equipment, leasehold improvements and software. At September 30, 2000, the amount outstanding under these agreements was $5.9 million. This indebtedness bears effective interest rates (including end-of-term interest payments of $1.1 million) ranging from 12.5% to 14.6% per annum and is secured by a security interest in specific items, principally comprised of test equipment, and is repayable over approximately the next four years.

Prior to receiving the net proceeds from our initial public offering, we funded our operations primarily through sales of preferred stock which resulted in gross aggregate proceeds to us of approximately $12.8 million, and debt financing under the credit and lease obligations described above and cash from operations. We raised $90.6 million through our initial public offering in March 2000. During the nine months ended September 30, 2000, cash provided by operating activities was $12.9 million as compared to cash provided by operating activities of $7.7 million during the nine months ended October 2, 1999.

Due to the nature of our business, we experience working capital needs in the areas of accounts receivable and inventory. Typically, we bill our customers on an open account basis on net 30 day payment terms or other specific terms that may vary from account to account as

individually negotiated with customers. As of September 30, 2000, we had an accounts receivable balance of $16.5 million dollars. If sales levels were to increase, it is likely that the level of receivables would also increase. In the event that customers delayed their payments to us, the levels of accounts receivable would also increase. In the area of inventory, we find that in order to maintain an adequate supply of product to customers, we must carry a certain level of inventory. This inventory level may vary based principally upon either orders received from customers or our forecast of demand for these products. Other considerations in determining inventory levels may include the product life cycle stage of our products and competitive situations in the marketplace. Such considerations are balanced against risk of obsolescence or potentially excess inventory levels. As of September 30, 2000, we had inventory of $6.9 million which we deemed adequate to address these inventory considerations.

Capital expenditures were $13.4 million for the nine months ended September 30, 2000 and $5.0 million in the nine months ended October 2, 1999. The expenditures in the recent quarter were incurred to purchase semiconductor test equipment, design software and engineering tools, other computer equipment, leasehold improvements and software to support our business expansion. We anticipate capital expenditures in the remainder of fiscal 2000 of approximately $3.5 million primarily to fund test floor operations and capital expenditures associated with expanded engineering product development activities.

Our future capital requirements will depend on many factors, including the rate of sales growth, market acceptance of our products, the timing and extent of research and development projects and the expansion of our sales and marketing activities. We believe the net proceeds received from our initial public offering, together with our existing cash balances, credit facilities and cash generated by our operations, are sufficient to meet our capital requirements through at least the next 12 months, although we could be required, or could elect, to seek additional funding prior to that time. We may enter into acquisitions or strategic arrangements in the future which also could require us to seek additional equity or debt financing. There can be no assurances that additional equity or debt financing, if required, will be available to us on acceptable terms or at all.

RECENT ACCOUNTING PRONOUNCEMENTS

Stock Based Compensation

On March 31, 2000, the Financial Accounting Standards Board issued FASB Interpretation No. 44, ACCOUNTING FOR CERTAIN TRANSACTIONS INVOLVING STOCK COMPENSATION, an interpretation of APB Opinion No. 25. The interpretation clarifies guidance for certain issues that arose in the application of APB Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES. The interpretation has been applied prospectively to new awards, modifications to outstanding awards, and changes in employee status on or after July 1, 2000, except as follows: (i) requirements related to the definition of an employee apply to new awards granted after December 15, 1998; (ii) modifications that directly or indirectly reduce the exercise price of an award apply to modifications made after December 15, 1998; and (iii) modifications to add a reload feature to an award apply to modifications made after January 12, 2000. The adoption of this pronouncement had no impact on the earnings or the financial condition of the Company.

QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. Due to the nature of our short-term investments, we have concluded that there is no material market risk exposure.

RISKS RELATED TO OUR BUSINESS

WE DEPEND ON A LIMITED NUMBER OF CUSTOMERS FOR THE VAST MAJORITY OF OUR SALES, AND THE LOSS OF, OR A SIGNIFICANT REDUCTION IN ORDERS FROM, ANY KEY CUSTOMER COULD SIGNIFICANTLY REDUCE OUR SALES

In fiscal 1999, our four largest customers, in the aggregate, accounted for approximately 92% of our sales. Of these customers, PC-Tel accounted for 62%, SmartLink for 12%, 3Com for 10% and Motorola for 8% of our fiscal 1999 sales. Our operating results in the foreseeable future will continue to depend on sales to a relatively small number of customers, as well as the ability of these customers to sell products that use our integrated circuit, or IC, products. In the future, these customers may decide not to purchase our ICs at all, purchase fewer ICs than they did in the past or alter their purchasing patterns, particularly because:

- we do not have any material long-term purchase arrangements with these or any of our other customers;

- substantially all of our sales to date have been made on a purchase order basis, which permits our customers to cancel, change or delay product purchase commitments with little or no notice to us and without penalty; and

- some of our customers have sought or are seeking relationships with current or potential competitors which may affect our customers' purchasing decisions.

While we have been the sole supplier of the direct access arrangement, or DAA, IC used in PC-Tel's products, we believe PC-Tel may seek to qualify alternative sources in the future in order to diversify its supplier base which would increase its negotiating leverage with us and protect its ability to secure DAA components. We have a volume purchase agreement with PC-Tel, but the agreement does not require PC-Tel to purchase any minimum number of units from us during fiscal 2000. We believe that any second source of DAA ICs for PC-Tel could have an adverse effect on the prices we are able to charge PC-Tel and the volume of DAA ICs that we sell to PC-Tel, which would negatively affect our sales and operating results.

On January 12, 2000, we filed a lawsuit against Analog Devices and 3Com claiming that Analog Devices has infringed, and is continuing to infringe, one of our issued U.S. patents with respect to our DAA technology and that Analog Devices and 3Com have misappropriated our confidential information, know-how and trade secrets. On February 24, 2000, 3Com filed an answer denying it has misappropriated our confidential information, know how and trade secrets and, without specifying, asserted we have acted with unclean hands. On August 11, 2000, we amended the original patent infringement claim against Analog Devices to include 3Com. On August 22, 2000, we amended the claim to include patent infringement on a recently issued related patent against both Analog Devices and 3Com. On September 6, 2000, Analog Devices and 3Com answered our amended complaints, denying that our patent is valid and infringed and asserting additional defenses and counterclaims. On September 26, 2000, we replied to Analog Devices' and 3Com's counterclaims denying the assertions of invalidity, unenforceability and noninfringement. Although 3Com, which is one of our key customers, may decide to cease purchasing direct access arrangement ICs from Analog Devices as a result of this suit, it is possible that 3Com may respond by ceasing its purchase of our DAA products. The loss of sales to 3Com could have a material adverse effect on our sales and operating results. 3Com accounted for 8% of our sales during the nine months ended September 30, 2000.

On March 21, 2000, 3Com announced a strategic alliance with Accton Technology and Nat Steel Electronics. The three companies will form a new company that will be responsible for the design, marketing and sales of Internet access products, including the 3Com products which currently incorporate our DAA IC's. If we are unable to establish and maintain a supplier relationship with this new company, our operating results could be adversely affected.

The loss of any of our key customers, or a significant reduction in sales to any one of them, would significantly reduce our sales and adversely affect our business.

WE HAVE DEPENDED ON OUR DIRECT ACCESS ARRANGEMENT, OR DAA, FAMILY OF PRODUCTS FOR SUBSTANTIALLY ALL OF OUR SALES TO DATE, AND SIGNIFICANT REDUCTIONS IN ORDERS FOR DAA PRODUCTS WOULD SIGNIFICANTLY REDUCE OUR SALES

A significant majority of our sales to date have been derived from sales of our DAA family of ICs. Until we are able to diversify our sales through the introduction of new products, we will continue to rely on sales of our DAA products. Reduced market acceptance of our DAA products or the introduction of products with superior price/performance characteristics by our competitors could significantly reduce our sales. In addition, substantially all of our DAA products that we have sold include technology related to one or more of our issued U.S. patents. If these patents are found to be invalid or unenforceable, our competitors could introduce competitive products that could reduce both the volume and price per unit of our products.

WE DEPEND ON OUR CUSTOMERS TO SUPPORT OUR PRODUCTS

Our DAA products are currently used by our customers to produce modems for the personal computer market. We rely on our customers to provide software and other technical support for the modems that use our DAA products. If our customers' software does not provide the required functionality or if our customers do not provide satisfactory support for their modem products, the demand for modems that incorporate our DAA products may diminish. Any reduction in the demand for modems would significantly reduce our sales.

IF WE ARE UNABLE TO DEVELOP NEW AND ENHANCED PRODUCTS THAT ACHIEVE MARKET ACCEPTANCE IN A TIMELY MANNER, OUR OPERATING RESULTS AND COMPETITIVE POSITION COULD BE HARMED

We currently sell only our DAA products in commercial quantities. Our future success will depend on our ability to reduce our dependence on our DAA products by developing new ICs and product enhancements that achieve market acceptance in a timely and cost-effective manner. The development of mixed-signal ICs is highly complex, and we occasionally have experienced delays in completing the development and introduction of new products and product enhancements. Successful product development and market acceptance of our products depend on a number of factors, including:

- changing requirements of customers within the wireline, wireless communications and optical networking markets;
- accurate prediction of market requirements;
- timely completion and introduction of new designs;
- timely qualification and certification of our ICs for use in our customers' products;
- commercial acceptance and volume production of the products into which our ICs will be incorporated;
- availability of foundry and assembly capacity;

- achievement of high manufacturing yields;

- quality, price, performance, power use and size of our products;

- availability, quality, price and performance of competing products and technologies;

- our customer service and support capabilities and responsiveness;

- successful development of our relationships with existing and potential customers; and

- changes in technology, industry standards or end-user preferences.

We cannot provide any assurance that new products which we recently have developed or may develop in the future will achieve market acceptance. We have recently introduced to market four new ICs:

- an RF synthesizer, which is used to generate high frequency signals that are used in wireless communications systems to select a particular radio channel;

- an ISOmodem, which is a miniaturized modem that can be embedded in electronic devices with low transmission requirements, such as credit card verification devices, to provide quick network access;

- a ProSLIC product, which provides dial tone, busy tone, caller ID and ring signal functions at the source end of the telephone; and

- a high speed optical network product, which is a fully integrated low-power clock and data recovery circuit designed for SONET/ATM routers, multiplexers, digital cross connects and optical transceiver modules.

We also are actively developing other ICs. If our recently introduced or other ICs fail to achieve market acceptance, our operating results and competitive position could be adversely affected.

DUE TO OUR LIMITED OPERATING HISTORY, WE MAY HAVE DIFFICULTY BOTH IN ACCURATELY PREDICTING OUR FUTURE SALES AND APPROPRIATELY BUDGETING FOR OUR EXPENSES

We were incorporated in 1996 and did not begin generating sales until the second quarter of 1998. As a result, we have only a short history from which to predict future sales. This limited operating experience combined with the rapidly evolving nature of the markets in which we sell our products, as well as other factors which are beyond our control, reduce our ability to accurately forecast quarterly or annual sales. Additionally, because most of our expenses are fixed in the short term or incurred in advance of anticipated sales, we may not be able to decrease our expenses in a timely manner to offset any shortfall of sales. We are currently expanding our staffing and increasing our expense levels in anticipation of future sales growth. If our sales do not increase as anticipated, significant losses could result due to our higher expense levels.

WE RELY ON THIRD PARTIES TO MANUFACTURE AND ASSEMBLE OUR PRODUCTS AND THE FAILURE TO SUCCESSFULLY MANAGE OUR RELATIONSHIPS WITH OUR MANUFACTURERS AND ASSEMBLERS WOULD NEGATIVELY IMPACT OUR ABILITY TO SELL OUR PRODUCTS

We do not have our own manufacturing facilities. Therefore, we must rely on third-party vendors to manufacture the ICs we design. We also currently rely on two third-party assembly contractors, Advanced Semiconductor Engineering and Amkor, to assemble and package the silicon chips provided by the wafers for use in final products. Additionally, we rely on third-party vendors for a portion of the testing requirements of our products prior to shipping.

There are significant risks associated with relying on these third-party contractors, including:

- failure by us, our customers or their end customers to qualify a selected supplier;

- capacity shortages during periods of high demand;

- reduced control over delivery schedules and quality;

- limited warranties on wafers or products supplied to us; and

- potential increases in prices.

We currently do not have long-term supply contracts with any of our third-party vendors, and therefore, they are not obligated to perform services or supply products to us for any specific period, or in any specific quantities, except as may be provided in a particular purchase order. Although we believe that other semiconductor foundries or assembly contractors can adequately address our needs, we expect that it would take approximately two to nine months to transition performance of these services from our current providers to new providers. Such a transition may also require a qualification process by our customers or their end customers. We generally place orders for products with some of our suppliers approximately four months prior to the anticipated delivery date, with order volumes based on our forecasts of demand from our customers. Accordingly, if we inaccurately forecast demand for our products, we may be unable to obtain adequate foundry or assembly capacity from our third-party contractors to meet our customers' delivery requirements, or we may accumulate excess inventories. On occasion, we have been unable to adequately respond to unexpected increases in customer purchase orders, and therefore, were unable to benefit from this incremental demand. None of our third-party foundry or assembly contractors have provided assurances to us that adequate capacity will be available to us within the time required to meet additional demand for our products.

From our inception through fiscal 1999, all of the silicon wafers for the products that we shipped were manufactured by Taiwan Semiconductor Manufacturing Co. To address capacity considerations, we have qualified Vanguard International Semiconductor, an affiliate of Taiwan Semiconductor Manufacturing Co., as an additional semiconductor fabricator. Our customers typically complete their own qualification process. Our customers may not elect to spend the time and expense necessary to put Vanguard through their qualification processes. Vanguard is currently producing on our behalf a majority of our current work in progress. If we fail to balance customer demand across semiconductor fabrications properly, we might not be able to fulfill demand for our products, which would adversely affect our operating results. Additionally, a resulting write-off of unusable inventories would contribute to a decline in earnings.

The semiconductor manufacturing process is highly complex and, from time to time, manufacturing yields may fall below our expectations which could result in our inability to timely satisfy demand for our products.

The manufacture of silicon wafers for our products is a highly complex and technologically demanding process. Although we work closely with our foundries to minimize the likelihood of reduced manufacturing yields, our foundries from time to time have experienced lower than anticipated manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance deficiencies. If our foundries fail to timely deliver fabricated silicon wafers of satisfactory quality, we will be unable to timely meet our customers' demand for our products, which would adversely affect our operating results and damage our customer relationships.

ANY ACQUISITIONS WE MAKE COULD DISRUPT OUR BUSINESS AND HARM OUR FINANCIAL CONDITION

As part of our growth strategy, we will continue to evaluate opportunities to acquire other businesses or technologies that would complement our current offerings, expand the breadth of our markets or enhance our technical capabilities. On August 9, 2000, we completed the acquisition of Krypton Isolation, Inc. for $42 million in cash and common stock. These acquisitions and any other potential future acquisitions entail a number of risks that could materially and adversely affect our business and operating results, including:

- problems integrating the acquired operations, technologies or products with our existing business and products;

- diversion of management's time and attention from our core business;

- difficulties in retaining business relationships with suppliers and customers of the acquired company;

- risks associated with entering markets in which we lack prior experience; and

- potential loss of key employees of the acquired company.

OUR CURRENT MANUFACTURERS AND ASSEMBLERS ARE CONCENTRATED IN THE SAME GEOGRAPHIC REGION WHICH INCREASES THE RISK THAT A NATURAL DISASTER, LABOR STRIKE, WAR OR POLITICAL UNREST COULD DISRUPT OUR OPERATIONS

Our current semiconductor manufacturers are located in the same region within Taiwan and our assembly contractors are located in the Pacific Rim region. The risk of earthquakes in Taiwan and the Pacific Rim region is significant due to the proximity of major earthquake fault lines in the area. We are not currently covered by insurance against business disruption caused by earthquakes as such insurance is not currently available on terms that we believe are commercially reasonable. Earthquakes, fire, flooding or other natural disasters in Taiwan or the Pacific Rim region, or political unrest, war, labor strikes or work stoppages in countries where our semiconductor manufacturers' and assemblers' facilities are located, likely would result in the disruption of our foundry or assembly capacity. Any disruption resulting from these events could cause significant delays in shipments of our products until we are able to shift our manufacturing or assembling from the affected contractor to another third-party vendor. There can be no assurance that such alternate capacity could be obtained on favorable terms, if at all.

WE ARE SUBJECT TO INCREASED INVENTORY RISKS AND COSTS BECAUSE WE BUILD OUR PRODUCTS BASED ON FORECASTS PROVIDED BY CUSTOMERS BEFORE RECEIVING PURCHASE ORDERS FOR THE PRODUCTS

In order to assure availability of our products for some of our largest customers, we start the manufacturing of our products in advance of receiving purchase orders based on forecasts provided by these customers. However, these forecasts do not represent binding purchase

commitments and we do not recognize sales for these products until they are shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated sales. Because demand for our products may not materialize, manufacturing based on forecasts subjects us to increased risks of high inventory carrying costs and increased obsolescence and may increase our operating costs.

WE MAY NOT BE ABLE TO MAINTAIN OUR EXISTING GROWTH RATE

Although we have experienced sales and earnings growth in our recent quarterly and annual periods, we may not be able to sustain these growth rates. In particular, we may gain significant market share in a relatively short period of time following the introduction of a new product, resulting in sales growth. However, incremental gains in market share for these newly introduced products may not occur. Accordingly, you should not rely on the results of any prior quarterly or annual periods as an indication of our future operating performance.

WE MAY EXPERIENCE SIGNIFICANT PERIOD-TO-PERIOD QUARTERLY AND ANNUAL FLUCTUATIONS IN OUR SALES AND OPERATING RESULTS, WHICH MAY RESULT IN VOLATILITY IN OUR STOCK PRICE

We may experience significant period-to-period fluctuations in our sales and operating results in the future due to a number of factors, and any such variations may cause our stock price to fluctuate. It is likely that in some future period our operating results will be below the expectations of public market analysts or investors. If this occurs, our stock price may drop, perhaps significantly.

A number of factors, in addition to those cited in other risk factors applicable to our business, may contribute to fluctuations in our sales and operating results, including:

- the timing and volume of orders from our customers;
- the rate of acceptance of our products by our customers, including the acceptance of new products we may develop for integration in the products manufactured by such customers, which we refer to as "design wins";
- the demand for and life cycles of the products incorporating our ICs;
- the rate of adoption of mixed-signal ICs in the markets we target;
- deferrals of customer orders in anticipation of new products or product enhancements from us or our competitors or other providers of ICs;
- changes in product mix; and
- the rate at which new markets emerge for products we are currently developing or for which our design expertise can be utilized to develop products for these new markets.

For example, the personal computer modem market is characterized by rapid fluctuations in demand which results in corresponding fluctuations in the demand for our DAA products that are incorporated in personal computer modems. Additionally, the rate of technology acceptance by our customers results in fluctuating demand for our products as customers are reluctant to incorporate a new IC into their products until the new IC has achieved market acceptance. However, once a new IC achieves market acceptance, demand for the new IC quickly accelerates and demand quickly declines for the product that the new IC replaces.

WE ARE A RELATIVELY SMALL COMPANY WITH LIMITED RESOURCES COMPARED TO SOME OF OUR CURRENT AND POTENTIAL COMPETITORS AND WE MAY NOT BE ABLE TO COMPETE EFFECTIVELY AND INCREASE MARKET SHARE

Some of our current and potential competitors have longer operating histories, significantly greater resources and name recognition and a larger base of customers than we have. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can to ours. In addition, some of our current and potential competitors have already established supplier or joint development relationships with the decision makers at our current or potential customers. These competitors may be able to leverage their existing relationships to discourage their customers from purchasing products from us or persuade them to replace our products with their products. Our competitors may also offer bundled chipset kit arrangements offering a more complete product despite the technical merits or advantages of our products. These competitors may elect not to support our products which could complicate our sales efforts.

In addition, our largest competitors may restructure their operations to create separate companies that are more focused on providing the types of products we produce. For example, Rockwell's restructuring led to the creation of Conexant which is a significant competitor. Additionally, Siemens spun off its semiconductor business to create a more focused company named Infineon Technologies. In July 2000, Lucent Technologies announced its plans to spin off its microelectronics business with includes the optoelectronics components and integrated circuits division, into a separate company in order to accelerate the growth of the business and alleviate strategic conflicts with Lucent's competitors. Increased competition could decrease our prices, reduce our sales, lower our margins or decrease our market share. These and other competitive pressures may prevent us from competing successfully against current or future competitors, and may materially harm our business.

WE DEPEND ON OUR KEY PERSONNEL TO MANAGE OUR BUSINESS EFFECTIVELY IN A RAPIDLY CHANGING MARKET, AND IF WE ARE UNABLE TO RETAIN OUR CURRENT PERSONNEL AND HIRE ADDITIONAL PERSONNEL, OUR ABILITY TO DEVELOP AND SUCCESSFULLY MARKET OUR PRODUCTS COULD BE HARMED

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering and sales and marketing personnel. Specifically, due to the relatively early stage of our company's business, we believe that our future success is highly dependent on Navdeep Sooch, our co-founder, Chief Executive Officer and Chairman of the Board, Jeffrey Scott, our co-founder and Vice President of Engineering, and David Welland, our co-founder and Vice President of Technology. There is currently a shortage of qualified personnel with significant experience in the design, development, manufacturing, marketing and sales of analog and mixed-signal communications ICs. In particular, there is a shortage of engineers who are familiar with the intricacies of the design and manufacturability of analog elements, and competition for such personnel is intense. Our key technical personnel represent a significant asset and serve as the source of our technological and product innovations. We may not be successful in attracting and retaining sufficient numbers of technical personnel to support our anticipated growth. The loss of any of our key employees or the inability to attract or retain qualified personnel, including engineers and sales and marketing personnel, could delay the development and introduction of, and negatively impact our ability to sell, our products.

OUR RESEARCH AND DEVELOPMENT EFFORTS ARE FOCUSED ON A LIMITED NUMBER OF NEW TECHNOLOGIES AND PRODUCTS, AND ANY DELAY IN THE DEVELOPMENT, OR ABANDONMENT, OF THESE TECHNOLOGIES OR PRODUCTS BY INDUSTRY PARTICIPANTS, OR THEIR FAILURE TO ACHIEVE MARKET ACCEPTANCE, COULD COMPROMISE OUR COMPETITIVE POSITION

Our ICs are used as components in communications devices in the wireline, wireless and optical networking markets. As a result, we have devoted and expect to continue to devote a large amount of resources to develop products based on new and emerging technologies and standards that will be commercially introduced in the future. In the first nine months of fiscal 2000, our research and development expense was $13.2 million, which represented 18.1% of our sales compared to $5.0 million, or 17.6% of our sales for the first nine months of fiscal year 1999. A number of large companies in the wireline, wireless and optical networking industries are actively involved in the development of these new technologies and standards. Should any of these companies delay or abandon their efforts to develop commercially available products based on new technologies and standards, our research and development efforts with respect to these technologies and standards likely would have no appreciable value. In addition, if we do not correctly anticipate new technologies and standards, or if the products that we develop based on these new technologies and standards fail to achieve market acceptance, our competitors may be better able to address market demand than would we. Furthermore, if markets for these new technologies and standards develop later than we anticipate, or do not develop at all, demand for our products that are currently in development would suffer, resulting in lower sales of these products than we currently anticipate. We have introduced to market a RF synthesizer product for use in cellular phones operating on the Global System for Mobile Communications, or GSM, standard. The RF synthesizer is also compatible with General Packet Radio Service, which is the emerging data communications protocol for GSM based cellular phones. We cannot be certain whether manufacturers of cellular phones using these standards will incorporate our RF synthesizer or that these standards will not change, thereby making our products unsuitable or impractical. In the area of Optical Networking, our recently introduced clock and data recovery integrated circuit operates within stringent specifications for high speed communications systems known as SONET. Changes to this standard could make our products uncompetitive or unsuitable to changing system requirements and result in the inability to sell these products.

OUR PRODUCTS ARE COMPLEX AND MAY REQUIRE MODIFICATIONS TO RESOLVE UNDETECTED ERRORS WHICH COULD LEAD TO AN INCREASE IN OUR COSTS OR A REDUCTION IN OUR SALES

Our products are complex and may contain errors when first introduced or as new versions are released. We rely primarily on our in-house testing personnel to design test operations and procedures to detect any errors prior to delivery of our products to our customers. Because our products are manufactured by third parties, should problems occur in the operation or performance of our ICs, we may experience delays in meeting key introduction dates or scheduled delivery dates to our customers. These errors also could cause us to incur significant re-engineering costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations and business reputation problems.

THE PERFORMANCE OF OUR DIRECT ACCESS ARRANGEMENT PRODUCTS MAY BE ADVERSELY AFFECTED BY SEVERE ENVIRONMENTAL CONDITIONS THAT MAY REQUIRE MODIFICATIONS, WHICH COULD LEAD TO AN INCREASE IN OUR COSTS OR A REDUCTION IN OUR SALES

Although our direct access arrangement products are compliant with published specifications, these established specifications might not adequately address all conditions that must be satisfied in order to operate in harsh environments. This includes environments where there are wide variations in electrical quality, telephone line quality, static electricity and operating temperatures or that may be affected by lightning or improper handling by customers and end users. Our products have had a limited period of time in the field under operation, and these environmental

factors may result in unanticipated returns of our products. Any necessary modifications could cause us to incur significant re-engineering costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations and business reputation problems.

A SUBSTANTIAL PORTION OF THE FINAL TESTING OF OUR PRODUCTS IS PERFORMED INTERNALLY BY US, WHICH INCREASES OUR FIXED COSTS

In 1999, approximately 74% of our final product test operations were performed in-house. The balance of the final testing of our products is provided by our contract manufacturers or other third parties. During the three and nine months ended September 30, 2000, substantially all of our final product test operations were performed in-house. While we believe performing this testing in-house provides us with advantages in terms of lower per unit cost, quality control and shorter time required to bring a product to market, we may encounter difficulties and delays in maintaining or expanding our internal test capabilities. In addition, final testing of complex semiconductors requires substantial resources to acquire state-of-the-art testing equipment and hiring additional qualified personnel, which has increased our fixed costs. If demand for our products does not support the effective utilization of these employees and additional equipment, we may not realize any benefit from replacing our outside vendors with internal final testing. Any decrease in the demand for our products could result in the underutilization of our testing equipment and personnel. If our internal test operations are underused or mismanaged, we may incur significant costs that could adversely affect our operating results.

WE PLAN TO INCREASE OUR INTERNATIONAL SALES ACTIVITIES SIGNIFICANTLY, WHICH WILL SUBJECT US TO ADDITIONAL BUSINESS RISKS INCLUDING INCREASED LOGISTICAL COMPLEXITY, POLITICAL INSTABILITY AND CURRENCY FLUCTUATIONS

We intend to open sales offices in international markets to expand our international sales activities in Europe and the Pacific Rim region. Our planned international sales growth will be limited if we are unable to hire additional personnel and develop relationships with international distributors. We may not be able to maintain or increase international market demand for our products. Our international operations are subject to a number of risks, including:

- increased complexity and costs of managing international operations;
- protectionist laws and business practices that favor local competition in some countries;
- multiple, conflicting and changing laws, regulations and tax schemes;
- longer sales cycles;
- greater difficulty in accounts receivable collection and longer collection periods; and
- political and economic instability.

To date, all of our sales to international customers and purchases of components from international suppliers have been denominated in U.S. dollars. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive for our international customers to purchase, thus rendering them less competitive.

OUR INABILITY TO MANAGE GROWTH COULD MATERIALLY AND ADVERSELY AFFECT OUR BUSINESS

During the past 21 months, we have significantly increased the scope of our operations and expanded our workforce from 42 employees at January 2, 1999 to 240 employees at September 30, 2000. This growth has placed, and any future growth of our operations will continue to place, a significant strain on our management personnel, systems and resources. We anticipate that we will need to implement a variety of new and upgraded operational and financial systems, procedures and controls, including the improvement of our accounting and other internal management systems. We also expect that we will need to continue to expand, train, manage and motivate our workforce. All of these endeavors will require substantial management effort. If we are unable to effectively manage our expanding operations, our business could be materially and adversely affected.

WE MAY BE UNABLE TO PROTECT OUR INTELLECTUAL PROPERTY, WHICH WOULD NEGATIVELY AFFECT OUR ABILITY TO COMPETE

Our products rely on our proprietary technology, and we expect that future technological advances made by us will be critical to sustain market acceptance of our products. Therefore, we believe that the protection of our intellectual property rights is and will continue to be important to the success of our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants and business partners, and control access to and distribution of our documentation and other proprietary information. Despite these efforts, unauthorized parties may attempt to copy or otherwise obtain and use our proprietary technology. Monitoring unauthorized use of our technology is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. We cannot be certain that patents will be issued as a result of our pending applications nor can we be certain that any issued patents would protect or benefit us or give us adequate protection from competing products. For example, issued patents may be circumvented or challenged and declared invalid or unenforceable. We also cannot be certain that others will not develop our unpatented proprietary technology or effective competing technologies on their own.

SIGNIFICANT LITIGATION OVER INTELLECTUAL PROPERTY IN OUR INDUSTRY MAY CAUSE US TO BECOME INVOLVED IN COSTLY AND LENGTHY LITIGATION WHICH COULD SERIOUSLY HARM OUR BUSINESS

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. From time to time, we receive letters from various industry participants alleging infringement of patents or trade secrets. The exploratory nature of these inquiries has become relatively common in the semiconductor industry. We typically respond when appropriate and as advised by legal counsel. We may become involved in litigation to protect our intellectual property rights or to defend allegations of infringement asserted by others. Legal proceedings could subject us to significant liability for damages or invalidate our proprietary rights. Legal proceedings initiated by us to protect our intellectual property rights could also result in counterclaims or countersuits against us. Any litigation, regardless of its outcome, would likely be time consuming and expensive to resolve and would divert our management's time and attention. Any intellectual property litigation also could force us to take specific actions, including:

- cease selling products that use the challenged intellectual property;

- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, which license may not be available on reasonable terms, or at all; or

- redesign those products that use infringing intellectual property.

On January 12, 2000, we filed a lawsuit against Analog Devices and 3Com claiming that Analog Devices has infringed, and is continuing to infringe, one of our issued U.S. patents with respect to our DAA technology and that Analog Devices and 3Com have misappropriated our confidential information, know-how and trade secrets. On January 26, 2000, Analog Devices served an answer denying that it has misappropriated our confidential information, know-how and trade secrets and brought a counterclaim against us seeking a declaratory judgment that our issued U.S. patent is invalid and unenforceable and that Analog Devices has not infringed our issued U.S. patent. We filed a reply to Analog Devices' counterclaim asserting that our issued U.S. patent is valid and enforceable and that Analog Devices has infringed our issued U.S. patent. On February 24, 2000, 3Com served an answer denying it has misappropriated our confidential information, know-how and trade secrets and, without specifying, asserted we have acted with unclean hands. On August 11, 2000, we amended the original patent infringement claim against Analog Devices to include 3Com. On August 22, 2000, we amended the claim to include patent infringement on a recently issued related patent against both Analog Devices and 3Com. On September 6, 2000, Analog Devices and 3Com answered our amended complaints, denying that our patent is valid and infringed and asserting additional defenses and counterclaims. On September 26, 2000, we replied to Analog Devices' and 3Com's counterclaims denying the assertions of invalidity, unenforceability and noninfringement. Our lawsuit will involve significant expense and divert our management's time and attention from other aspects of our business. The lawsuit may also damage our business relationship with 3Com which accounted for 8% of our sales in the nine months ended September 30, 2000, 10% of our sales in fiscal 1999 and 20% of our sales in fiscal 1998. Due to the inherent uncertainties of litigation, we cannot be certain of the outcome of this lawsuit.

FAILURE TO EXPAND OUR DISTRIBUTION CHANNELS AND MANAGE OUR DISTRIBUTION RELATIONSHIPS COULD IMPEDE OUR FUTURE GROWTH

The future growth of our business will depend in part on our ability to expand our existing relationships with distributors and sales representatives, develop additional channels for the distribution and sale of our products and manage these relationships. As part of our channel sales strategy, we intend to expand our relationships with distributors and sales representatives. As we develop our indirect sales capabilities, we will need to manage the potential conflicts that may arise with our direct sales efforts. The inability to successfully execute or manage a multi-channel sales strategy could impede our future growth.

RISKS RELATED TO OUR INDUSTRY

COMPETITION WITHIN THE NUMEROUS MARKETS WE TARGET MAY REDUCE SALES OF OUR PRODUCTS AND REDUCE MARKET SHARE

The markets for semiconductors in general, and for mixed-signal ICs in particular, are intensely competitive. We expect that the market for our products will continually evolve and will be subject to rapid technological change. In addition, as we target and supply products to numerous markets and applications, including wireline, wireless and other communications markets, we face competition from a relatively large number of competitors. Across all of our product areas, we compete with Advanced Micro Devices, Analog Devices, Conexant, Delta Integration, Fujitsu, Infineon Technologies, National Semiconductor, Philips and Texas Instruments, among others. We expect to face competition in the future from our current competitors, other manufacturers and designers of semiconductors, and innovative start-up semiconductor design companies. Some of our customers, such as Intel, Lucent and Motorola, are also large, established semiconductor suppliers. Our sales to and support of these customers may

enable them to become a source of competition to us, despite our efforts to protect our intellectual property rights. As the markets for communications products grow, we also may face competition from traditional communications device companies. These companies may enter the mixed-signal semiconductor market by introducing their own ICs or by entering into strategic relationships with or acquiring other existing providers of semiconductor products.

THE AVERAGE SELLING PRICES OF OUR PRODUCTS COULD DECREASE RAPIDLY WHICH MAY NEGATIVELY IMPACT OUR GROSS MARGINS AND SALES

We may experience substantial period-to-period fluctuations in future operating results due to the erosion of our average selling prices. We have reduced the average unit price of our products in anticipation of future competitive pricing pressures, new product introductions by us or our competitors and other factors. We expect that we will have to do so again in the future. If we are unable to offset any such reductions in our average selling prices by increasing our sales volumes, our gross profits and sales will suffer. To maintain gross margins, we will need to develop and introduce new products and product enhancements on a timely basis and continually reduce our costs. Our failure to do so would cause our sales and gross margins to decline.

OUR CUSTOMERS REQUIRE OUR PRODUCTS TO UNDERGO A LENGTHY AND EXPENSIVE QUALIFICATION PROCESS WHICH DOES NOT ASSURE PRODUCT SALES

Prior to purchasing our products, our customers require that our products undergo an extensive qualification process, which involves testing of the products in the customer's system as well as rigorous reliability testing. This qualification process may continue for six months or longer. However, qualification of a product by a customer does not assure any sales of the product to that customer. Even after successful qualification and sales of a product to a customer, a subsequent revision to the IC, changes in its manufacturing process or the selection of a new supplier by us may require a new qualification process, which may result in delays and in us holding excess or obsolete inventory. After our products are qualified, it can take an additional six months or more before the customer commences volume production of components or devices that incorporate our products. Despite these uncertainties, we devote substantial resources, including design, engineering, sales, marketing and management efforts, toward qualifying our products with customers in anticipation of sales. If we are unsuccessful or delayed in qualifying any of our products with a customer, such failure or delay would preclude or delay sales of such product to the customer, which may impede our growth and cause our business to suffer.

WE ARE SUBJECT TO THE CYCLICAL NATURE OF THE SEMICONDUCTOR INDUSTRY

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns, often connected with, or in anticipation of, maturing product cycles of both semiconductor companies' and their customers' products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. Any future downturns could have a material adverse effect on our business and operating results. Furthermore, any upturn in the semiconductor industry could result in increased competition for access to third-party foundry and assembly capacity. We are dependent on the availability of such capacity to manufacture and assemble our ICs. None of our third-party foundry or assembly contractors have provided assurances that adequate capacity will be available to us.

OUR PRODUCTS MUST CONFORM TO INDUSTRY STANDARDS IN ORDER TO BE ACCEPTED BY END USERS IN OUR MARKETS

Generally, our products comprise only a part of a communications device. All components of such devices must uniformly comply with industry standards in order to operate efficiently together. We depend on companies that provide other components of the devices to support prevailing industry standards. Many of these companies are significantly larger and more influential in effecting industry standards than we are. Some industry standards may not be widely adopted or implemented uniformly, and competing standards may emerge that may be preferred by our customers or end users. If larger companies do not support the same industry standards that we do, or if competing standards emerge, market acceptance of our products could be adversely affected which would harm our business.

Products for communications applications are based on industry standards that are continually evolving. Our ability to compete in the future will depend on our ability to identify and ensure compliance with these evolving industry standards. The emergence of new industry standards could render our products incompatible with products developed by other suppliers. As a result, we could be required to invest significant time and effort and to incur significant expense to redesign our products to ensure compliance with relevant standards. If our products are not in compliance with prevailing industry standards for a significant period of time, we could miss opportunities to achieve crucial design wins. We may not be successful in developing or using new technologies or in developing new products or product enhancements that achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Information related to quantitative and qualitative disclosures regarding market risk is set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations and the risk factors under Item 2 above. Such information is incorporated by reference herein.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On January 12, 2000, we filed a lawsuit against Analog Devices and 3Com in the United States District Court for the Western District of Texas (Austin Division). The complaint asserts that Analog Devices has infringed, and is continuing to infringe, on our U.S. Patent 5,870,046, entitled "Analog Isolation System With Digital Communication Across A Capacitive Barrier," by making, using, selling, offering to sell and/or importing silicon DAAs that embody or use inventions claimed by our patent. The complaint also asserts, among other things, that Analog Devices and 3Com have misappropriated our confidential information, know-how and trade secrets relating to our DAA technology, tortuously interfered with our business relations with our existing and prospective customers, and been unjustly enriched by this misappropriation. The suit seeks unspecified damages from Analog Devices, including damages for willful infringement of our patent, and an injunction prohibiting Analog Devices from infringing our patent. In addition, the suit seeks unspecified damages, including punitive damages and attorneys' fees arising, among other things, out of the misappropriation, tortious interference and unjust enrichment, and an injunction prohibiting Analog Devices and 3Com from designing, manufacturing, reproducing, using or selling any ICs, modems or other products the conception, design or development of which was based on our confidential information, know-how and trade secrets.

On January 26, 2000, Analog Devices served an answer denying that it has misappropriated our confidential information, know-how and trade secrets and brought a counterclaim against us seeking a declaratory judgment that our issued U.S. patent is invalid and unenforceable and that

Analog Devices has not infringed our issued U.S. patent. The counterclaim further alleges that we improperly failed to disclose a relevant pre-existing patent to the U.S. Patent and Trademark Office during the course of our patent application process, and that we therefore are unable to enforce our patent. We filed a reply to Analog Devices' counterclaim asserting that our issued U.S. patent is valid and enforceable and that Analog Devices has infringed our issued U.S. patent. We also denied that we improperly excluded any relevant information in the course of our patent application process.

On February 24, 2000, 3Com served an answer denying it has misappropriated our confidential information, know-how and trade secrets and, without specifying, asserted we have acted with unclean hands. This litigation is in the discovery phase and no trial date has been set by the trial court.

On May 22, 2000, Analog Devices filed a complaint in the United States District Court for the District of Massachusetts asserting that we have infringed on one of their patents. On June 26, 2000, Analog Devices withdrew their complaint without prejudice before we were required to file a response.

On August 11, 2000, the Company filed an Amended Complaint in this action to add a count for infringement of the Company's `046 patent against 3Com Corporation. The Amended Complaint avers that 3Com also has infringed the `046 patent by making, using, selling, offering for sale and/or importing modems that contain certain silicon DAA integrated circuits and chipsets. The complaint seeks a preliminary and permanent injunction and unspecified damages.

On August 22, 2000, the Company filed a Second Amended Complaint to add a count for infringement of the Company's Scott et al. United States patent 6,107,948 (the `948 patent) against both Analog Devices and 3Com Corporation. The amended complaint avers, inter alia, that Analog Devices has infringed the `948 patent by making, using, selling, offering for sale and/or importing certain silicon DAA integrated circuits and chipsets, and that 3Com has infringed the `948 patent by making, using, selling, offering for sale and/or importing modems that contain those same silicon DAA integrated circuits and chipsets. The complaint seeks a preliminary and permanent injunction and unspecified damages.

On September 6, 2000, Analog Devices and 3Com answered the Company's amended complaints. Analog Devices denied that the `948 patent is valid and infringed and asserted additional defenses and counterclaims. Analog Devices also counterclaimed for a declaratory judgment that the `948 patent is invalid and unenforceable, and not infringed. 3Com denied that the `046 and `948 patents are valid and infringed and asserted additional defenses and counterclaims. 3Com also counterclaimed for a declaratory judgement that the `046 and `948 patents are invalid and unenforceable, not infringed.

On September 26, 2000, the Company filed replies to Analog Devices' and 3Com's counterclaims, denying Analog Devices' and 3Com's assertions of invalidity, unenforceability and noninfringement.

The parties are conducting discovery, and the Court has set this case for trial in March 2001. At present, we are unable to predict the outcome of this matter.

For a description of risks associated with this pending lawsuit, please see "We depend on a limited number of customers for the vast majority of our sales, and the loss of, or a significant reduction in orders from, any key customer could significantly reduce our sales" and "Significant litigation over intellectual property in our industry may cause us to become involved in costly and lengthy litigation which could seriously harm our business" in the risk factors included in Item 2 of Part I of this Form 10-Q.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On August 9, 2000, we issued 384,100 shares of Silicon Laboratories common stock in exchange for the outstanding capital stock of Krypton Isolation, Inc. The issuance of Silicon Laboratories common stock in connection with the acquisition of Krypton was deemed exempt from registration under Section 5 of the Securities Act of 1933 in reliance upon Section 3(a)(10) thereof, pursuant to a fairness hearing conducted by the California Department of Corporations.

Our registration statement (Registration No. 333-94853) under the Securities Act of 1933, as amended, relating to our initial public offering of our common stock became effective on March 23, 2000. A total of 3,680,000 shares of common stock were registered. We sold a total of 3,200,000 shares of our common stock and selling stockholders sold a total of 480,000 to an underwriting syndicate. The managing underwriters were Morgan Stanley & Co. Incorporated, Lehman Brothers Inc., and Salomon Smith Barney Inc. The offering commenced and was completed on March 24, 2000, at a price to the public of $31.00 per share. The initial public offering resulted in net proceeds to us of $90.6 million, after deducting underwriting commissions of $6.9 million and offering expenses of $1.7 million. We used $15 million of the proceeds as part of the consideration paid in the acquisition of Krypton Isolation Inc. on August 9, 2000. Another $4.3 million was used to pay off the equipment loans at Imperial Bank. As of September 30, 2000, the remaining proceeds were invested in government securities and other short-term, investment-grade, interest bearing instruments.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable

ITEM 5 OTHER INFORMATION

Not applicable

ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K

(a) The following exhibit is filed as part of this report:

2.1 Merger Agreement and Plan of Reorganization dated as of June 22, 2000, by and among Silicon Labs, Karst Corporation, a California corporation and wholly-owned subsidiary of Silicon Labs, and Krypton Isolation, Inc., a California corporation, and with respect to Section 7.2 of the Merger Agreement only, Charles Welch, a Shareholder Agent, is incorporated herein by reference to Exhibit 2.1 to our Current report on Form 8-K filed with the SEC on August 11, 2000

27.01 Financial Data Schedule (EDGAR version only)

(b) During the quarter ended September 30, 2000, we filed the following Current Reports on Form 8-K:

1. We filed a Form 8-K on August 11, 2000 (Item 2) announcing the completion of the Krypton acquisition

2. We filed a Form 8-K/A on September 8, 2000 (Item 7) including the required financial statements with respect to the Krypton acquisition

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.

SILICON LABORATORIES INC.

By: /s/ John W. McGovern

John W. McGovern
VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER

10/16/2000

Date

/s/ Navdeep S. Sooch

Navdeep S. Sooch
CHAIRMAN AND
CHIEF EXECUTIVE OFFICER

10/16/2000

Date

/s/ John W. McGovern

John W. McGovern
VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER
(PRINCIPAL ACCOUNTING OFFICER)

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