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NEXT LEVEL COMMUNICATIONS INC

Form 10-Q

August 02, 2001

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

THE QUARTERLY PERIOD ENDED JUNE 30, 2001

OR

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

COMMISSION FILE NUMBER: 0-27877

NEXT LEVEL COMMUNICATIONS, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE
(State or Other Jurisdiction of
Incorporation or Organization)

94-3342408
(I.R.S. Employer
Identification No.)

6085 STATE FARM DRIVE
ROHNERT PARK, CALIFORNIA 94928
(Address of Principal Executive Offices, Including Zip Code)

Registrant's Telephone Number, Including Area Code: (707) 584-6820

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

The number of shares of our common stock, par value \$0.01 per share, outstanding as of July 17, 2001 was approximately 85,469,007.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Next Level Communications, INC.
CONDENSED CONSOLIDATED Statements OF OPERATIONS
Three Months and Six Months Ended June 30, 2001 and 2000
(In thousands, except share data, unaudited)

| | THREE MONTHS ENDED | | SIX MONTHS ENDED |
|-------------------------------------|--------------------|---------------|------------------|
| | JUNE 30, 2001 | JUNE 30, 2000 | JUNE 30, 2000 |
| Revenues | | | |
| Equipment | \$ 31,029 | \$ 39,340 | \$ 59,340 |
| Software | 875 | 836 | 1,711 |
| | 31,904 | 40,176 | 60,051 |
| COST OF REVENUES | | | |
| Equipment | 25,925 | 32,076 | 48,001 |
| Software | 1 | 25 | 26 |
| Inventory charge | 72,016 | -- | 72,016 |
| | 97,942 | 32,101 | 120,043 |
| GROSS PROFIT (LOSS) | (66,038) | 8,075 | (59,992) |
| OPERATING EXPENSES | | | |
| Research and development | 12,859 | 13,652 | 26,511 |
| Selling, general and administrative | 15,087 | 10,966 | 29,473 |
| Noncash compensation charge | -- | -- | -- |
| | 27,946 | 24,618 | 56,034 |
| OPERATING LOSS | (93,984) | (16,543) | (116,026) |
| Interest income (expense), net | (3,192) | 1,956 | (3,192) |
| Other income (expense), net | (4,959) | (46) | (5,005) |
| NET LOSS | \$ (102,135) | \$ (14,633) | \$ (124,226) |

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| | | | | | | |
|--|----|------------|----|------------|----|---------|
| Basic and diluted net loss per common share | \$ | (1.20) | \$ | (0.18) | \$ | (1 |
| Shares used to compute basic and diluted net loss per common share | | 85,233,000 | | 80,322,000 | | 84,932, |

See notes to condensed consolidated financial statements.

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NEXT LEVEL COMMUNICATIONS, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 June 30, 2001 and December 31, 2000
 (In thousands, except share data, unaudited)

ASSETS

| | JUNE 30, 2001 |
|--|------------------|
| | ----- |
| Current Assets: | |
| Cash and cash equivalents | \$ 16,919 |
| Restricted marketable securities | -- |
| Trade receivables, less allowance for doubtful accounts of \$1,332 and \$1,332 | 36,527 |
| Other receivables | 2,612 |
| Inventories | 74,726 |
| Prepaid expenses and other | 1,355 |
| | ----- |
| Total current assets | 132,139 |
| Property and equipment, net | 50,808 |
| Long-term investments | 15,583 |
| Goodwill, less accumulated amortization of \$10,232 and \$6,883 | 14,464 |
| Other assets | 2,078 |
| | ----- |
| Total Assets | \$ 215,072 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | |
|--|-----------|
| Current Liabilities: | |
| Accounts payable | \$ 35,725 |
| Accrued liabilities | 20,745 |
| Due to Motorola: | |
| Note payable, net of discount | 36,638 |
| Tax sharing agreement liability | 32,300 |
| Note payable | -- |
| Note payable to vendor | 24,340 |
| Deferred revenue | 2,456 |
| Current portion of capital lease obligations | 173 |
| | ----- |
| Total current liabilities | 152,377 |
| Long-term obligations | -- |
| Stockholders' Equity: | |

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| | |
|---|------------|
| Common stock - \$.01 par value, 400,000,000 shares authorized, 85,441,000 and 84,443,000 shares issued and outstanding | 786 |
| Additional paid-in-capital | 466,372 |
| Accumulated deficit | (404,443) |
| Unearned compensation | (20) |
| | ----- |
| Total Stockholders' Equity | 62,695 |
| | ----- |
| Total Liabilities and Stockholders' Equity | \$ 215,072 |
| | ===== |

See notes to condensed consolidated financial statements.

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NEXT LEVEL COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
Six Months Ended June 30, 2001 and 2000
(In thousands, unaudited)

| | JUNE 30, 2001 ----- |
|---|---------------------------|
| OPERATING ACTIVITIES: | |
| Net loss | \$(124,533) |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Inventory charge | 72,016 |
| Write-down of investments and property and equipment | 6,286 |
| Non-cash compensation charge | 334 |
| Depreciation and amortization | 8,558 |
| Amortization of discount on note payable | 2,617 |
| Equity in net loss of investee | 450 |
| Changes in assets and liabilities: | |
| Trade receivables | (1,881) |
| Inventories | (49,978) |
| Other assets | (527) |
| Accounts payable | (3,302) |
| Accrued liabilities and deferred revenue | 17,231 |
| | ----- |
| Net cash used in operating activities | (72,729) |
| INVESTING ACTIVITIES: | |
| Purchases of property and equipment | (3,224) |
| Proceeds from sale of marketable securities | -- |
| Long-term investments | (5,000) |
| | ----- |
| Net cash used in investing activities | (8,224) |
| FINANCING ACTIVITIES: | |
| Issuance of common stock | 2,166 |
| Proceeds from Motorola financing | 60,000 |
| Proceeds from borrowings, net | -- |
| Repayment of capital lease obligations | (157) |

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| | |
|--|-----------|
| Initial public offering expenses, net | -- |
| | ----- |
| Net cash provided by financing activities | 62,009 |
| Net Decrease in Cash and Cash Equivalents | (18,944) |
| Cash and Cash Equivalents, Beginning of Period | 35,863 |
| | ----- |
| Cash and Cash Equivalents, End of Period | \$ 16,919 |
| | ===== |

See notes to condensed consolidated financial statements.

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NEXT LEVEL COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. BASIS OF PRESENTATION

Next Level Communications, Inc. (the "Company") is a leading provider of broadband communications systems that enable telephone companies and other emerging communications service providers to cost effectively deliver voice, data and video services over the existing copper wire telephone infrastructure.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. While these financial statements reflect all adjustments (consisting of normal recurring items, except as discussed in Notes 2 and 4) which are, in the opinion of management, necessary to present fairly the results of the interim period, they do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements and notes should be read in conjunction with the financial statements and notes thereto, for the year ended December 31, 2000 contained in the Company's Annual Report on Form 10-K. Certain prior period amounts have been reclassified to conform to the current period presentation. The results of operations for the three and six months ended June 30, 2001 are not necessarily indicative of the operating results for the full year.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the year. Significant estimates include the inventory write-down and loss on purchase commitments (see Note 2) and investment and property and equipment write-down (see Note 4). Actual results could differ from those estimates.

New Accounting Standard - In June 2001, the Financial Accounting

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Standards Board issued Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but rather will be tested at least annually for impairment. The Company will adopt SFAS No. 142 for its fiscal year beginning January 1, 2002. Upon adoption of SFAS 142, the Company will stop the amortization of goodwill that resulted from business combinations initiated prior to the adoption of SFAS 141, Business Combinations. The Company will evaluate goodwill under the SFAS 142 transitional impairment test and has not yet determined whether or not there will be an impairment loss. Any transitional impairment loss will be recognized as a change in accounting principle.

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2. SECOND QUARTER 2001 INVENTORY WRITE-DOWN AND LOSS ON PURCHASE COMMITMENTS

In the quarter ended June 30, 2001, the Company recorded a write-down of inventory and purchase commitments for excess and obsolete quantities and lower of cost or market adjustments related to its current generation product platform and related communications equipment totaling \$72,016,000. To meet forecasted demand and reduce the anticipated component supply constraints that had existed in the past, the Company increased inventory levels for certain components and entered into purchase commitments for certain components with long lead times. However, in the quarter ended June 30, 2001, the Company's actual sales, as well as the Company's estimates of forecasted sales in 2001 and 2002, for its current generation of products declined significantly. As a result, the inventory charges were required and were calculated based upon (i) the substantial completion of the negotiation process with the Company's contract manufacturers and their suppliers and the Company's other vendors regarding purchase commitments and cancellations made by the Company, (ii) the inventory levels in excess of forecasted demand through December 31, 2002 and (iii) the Company's estimates of salvage or recovery value for each raw material or finished good on an item by item basis. The Company does not currently anticipate that the excess inventory included in this provision will be used after December 31, 2002 based on the Company's current demand forecast. Such write-down was included in cost of revenues in the quarter ended June 30, 2001 and consisted of the following:

| | |
|--|--------------|
| Excess quantities of raw materials on hand and under purchase commitments at June 30, 2001, net of salvage | \$34,762,000 |
| Excess quantities of finished goods on hand at June 30, 2001, net of salvage | 10,785,000 |
| Obsolescence | 13,198,000 |
| Cancellation charges on purchase commitments | 5,234,000 |
| Lower of cost or market write-down on current generation product platform | 8,037,000 |
| | ----- |
| Total | \$72,016,000 |

Significant estimates included in the calculation of the inventory write-down above include forecasted demand for the Company's products, sales prices for residential gateways and other finished goods and estimated salvage

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or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

3. LOAN AGREEMENT WITH MOTOROLA

On May 16, 2001, the Company entered into a \$60,000,000 loan agreement with Motorola, Inc. Under the terms of the agreement, Motorola, which currently owns approximately 75% of Next Level Communications, Inc., made a \$60,000,000 loan commitment to the Company over a two-year period, beginning May 17, 2001. Interest is determined by Motorola based on either the base rate (as defined in the agreement) plus 2% or the Eurodollar rate plus 3 1/2%.

As of June 30, 2001, the Company had borrowed \$60,000,000 under this loan agreement.

In the event of a debt or equity security offering or a sale of assets in excess of \$25,000,000, the first \$25,000,000 of proceeds may be retained by the Company; the next \$25,000,000 (between

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\$25,000,000 and \$50,000,000) of such proceeds will be allocated at least one-third to repay the Company's obligations under the Company's tax sharing agreement with Motorola (the "Tax Sharing Agreement"), and the balance may be retained by the Company; the next \$25,000,000 of such proceeds (between \$50,000,000 and \$75,000,000) will be allocated at least one-half to repay the Company's obligations under the Tax Sharing Agreement and the balance may be retained by the Company; amounts of such proceeds in excess of \$75,000,000 must be used 100% first to repay the Company's obligations under the Tax Sharing Agreement (to the extent of such obligations) and then to repay and reduce the amount owed under the loan agreement.

The loan agreement provides for the issuance of warrants, to purchase up to 7,500,000 shares of the Company's common stock, all at an exercise price of \$7.39 per share. Such warrants become exercisable as follows:

- 1,500,000 shares upon the effective date of the loan agreement;
- 750,000 shares upon cumulative borrowings outstanding equaling or exceeding \$20,000,000;
- 750,000 shares upon cumulative borrowings outstanding equaling or exceeding \$30,000,000;
- 750,000 shares upon cumulative borrowings outstanding equaling or exceeding \$40,000,000;
- 750,000 shares upon cumulative borrowings outstanding equaling or exceeding \$50,000,000;
- 1,000,000 shares become exercisable unless, prior to May 17, 2002, all borrowings under the loan agreement have been repaid in full and it has been terminated;
- 1,000,000 shares become exercisable unless, prior to November 17, 2002 all borrowings under the loan agreement have been repaid in full and it has been terminated; and
- 1,000,000 shares become exercisable unless, prior to February 17, 2003, all borrowings under the loan agreement have been repaid in full and it has been terminated.

As of June 30, 2001, based upon borrowings to date, warrants to purchase

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4,500,000 shares of the Company's common stock at \$7.39 per share were issued and exercisable. The fair value of the warrants of \$25,979,000 was recorded as a discount to the note payable with a corresponding increase to additional paid-in capital. Such amount was determined based upon the Black-Scholes option pricing model using expected volatility of 101%, a risk-free interest rate of 4.9% and an expected term of four years. As a result, at June 30, 2001, the borrowings from Motorola with a stated value of \$60,000,000 were recorded at \$36,638,000, net of the unamortized discount related to the fair value of the warrants. In the quarter ended June 30, 2001, non-cash discount amortization of \$2,617,000 was recorded; non-cash interest expense will be recorded through May 2002 to reflect amortization of the remaining discount.

The loan agreement contains various covenants, including compliance with net worth requirements, and restrictions on additional indebtedness, capital expenditures, and dividends. As of June 30, 2001, the Company was not in compliance with the net worth financial covenant. On July 25, 2001, the Company and Motorola amended the loan agreement. The amendment waived the debt covenant violation and established revised financial covenants for net worth.

4. INVESTMENT AND PROPERTY AND EQUIPMENT WRITE-DOWNS/OTHER EXPENSE

The Company recorded a write-down of \$4.0 million to one of its long-term investments in the quarter ended June 30, 2001. Such amount was measured as the amount by which the carrying amount exceeded the investment's estimated fair value.

In addition, the Company wrote off \$1.1 million of property and equipment related to the second

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quarter closure of a small research and development facility in Vietnam.

5. TAX SHARING AND ALLOCATION AGREEMENT WITH MOTOROLA

In December 2000, the Company received a \$15 million advance from Motorola related to a tax sharing and allocation agreement. The Company received an additional \$17.3 million in January 2001 and the tax agreement was finalized in February 2001. The amount advanced to the Company is based on an estimate of the present value of income tax benefits to Motorola from the inclusion of the Company's operating losses for the period from January 6, 2000 to May 17, 2000 in Motorola's consolidated tax return. Subsequent to May 17, 2000, the Company has not been included in Motorola's tax return. To the extent Motorola does not achieve the expected tax benefits by September 30, 2006, the Company must repay any difference. In addition, should the Company obtain certain specified levels of financing from independent third parties, it must also repay all or a portion of the advance. The Company has included such \$32.3 million as a current liability at June 30, 2001.

6. INVENTORIES

Inventories at June 30, 2001 and December 31, 2000 consisted of (in thousands):

June 30,

December 31,

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

Some of the statements in the following discussion and elsewhere in this report constitute forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential" or "continue" or the negative of such terms or other comparable terminology. These statements involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. These factors include, among other things, those listed under "Risk Factors" below and elsewhere in this report.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

OVERVIEW

We design and market broadband communications equipment that enables telephone companies and other communications service providers to cost-effectively deliver a full suite of voice, data and video services over the existing copper wire telephone infrastructure. We commenced operations in July 1994 and recorded our first sale in September 1997. From January 1998 until November 1999, we operated through Next Level Communications L.P., which was formed in connection with the transfer of all of the net assets, management and workforce of a wholly-owned subsidiary of General Instrument. In November 1999, the business and assets of that partnership were merged into Next Level Communications, Inc. as part of our recapitalization. In January 2000, General Instrument was acquired by Motorola, Inc., making us an indirect subsidiary of Motorola.

We generate our revenues primarily from sales of our equipment. A small number of customers have accounted for a large part of our revenues to date, and we expect this concentration to continue in the future. Qwest (formerly U S WEST) accounted for 54% of our total revenues for the quarter ended June 30, 2001 and 67% of our total revenues for the quarter ended June 30, 2000. Our agreements with our largest customers are cancelable by these customers on short notice and without penalty, and do not obligate the customers to purchase any products. In addition, our significant customer agreements generally contain fixed-price provisions. As a result, our ability to generate a profit on these contracts depends upon our ability to produce and market our products at costs lower than these fixed prices.

The timing of our revenues is difficult to predict because of the length and variability of the sales cycle for our products. Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deploying them. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. While our customers are evaluating our products and before they place an order, if at all, we may incur substantial sales and marketing expenses and expend significant

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management efforts.

Revenues. Our revenues consist primarily of sales of equipment and sales of data communications software. We recognize equipment revenues upon shipment of our products. Software revenues consist of sales to original equipment manufacturers that supply communications software and hardware to distributors. We recognize software license revenues when a non-cancelable license agreement has been signed, delivery has occurred, the fees are fixed and determinable and collection is probable. The portion of revenues from new software license agreements that relates to our obligations to provide customer support is deferred and recognized ratably over the maintenance period.

Cost of revenues. Cost of equipment revenues includes direct material and labor, depreciation and amortization expense on property and equipment, warranty expenses, license fees and manufacturing and service overhead. Cost of software revenues primarily includes the cost of the media the software is shipped on, which is usually CDs. In the quarter ended June 30, 2001, we recorded an inventory charge of \$72.0 million (see Note 2 to the condensed consolidated financial statements).

Research and development. Research and development expenses consist principally of salaries and related personnel expenses, consultant fees, prototype component expenses and development contracts related to the design, development, testing and enhancement of our products. We expense all research and development costs as incurred.

Selling, general and administrative. Selling, general and administrative expenses consist primarily of salaries and related expenses for personnel engaged in direct marketing and field service

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support functions, executive, accounting and administrative personnel, recruiting expenses, professional fees and other general corporate expenses.

RESULTS OF OPERATIONS

Revenues. Total revenues in the quarter ended June 30, 2001 decreased to \$31.9 million from \$40.2 million in the second quarter of 2000. Total revenues in the first six months of 2001 decreased to \$60.6 million from \$70.7 million in the six-month period ended June 30, 2000. The decrease was primarily due to a decrease in equipment sales to Qwest, partially offset by an increase in equipment sales to independent operating companies. Total revenues for the second quarter of 2001 included \$31.0 million of equipment sales, compared to \$39.3 million for the comparable quarter in 2000. Equipment sales for the six-month period ended June 30, 2001 were \$59.1 million, compared to \$69.0 million for the comparable period in 2000. Qwest and other regional and national bell operating companies accounted for \$17.8 million of equipment revenue in the second quarter of 2001 as compared to \$26.8 million in the second quarter of 2000. Equipment sales to Qwest and other regional and national bell operating companies for the six-month period ended June 30, 2001 were \$33.4 million, compared to \$52.3 million for the comparable period in 2000. As a result of the merger between U S WEST and Qwest, Qwest slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. The re-evaluation by Qwest is continuing and sales to Qwest in the future are dependent upon its decision regarding the deployment of our product. Sales to independent operating companies were \$12.1 million in the second quarter of 2001, compared to \$11.1 million in the second quarter of 2000. Equipment sales to independent operating companies for the six-month period

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ended June 30, 2001 were \$23.2 million, compared to \$15.2 million for the comparable period in 2000. Sales to multiple service organizations were \$1.7 million in the six months ended June 30, 2001, compared to \$1.5 million for the comparable prior year period. International sales were \$839,000 in the six month period ended June 30, 2001. The prior comparable period had no international sales. We expect to continue to derive substantially all of our revenues from sales of equipment to Qwest and local, foreign and independent telephone companies for the foreseeable future. In addition, sales in general were slow due to the challenging economic environment that currently exists in the general marketplace, and in particular, the especially depressed telecommunications industry of which we are a part. Equipment revenue levels in future quarters will depend upon Qwest's decision and general economic conditions, as well as whether and how quickly our existing customers roll out broadband services in their coverage areas and whether and how quickly we obtain new customers.

Software revenue in the quarters ended June 30, 2001 and 2000 were \$875,000 and \$836,000, respectively. Software revenue was \$1.6 million in the six-month periods ended June 30, 2001 and 2000. We expect demand for our software to remain relatively flat in the near term because the market for these products is mature.

Cost of Revenues. Total cost of revenues increased to \$97.9 million in the quarter ended June 30, 2001 from \$32.1 million in the quarter ended June 30, 2000. Total cost of revenues in the first six months of 2001 increased to \$120.6 million from \$57.0 million in the six-month period ended June 30, 2000. The increase in our cost of revenues is primarily attributable to a \$72.0 million charge related to excess inventory, obsolescence and lower of cost or market adjustments. We recorded a write-down of inventory and purchase commitments for excess and obsolete quantities and lower of cost or market adjustments related to our current generation product platform and related communications equipment totaling \$72.0 million. To meet forecasted demand and reduce the anticipated component supply constraints that had existed in the past, we had increased inventory levels for certain components and had entered into purchase commitments for certain components with long lead times. However, in the quarter ended June

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30, 2001, our actual sales, as well as our estimates of forecasted sales in 2001 and 2002, for our current generation product platform declined significantly. As a result, the inventory charges were required and were calculated based upon (i) the substantial completion of the negotiation process with our contract manufacturers and their suppliers and our other vendors regarding purchase commitments and cancellations made by us, (ii) the inventory levels in excess of forecasted demand through December 31, 2002 and (iii) our estimates of salvage or recovery value for each raw material or finished good on an item by item basis. We do not currently anticipate that the excess inventory included in this provision will be used after December 31, 2002 based on our current demand forecast. Such write-down was included in costs of revenues in the quarter ended June 30, 2001 and consisted of the following:

| | |
|--|-------|
| Excess quantities of raw materials on hand and under purchase commitments at June 30, 2001, net of salvage | \$34, |
| Excess quantities of finished goods on hand at June 30, 2001, net of salvage | 10, |
| Obsolescence | 13, |
| Cancellation charges on purchase commitments | 5, |
| Lower of cost or market write-down on current generation product platform | 8, |
| | ---- |

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Total

\$72,

Significant estimates included in the calculation of the inventory write-down above include forecasted demand for our products, sales prices for residential gateways and other finished goods and estimated salvage or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

Our gross margin percentage, excluding charges related to inventory, decreased to 19.9% in the second quarter of 2001 from 20.1% in the second quarter of 2000. Our gross margin percentage, excluding charges related to inventory, increased to 20.6 % in the six-month period ended June 30, 2001 from 19.3% in the comparable 2000 period. The change in our gross margin percentage was primarily the result of a change in our product mix. In the future, cost of revenues as a percent of revenues may fluctuate due to a wide variety of factors, including customer mix, product mix, the timing and size of orders which are received, the availability of adequate supplies of key components and assemblies, our ability to introduce new products and technologies on a timely basis, the timing of new product introductions or announcements by us or our competitors, price competition and unit volume.

Research and development. Research and development expenses decreased to \$12.9 million in the period ended June 30, 2001 from \$13.7 million in the period ended June 30, 2000. Research and development expenses in the first six months of 2001 and 2000 were comparable at \$27.0 million and \$27.5 million. The decrease in the quarterly research and development expenses for both periods was primarily due to cost cutting measures, including a reduction in research and development personnel, implemented in the current year. We believe that continued investment in research and development is critical to attaining our strategic product development and cost reduction objectives and, as a result, expect these expenses to increase in absolute dollars, as necessary to achieve our research and development objectives. We expense all of our research and development costs as incurred.

Selling, general and administrative. Selling, general and administrative expenses increased to \$15.1 million in the quarter ended June 30, 2001 from \$11.0 million in the quarter ended June 30, 2000. Selling, general and administrative expenses increased to \$29.3 million in the six-month period ended

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June 30, 2001 from \$20.5 million in the comparable 2000 period. The increase was primarily attributable to increased goodwill amortization arising from the purchase of SoftProse in July 2000. In addition, we have generated higher sales expenses by hiring new sales representatives in our efforts to increase the number and size of our customer accounts.

Non-cash compensation charge. Substantially all of our employees had been granted contingently exercisable stock options that became options to purchase our common stock upon our recapitalization in 1999. In addition, tandem stock options were granted in January 1997 to some of our employees. As a result, non-cash compensation expense was recognized upon the completion of our initial public offering based on the difference between the exercise price of these options and the initial public offering price of our common stock. The non-cash compensation expense related to these option grants in the period ended June 30, 2000 was \$2.4 million. There was no such expense in 2001.

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Interest income (expense), net. Interest expense, net in the three-month period and six-month period ended June 30, 2001 was \$3.2 and \$3.1 million, respectively. Interest expense in the current period is primarily related to the cash and non-cash interest expense related to our credit agreement with Motorola (see Note 3 to the condensed consolidated financial statements). Interest income, net in the quarter and six-month period ended June 30, 2000 was \$2.0 million and \$3.8 million. Interest income earned in these periods related primarily to interest earned on our initial public offering proceeds.

Other income (expense), net. Other expense, net in the three-month period and six-month period ended June 30, 2001 was \$5.0 and \$5.2 million. Other expense in the current period is primarily related to the write-down of certain investments and certain property, plant and equipment. (See Note 4 in the condensed consolidated financial statements). Other expense in the prior comparable periods was not significant.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was \$72.7 million in the six months ended June 30, 2001 and \$37.1 million in the six months ended June 30, 2000. In the current period, the use of cash in operating activities was primarily due to our net losses and inventory purchases. During the period ended June 30, 2000, the cash used in operating activities was primarily due to net losses.

Net cash used in investing activities was \$8.2 million in the six months ended June 30, 2001 and \$3.8 million in the six months ended June 30, 2000. The current period amount was attributable to capital expenditures made to support our engineering and testing activities as well as an additional \$5.0 million investment in Virtual Access. In the prior period, the amount was primarily attributable to capital expenditures.

Net cash provided by financing activities was \$62.0 million in the six months ended June 30, 2001 and \$2.4 million in the six-months ended June 30, 2000. The current period amount is primarily related to borrowings of \$60.0 million from Motorola. In the prior period, amount was primarily attributable to the sale of common stock, partially off-set by the payment of expenses related to our initial public offering.

On May 16, 2001 we entered into a \$60.0 million loan agreement with Motorola, Inc. Under the terms of the agreement, Motorola, which currently owns approximately 75% of the outstanding shares of our common stock, made a \$60.0 million loan commitment to us over a two-year period, beginning May 17, 2001. Interest is determined by Motorola based on either the base rate (as defined in the agreement) plus 2% or the Eurodollar rate plus 3 1/2%.

As of June 30, 2001, we had borrowed \$60.0 million under this loan agreement.

In the event of a debt or equity security offering or a sale of assets in excess of \$25.0 million, the first \$25.0 million of proceeds may be retained by us; the next \$25.0 million (between \$25.0 million and \$50.0 million) of such proceeds will be allocated at least one-third to repay our obligations under our tax sharing agreement with Motorola (the "Tax Sharing Agreement"), and the balance may be retained by us; the next \$25.0 million of such proceeds (between \$50.0 million and \$75.0 million) will be allocated at least one-half to repay our obligations under the Tax Sharing Agreement and the balance may be retained by us; amounts of such proceeds in excess of \$75.0 million must be used 100% first to repay our obligations under the Tax Sharing Agreement (to the extent of such obligations) and then to repay and reduce the amount owed under the loan

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agreement.

The loan agreement provides for the issuance of warrants, to purchase up to 7.5 million shares of our common stock, all at an exercise price of \$7.39 per share. As of June 30, 2001, based upon borrowings to date, warrants to purchase 4.5 million shares of our common stock at \$7.39 per share were issued and exercisable. The fair value of the warrants of \$26.0 million was recorded as a discount to the note payable with a corresponding increase to additional paid-in capital. Such amount was determined based upon the Black-Scholes option pricing model using expected volatility of 101%, a risk-free interest rate of 4.9% and an expected term of four years. As a result, at June 30, 2001, the borrowings from Motorola with a stated value of \$60.0 million were recorded at \$36.6 million, net of the unamortized discount related to the fair value of the warrants. In the quarter ended June 30, 2001, non-cash discount amortization of \$2.6 million was recorded; non-cash interest expense will be recorded through May 2002 to reflect amortization of the remaining discount.

The loan agreement contains various covenants, including compliance with net worth requirements, and restrictions on additional indebtedness, capital expenditures, and dividends. As of June 30, 2001, we were not in compliance with the net worth financial covenant. On July 25, 2001, the loan agreement was amended. The amendment waived the debt covenant violation and established revised financial covenants for net worth.

At June 30, 2001, we had \$16.9 million of cash and cash equivalents and a working capital deficit of \$20.2 million. We have instituted and continue to pursue initiatives intended to increase liquidity.

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From December 2000 through July 2001, we have instituted the following measures to improve liquidity:

- Obtained \$32.3 million from Motorola pursuant to the existing Tax Sharing and Allocation Agreement between the parties;
- Obtained a \$60.0 million loan from Motorola, all of which has been drawn down, due in May 2003;
- Extended payment terms until May 2002 for \$24.3 million of vendor payables; and
- Reduced the number of employees from approximately 490 at February 28, 2001 to approximately 458 at June 30, 2001.

We will endeavor to take the following actions, among others, to help sustain our operations and to meet our financial obligations for the remainder of 2001 and into the first quarter of 2002:

- Obtain financing through the mortgage of our largest Company-owned office/engineering space;
- Liquidate certain investments and other non-core assets;
- Renegotiate payment terms under vendor payables and purchase commitments;
- Dispose of excess inventories;
- Accelerate collections of accounts receivable; and

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- Decrease discretionary spending on general and administrative items.

In addition to the \$16.9 million of existing cash and cash equivalents as of June 30, 2001, the foregoing new initiatives must result in additional cash or deferral of payment of expenses or other commitments totaling approximately \$35.0 million in order for us to meet our liquidity needs through December 31, 2001. We will also need to obtain additional external equity or debt financing by the end of the first quarter of 2002 in order to maintain current operations. We cannot assure that we will be successful in any of these new initiatives or that external equity or debt financing will be available on favorable terms, or at all, which in either case would cause us to curtail or suspend our operations.

RISK FACTORS

You should carefully consider the risk factors set forth below.

WE MAY NOT BE ABLE TO OBTAIN SUFFICIENT FINANCING TO FUND OUR BUSINESS, WHICH WOULD CAUSE US TO CURTAIL OR SUSPEND OUR OPERATIONS.

In addition to our \$16.9 million of existing cash and cash equivalents as of June 30, 2001, the new initiatives set forth in "Liquidity and Capital Resources" above must result in additional cash or deferral of payment of expenses or other commitments totaling approximately \$35.0 million in order for us to meet our liquidity needs through December 31, 2001. We will also need to obtain additional external equity or debt financing by the end of the first quarter of 2002 in order to maintain current operations. We cannot assure that we will be successful in any of these new initiatives or that external equity or debt financing will be available on favorable terms, or at all, which in either case would cause us to curtail or suspend our operations.

WE HAVE INCURRED NET LOSSES AND NEGATIVE CASH FLOW FOR OUR ENTIRE HISTORY, WE EXPECT TO INCUR FUTURE LOSSES AND NEGATIVE CASH FLOW, AND WE MAY NEVER ACHIEVE PROFITABILITY.

We incurred net losses of \$124.5 million in the six months ended June 30, 2001 and \$74.8 million in the year ended December 31, 2000. Our ability to achieve profitability on a continuing basis will depend on the successful design, development, testing, introduction, marketing and broad commercial distribution of our broadband equipment products.

We expect to incur significant product development, sales and marketing, and administrative expenses. In addition, we depend in part on cost reductions to improve gross profit margins because the fixed-price nature of most of our long-term customer agreements prevents us from increasing prices. As a result, we will need to generate significant revenues and improve gross profit margins to achieve and maintain profitability. We may not be successful in reducing our costs or in selling our products in

sufficient volumes to realize cost benefits from our manufacturers. We cannot be certain that we can achieve sufficient revenues or gross profit margin improvements to generate profitability.

OUR LIMITED OPERATING HISTORY MAKES IT DIFFICULT FOR YOU TO EVALUATE OUR BUSINESS AND PROSPECTS.

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We recorded our first sale in September 1997. As a result, we have only a limited operating history upon which you may evaluate our business and prospects. You should consider our prospects in light of the heightened risks and unexpected expenses and difficulties frequently encountered by companies in an early stage of development. These risks, expenses and difficulties, which are described further below, apply particularly to us because the market for equipment for delivering voice, data and video services is new and rapidly evolving. Due to our limited operating history, it will be difficult for you to evaluate whether we will successfully address these risks.

WE EXPECT OUR QUARTERLY REVENUES AND OPERATING RESULTS TO FLUCTUATE, AND THESE FLUCTUATIONS MAY MAKE OUR STOCK PRICE VOLATILE.

Our quarterly revenues and operating results have fluctuated in the past and are likely to fluctuate significantly in the future. As a result, we believe that quarter-to-quarter comparisons of our operating results may not be meaningful. Fluctuations in our quarterly revenues or operating results may cause volatility in the price of our stock. It is likely that in some future quarter our operating results may be below the expectations of public market analysts and investors, which may cause the price of our stock to fall. Factors likely to cause variations in our quarterly revenues and operating results include:

- delays or cancellations of any orders by Qwest, which accounted for approximately 54% of our revenues in the quarter ended June 30, 2001, or by any other customer accounting for a significant portion of our revenues;
- variations in the timing, mix and size of orders and shipments of our products throughout a quarter or year;
- new product introductions by us or by our competitors;
- the timing of upgrades of telephone companies' infrastructure;

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- variations in capital spending budgets of telephone companies; and
- increased expenses, whether related to sales and marketing, product development or administration.

The amount and timing of our operating expenses generally will vary from quarter to quarter depending on the level of actual and anticipated business activity. Because most of our operating expenses are fixed in the short term, we may not be able to quickly reduce spending if our revenues are lower than we had projected and our results of operations could be harmed.

OUR CUSTOMER BASE OF TELEPHONE COMPANIES IS EXTREMELY CONCENTRATED AND THE LOSS OF OR REDUCTION IN BUSINESS FROM EVEN ONE OF OUR CUSTOMERS, PARTICULARLY QWEST, COULD CAUSE OUR SALES TO FALL SIGNIFICANTLY.

A small number of customers have accounted for a large part of our revenues to date. We expect this concentration to continue in the future. If we lose one of our significant customers, our revenues could be significantly

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reduced. Qwest accounted for 54% and 67% of total revenues in the quarters ended June 30, 2001 and 2000. Our agreements with our customers are cancelable by these customers on short notice, without penalty, do not obligate the customers to purchase any products and are not exclusive. As a result of the merger between U S WEST and Qwest, Qwest slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon their decision regarding the deployment of our product. A significant reduction in purchases of our equipment by Qwest could have a material adverse effect on us.

CONSOLIDATION AMONG TELEPHONE COMPANIES MAY REDUCE OUR SALES.

Consolidation in the telecommunications industry may cause delays in the purchase of our products and cause a reexamination of strategic and purchasing decisions by our customers. In addition, we may lose relationships with key personnel within a customer's organization due to budget cuts, layoffs, or other disruptions following a consolidation. For example, our sales to NYNEX, previously one of our largest clients, have decreased significantly as a result of a shift in focus resulting from its merger with Bell Atlantic. In addition, as a result of the merger between U S WEST and Qwest, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding deployment of VDSL across its network.

BECAUSE OUR SALES CYCLE IS LENGTHY AND VARIABLE, THE TIMING OF OUR REVENUE IS DIFFICULT TO PREDICT, AND WE MAY INCUR SALES AND MARKETING EXPENSES WITH NO GUARANTEE OF A FUTURE SALE.

Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deployment. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. Before a customer places an order, we may incur substantial sales and marketing expenses and expend significant management efforts. In addition, product purchases are frequently subject to unexpected administrative, processing and other delays on the part of our customers. This is particularly true for customers for whom our products represent a very small percentage of their overall purchasing activities. As a result, sales forecasted to be made to a specific customer for a particular quarter may not be realized in that quarter; and this could result in lower than expected revenues.

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WE INCURRED A SIGNIFICANT WRITE-DOWN OF OUR INVENTORY IN THE QUARTER ENDED JUNE 30, 2001 BASED ON ESTIMATES WHICH MAY VARY FROM ACTUAL RESULTS; THEREFORE, ADDITIONAL INVENTORY WRITE-DOWNS MAY BE NECESSARY IN FUTURE PERIODS.

In the quarter ended June 30, 2001, we recorded an inventory write-down (including purchase commitments) related to our current generation product platform and related communications equipment totaling \$72,016,000. To meet forecasted demand and reduce the anticipated component supply constraints that had existed in the past, we had increased inventory levels for certain components and had entered into purchase commitments for certain components with long lead times. In the quarter ended June 30, 2001, actual sales, as well as our estimates of forecasted sales in 2001 and 2002, for our current generation of products declined significantly. As a result, the inventory charges were calculated based on:

- the substantial completion of the negotiation process with our contract manufacturers and their suppliers and our other vendors regarding purchase commitments and cancellations made by us,

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- the inventory levels in excess of forecasted demand through December 31, 2002 and
- our estimates of salvage or recovery value for each raw material of finished good on an item by item basis.

We do not currently anticipate that the excess inventory included in this provision will be used after December 31, 2002 based on our current demand forecast. Significant estimates included in the calculation of the inventory write-down above include forecasted demand for our products, sales prices for residential gateways and other finished goods and estimated salvage or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

A SIGNIFICANT MARKET FOR OUR PRODUCTS MAY NOT DEVELOP IF TELEPHONE COMPANIES DO NOT SUCCESSFULLY DEPLOY BROADBAND SERVICES SUCH AS HIGH-SPEED DATA AND VIDEO.

Telephone companies have just recently begun offering high-speed data services, and most telephone companies have not offered video services at all. Unless telephone companies make the strategic decision to enter the market for providing broadband services, a significant market for our products may not develop. Sales of our products largely depend on the increased use and widespread adoption of broadband services and the ability of our customers to market and sell broadband services, including video services, to their customers. Certain critical issues concerning use of broadband services are unresolved and will likely affect their use. These issues include security, reliability, speed and volume, cost, government regulation and the ability to operate with existing and new equipment.

Even if telephone companies decide to deploy broadband services, this deployment may not be successful. Our customers have delayed deployments in the past and may delay deployments in the future. Factors that could cause telephone companies not to deploy, to delay deployment of, or to fail to deploy successfully the services for which our products are designed include the following:

- industry consolidation;
- regulatory uncertainties and delays affecting telephone companies;

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- varying quality of telephone companies' network infrastructure and cost of infrastructure upgrades and maintenance;
- inexperience of telephone companies in obtaining access to video programming content from third party providers;
- inexperience of telephone companies in providing broadband services and the lack of sufficient technical expertise and personnel to install products and implement services effectively;
- uncertain subscriber demand for broadband services; and
- inability of telephone companies to predict return on their

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investment in broadband capable infrastructure and equipment.

Unless our products are successfully deployed and marketed by telephone companies, we will not be able to achieve our business objectives and increase our revenues.

GOVERNMENT REGULATION OF OUR CUSTOMERS AND RELATED UNCERTAINTY COULD CAUSE OUR CUSTOMERS TO DELAY THE PURCHASE OF OUR PRODUCTS.

The Telecommunications Act requires telephone companies, such as the regional Bell operating companies, to offer their competitors cost-based access to some elements of their networks, including facilities and equipment used to provide high-speed data and video services. These telephone companies may not wish to make expenditures for infrastructure and equipment required to provide broadband services if they will be forced to allow competitors access to this infrastructure and equipment. The Federal Communications Commission, or FCC, announced that, except in limited circumstances, it will not require incumbent carriers to offer their competitors access to the facilities and equipment used to provide high-speed data services. Nevertheless, other regulatory and judicial proceedings relating to telephone companies' obligations to provide elements of their network to competitors are pending. The FCC also requires incumbent carriers to permit competitive carriers to collocate their equipment with the local switching equipment of the incumbents. The FCC's collocation rules recently have been vacated in part and continue to be subject to regulatory and judicial proceedings. The uncertainties caused by these regulatory proceedings may cause these telephone companies to delay purchasing decisions at least until the proceedings and any related judicial appeals are completed. The outcomes of these regulatory proceedings, as well as other FCC regulation, may cause these telephone companies not to deploy services for which our products are designed or to further delay deployment. Additionally, telephone companies' deployment of broadband services may be slowed down or stopped because of the need for telephone companies to obtain permits from city, state or federal authorities to implement infrastructure.

OUR CUSTOMERS AND POTENTIAL CUSTOMERS WILL NOT PURCHASE OUR PRODUCTS IF THEY DO NOT HAVE THE INFRASTRUCTURE NECESSARY TO USE OUR PRODUCTS.

The copper wire infrastructures over which telephone companies may deliver voice, data and video services using our products vary in quality and reliability. As a result, some of these telephone companies may not be able to deliver a full set of voice, data and video services to their customers, despite their intention to do so, and this could harm our sales. Even after installation of our products, we remain highly dependent on telephone companies to continue to maintain their infrastructure so that our products will operate at a consistently high performance level. Infrastructure upgrades and maintenance may be costly, and telephone companies may not have the necessary financial resources. This may be

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particularly true for our smaller customers and potential customers such as independent telephone companies and domestic local telephone companies. If our current and potential customers' infrastructure is inadequate, we may not be able to generate anticipated revenues from them.

IF COMPETING TECHNOLOGIES THAT OFFER ALTERNATIVE SOLUTIONS TO OUR PRODUCTS ACHIEVE WIDESPREAD ACCEPTANCE, THE DEMAND FOR OUR PRODUCTS MAY NOT DEVELOP.

Technologies that compete with our products include other

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telecommunications-related wireline technologies, cable-based technologies, fixed wireless technologies and satellite technologies. If these alternative technologies are chosen by our existing and potential customers, our business, financial condition and results of operations could be harmed. In particular, cable operators are currently deploying products that will be capable of delivering voice, high-speed data and video services over cable, including products from General Instrument, our principal stockholder, and Motorola, its parent. Our technology may not be able to compete effectively against these technologies on price, performance or reliability.

Our customers or potential customers that also offer cable-based services may choose to purchase cable-based technologies. Cable service providers that offer not only data and video but also telephony over cable systems will give subscribers the alternative of purchasing all communications services from a single communications service provider, allowing the potential for more favorable pricing and a single point of contact for bill payment and customer service. If these services are implemented successfully over cable connections, they will compete directly with the services offered by telephone companies using our products. In addition, several telephone companies have commenced the marketing of video services over direct broadcast satellite while continuing to provide voice and data services over their existing copper wire infrastructure. If any of these services are accepted by consumers, the demand for our products may not develop and our ability to generate revenues will be harmed.

WE FACE INTENSE COMPETITION IN PROVIDING EQUIPMENT FOR TELECOMMUNICATIONS NETWORKS FROM LARGER AND MORE WELL-ESTABLISHED COMPANIES, AND WE MAY NOT BE ABLE TO COMPETE EFFECTIVELY WITH THESE COMPANIES.

Many of our current and potential competitors have longer operating histories, greater name recognition and significantly greater financial, technical, marketing and distribution resources than we do. These competitors may undertake more extensive marketing campaigns, adopt more aggressive pricing policies and devote substantially more resources to developing new products than we are able to, which could result in the loss of current customers and impair our ability to attract potential customers.

Our significant current competitors include Advanced Fibre Communications, Alcatel, Cisco Systems, Efficient Networks, Ericsson, Lucent Technologies, Nokia, Nortel Networks, RELTEC (acquired by BAE Systems, CNI Division, formerly GEC Marconi), Scientific Atlanta, Siemens and our largest stockholder, General Instrument/Motorola, as well as emerging companies that are developing new technologies. Some of these competitors have existing relationships with our current and prospective customers. In addition, we anticipate that other large companies, such as Matsushita Electric Industrial which markets products under the Panasonic brand name, Microsoft, Network Computer, Philips, Sony, STMicroelectronics and Toshiba America will likely introduce products that compete with our N(3) Residential Gateway product in the future. Our customer base may be attracted by the name and resources of these large, well-known companies and may prefer to purchase products from them instead of us.

CONSOLIDATION OF OUR COMPETITORS MAY CAUSE US TO LOSE CUSTOMERS AND NEGATIVELY AFFECT OUR SALES.

Consolidation in the telecommunications equipment industry may strengthen our competitors' positions in our market, cause us to lose customers and hurt our sales. For example, as a result of the

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merger between U S WEST and Qwest, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. In addition, Alcatel acquired DSC Communications, Lucent acquired Ascend Communications and BAE Systems, CNI Division, formerly GEC Marconi, acquired RELTEC. Acquisitions such as these may strengthen our competitors' financial, technical and marketing resources and provide them access to regional Bell operating companies and other potential customers. Consolidation may also allow some of our competitors to penetrate new markets that we have targeted, such as domestic local, independent and international telephone companies. This consolidation may negatively affect our ability to increase revenues.

IF WE DO NOT RESPOND QUICKLY TO CHANGING CUSTOMER NEEDS AND FREQUENT NEW PRODUCT INTRODUCTIONS BY OUR COMPETITORS, OUR PRODUCTS MAY BECOME OBSOLETE.

Our position in existing markets or potential markets could be eroded rapidly by product advances. The life cycles of our products are difficult to estimate. Our growth and future financial performance will depend in part upon our ability to enhance existing products and develop and introduce new products that keep pace with:

- the increasing use of the Internet;
- the growth in remote access by telecommuters;
- the increasingly diverse distribution sources for high quality digital video; and
- other industry and technological trends.

We expect that our product development efforts will continue to require substantial investments. We may not have sufficient resources to make the necessary investments. If we fail to timely and cost-effectively develop new products that respond to new technologies and customer needs, the demand for our products may fall and we could lose revenues.

OUR EXECUTIVE OFFICERS AND CERTAIN KEY PERSONNEL ARE CRITICAL TO OUR BUSINESS AND THE LOSS OF THEIR SERVICES COULD DISRUPT OUR OPERATIONS AND OUR CUSTOMER RELATIONSHIPS.

None of our executive officers or key employees is bound by an employment agreement. Many of these employees have a significant number of options to purchase our common stock. Many of these options are currently vested and some of our key employees may leave us once they have exercised their options. In addition, our engineering and product development teams are critical in developing our products and have developed important relationships with our regional Bell operating company customers and their technical staffs. The loss of any of these key personnel could harm our operations and customer relationships.

COMPETITION FOR QUALIFIED PERSONNEL IN THE TELECOMMUNICATIONS EQUIPMENT INDUSTRY IS INTENSE, AND IF WE ARE NOT SUCCESSFUL IN ATTRACTING AND RETAINING THESE PERSONNEL, OUR ABILITY TO GROW OUR BUSINESS MAY BE HARMED.

Competition for qualified personnel in the telecommunications equipment industry, specifically in the Rohnert Park, California area, is intense, and we may not be successful in attracting and retaining such personnel. Failure to attract qualified personnel could harm the growth of our business.

We are actively searching for research and development engineers and sales and marketing personnel who are in short supply. Competitors and others have in the past and may in the future attempt to recruit our employees. In addition, companies in the telecommunications industry whose employees accept positions with competitors frequently claim that the competitors have engaged in unfair hiring practices. We may receive such notices in the future as we seek to hire qualified personnel and such notices may result in material litigation and related disruption to our operations.

OUR OPERATIONS AND CUSTOMER RELATIONSHIPS MAY BECOME STRAINED DUE TO RAPID EXPANSION.

We have expanded our operations rapidly since inception. We intend to continue to expand in the foreseeable future to pursue existing and potential market opportunities both inside and outside the United States. This rapid growth places a significant demand on management and operational resources. Our management, personnel, systems, procedures, controls and customer service may be inadequate to support our future operations. To manage expansion effectively, we must implement and improve our operational systems, procedures, controls and customer service on a timely basis. We expect significant strain on our order and fulfillment process and our quality control systems if significant expansion of business activity occurs. If we are unable to properly manage this growth, our operating results, reputation and customer relationships could be harmed.

OUR LIMITED ABILITY TO PROTECT OUR INTELLECTUAL PROPERTY MAY AFFECT OUR ABILITY TO COMPETE, AND WE COULD LOSE CUSTOMERS.

We rely on a combination of patent, copyright and trademark laws, and on trade secrets and confidentiality provisions and other contractual provisions to protect our intellectual property. There is no guarantee that these safeguards will protect our intellectual property and other valuable confidential information. If our methods of protecting our intellectual property in the United States or abroad are not adequate, our competitors may copy our technology or independently develop similar technologies and we could lose customers. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. If we fail to adequately protect our intellectual property, it would be easier for our competitors to sell competing products, which could harm our business.

THIRD-PARTY CLAIMS REGARDING INTELLECTUAL PROPERTY MATTERS COULD CAUSE US TO STOP SELLING OUR PRODUCTS, LICENSE ADDITIONAL TECHNOLOGY OR PAY MONETARY DAMAGES.

From time to time, third parties, including our competitors and customers, have asserted patent, copyright and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in our market grows and the functionality of products overlaps, and our products may currently infringe on one or more United States or international patents. The results of any litigation are inherently uncertain. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required:

- to pay substantial damages, including paying treble damages if we are held to have willfully infringed;
- to halt the manufacture, use and sale of infringing products;

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- to expend significant resources to develop non-infringing technology; and/or
- to obtain licenses to the infringing technology.

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Licenses may not be available from any third party that asserts intellectual property claims against us, on commercially reasonable terms, or at all. In addition, litigation frequently involves substantial expenditures and can require significant management attention, even if we ultimately prevail. In addition, we indemnify our customers for patent infringement claims, and we may be required to obtain licenses on their behalf, which could subject us to significant additional costs.

WE DEPEND ON THIRD-PARTY MANUFACTURERS AND ANY DISRUPTION IN THEIR MANUFACTURE OF OUR PRODUCTS WOULD HARM OUR OPERATING RESULTS.

We contract for the manufacture of all of our products and have limited in-house manufacturing capabilities. We rely primarily on two large contract manufacturers: SCI Systems and ACT Manufacturing. The efficient operation of our business will depend, in large part, on our ability to have these and other companies manufacture our products in a timely manner, cost-effectively and in sufficient volumes while maintaining consistent quality. As our business grows, these manufacturers may not have the capacity to keep up with the increased demand. Any manufacturing disruption could impair our ability to fulfill orders and could cause us to lose customers.

WE HAVE NO LONG-TERM CONTRACTS WITH OUR MANUFACTURERS, AND WE MAY NOT BE ABLE TO DELIVER OUR PRODUCTS ON TIME IF ANY OF THESE MANUFACTURERS STOP MAKING OUR PRODUCTS.

We have no long-term contracts or arrangements with any of our contract manufacturers that guarantee product availability, the continuation of particular payment terms or the extension of credit limits. If our manufacturers are unable or unwilling to continue manufacturing our products in required volumes, we will have to identify acceptable alternative manufacturers, which could take in excess of three months. It is possible that a source may not be available to us when needed or be in a position to satisfy our production requirements at acceptable prices and on a timely basis. If we cannot find alternative sources for the manufacture of our products, we will not be able to meet existing demand. As a result, we may lose existing customers, and our ability to gain new customers may be significantly constrained.

OUR INABILITY TO PRODUCE SUFFICIENT QUANTITIES OF OUR PRODUCTS BECAUSE OF OUR DEPENDENCE ON COMPONENTS FROM KEY SOLE SUPPLIERS COULD RESULT IN DELAYS IN THE DELIVERY OF OUR PRODUCTS AND COULD HARM OUR REVENUES.

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers or we fail to obtain components in sufficient quantities when required, delivery of our products could be delayed resulting in decreased revenues. Additional sole-sourced components may be incorporated into our equipment in the future. We do not have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

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THE OCCURRENCE OF ANY DEFECTS, ERRORS OR FAILURES IN OUR PRODUCTS COULD RESULT IN DELAYS IN INSTALLATION, PRODUCT RETURNS AND OTHER LOSSES TO US OR TO OUR CUSTOMERS OR END-USERS.

Our products are complex and may contain undetected defects, errors or failures. These problems have occurred in our products in the past and additional problems may occur in our products in the future and could result in the loss of or delay in market acceptance of our products. In addition, we have limited

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experience with commercial deployment and we expect additional defects, errors and failures as our business expands from trials to commercial deployment at certain customers. We will have limited experience with the problems that could arise with any new products that we introduce. Further, our customer agreements generally include a longer warranty for defects than our manufacturing agreements. These defects could result in a loss of sales and additional costs and liabilities to us as well as damage to our reputation and the loss of our customers.

WE DO NOT HAVE SIGNIFICANT EXPERIENCE IN INTERNATIONAL MARKETS AND MAY HAVE UNEXPECTED COSTS AND DIFFICULTIES IN DEVELOPING INTERNATIONAL REVENUES.

We plan to extend the marketing and sales of our products internationally. International operations are generally subject to inherent risks and challenges that could harm our operating results, including:

- unexpected changes in telecommunications regulatory requirements;
- limited number of telephone companies operating internationally;
- expenses associated with developing and customizing our products for foreign countries;
- tariffs, quotas and other import restrictions on telecommunications equipment;
- longer sales cycles for our products; and
- compliance with international standards that differ from domestic standards.

To the extent that we generate international sales in the future, any negative effects on our international business could harm our business, operating results and financial condition. In particular, fluctuating exchange rates may contribute to fluctuations in our results of operations.

MOTOROLA MAY EXERCISE SIGNIFICANT INFLUENCE OVER OUR BUSINESS AND AFFAIRS AND OUR STOCKHOLDER VOTES AND, FOR ITS OWN REASONS, COULD PREVENT TRANSACTIONS WHICH OUR OTHER STOCKHOLDERS MAY VIEW AS FAVORABLE.

Motorola beneficially owns approximately 75% of the outstanding shares of our common stock as of June 30, 2001 and approximately 81%, assuming exercise of the warrants held by them. Motorola will be able to exercise significant influence over all matters relating to our business and affairs, including approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us and could prevent you from receiving a

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premium for your shares.

We do not know whether Motorola's plans for our business and affairs will be different than our existing plans and whether any changes that may be implemented under Motorola's control will be beneficial or detrimental to our other stockholders.

OUR PRINCIPAL STOCKHOLDER AND ITS PARENT MAY HAVE INTERESTS THAT CONFLICT WITH THE BEST INTERESTS OF OUR OTHER STOCKHOLDERS AND US AND MAY CAUSE US TO FORGO OPPORTUNITIES OR TAKE ACTIONS THAT DISPROPORTIONATELY BENEFIT OUR PRINCIPAL STOCKHOLDER.

It is possible that Motorola could be in a position involving a conflict of interest with us. In addition, individuals who are officers or directors of Motorola and of us may have fiduciary duties to both companies. For example, a conflict may arise if our principal stockholder were to engage in activities or pursue corporate opportunities that may overlap with our business. These conflicts could harm our

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business and operating results. Our certificate of incorporation contains provisions intended to protect our principal stockholder and these individuals in these situations. These provisions limit your legal remedies.

THE PRICE OF OUR COMMON STOCK HAS BEEN AND MAY CONTINUE TO BE HIGHLY VOLATILE.

The stock markets have in general, and with respect to high technology companies, including us, in particular, recently experienced extreme stock price and volume volatility, often unrelated to the financial performance of particular companies. The price at which our common stock will trade in the future is likely to also be highly volatile and may fluctuate substantially due to factors such as:

- actual or anticipated fluctuations in our operating results;
- changes in or our failure to meet securities analysts' expectations;
- announcements of technological innovations by us or our competitors;
- introduction of new products and services by us or our competitors;
- limited public float of our common stock;
- conditions and trends in the telecommunications and other technology industries; and
- general economic and market conditions.

SALES OF SHARES OF OUR COMMON STOCK BY EXISTING STOCKHOLDERS COULD CAUSE THE MARKET PRICE OF OUR COMMON STOCK TO DROP SIGNIFICANTLY.

As of July 17, 2001, Motorola owned 64,103,724 shares of our common stock and warrants to purchase an additional 4,500,000 shares of our common stock and Kevin Kimberlin Partners, LP and its affiliates owned 2,933,128 shares of our common stock and its affiliates held warrants to purchase an additional

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4,288,764 shares of our common stock. FMR Corporation owned 5,601,500 shares of our common stock as of April 6, 2001. If Motorola, FMR Corporation, Kevin Kimberlin Partners LP and its affiliates or any of our other stockholders sells substantial amounts of common stock, including shares issued upon exercise of outstanding options and warrants, in the public market, the market price of the common stock could fall. In addition, any distribution of shares of our common stock by Motorola to its stockholders could also have an adverse effect on the market price.

Motorola and Kevin Kimberlin Partners LP and its related persons and their transferees are entitled to registration rights pursuant to which they may require that we register their shares under the Securities Act.

In addition, as of July 6, 2001, there were outstanding options to purchase 22,144,358 shares of our common stock. Subject to vesting provisions and, in the case of our affiliates, volume and manner of sale restrictions, the shares of common stock issuable upon the exercise of our outstanding employee options will be eligible for sale into the public market at various times.

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ANTI-TAKEOVER PROVISIONS IN OUR CHARTER DOCUMENTS AND DELAWARE LAW COULD PREVENT OR DELAY A CHANGE IN CONTROL OF OUR COMPANY THAT A STOCKHOLDER MAY CONSIDER FAVORABLE.

Several provisions of our certificate of incorporation and by-laws and Delaware law may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the issuance of preferred stock without stockholder approval;
- providing for a classified board of directors with staggered, three-year terms;
- prohibiting cumulative voting in the election of directors;
- restricting business combinations with interested stockholders;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to the board of directors and for proposing matters that can be acted on by stockholders at stockholder meetings; and
- requiring super-majority voting to effect amendments to our certificate of incorporation and by-laws.

Some of these provisions do not currently apply to Motorola and its affiliates.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is limited to interest rate fluctuation. We do not engage in any hedging activities, and we do not use derivatives or equity

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investments for cash investment purposes. The marketable securities portfolio is classified as available for sale and recorded at fair value on the balance sheet. Our portfolio consists solely of corporate bonds, commercial paper and government securities, and therefore, our market risk is deemed relatively low.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Securities Litigation. Several law firms have published press releases announcing that they have filed, or intend to file, class action complaints against us alleging various violations of law, including alleged violations of Sections 11, 12 and 15 of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, based on alleged excessive commissions, and agreements to engage in after-market transactions, received by underwriters in exchange for the receipt of allocations of stock in our initial public offering. These law firms seek to represent a class comprised of all persons who purchased our common stock during the period from November 9, 1999 through December 6, 2000. As of July 26, 2001, we had not been served with those complaints. Based upon information presently known to us, we do not believe that the ultimate resolution of these lawsuits will have a material adverse effect on our business.

Other Matters. From time to time, we are a party to other actions which arose in the normal course of business. In our opinion, the ultimate disposition of these matters will not have a material adverse effect on our business.

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

Our 2001 annual meeting of stockholders was held on May 24, 2001. The following matters were voted upon by the stockholders:

ELECTION OF DIRECTORS:

Election of two Class II Directors. Paul S. Latchford and James G. Roseland were elected to serve for a term of one year until their successors are duly elected and qualified. The result of the voting was as follows: 83,162,475 shares in favor of Paul S. Latchford, with 60,272 shares withheld, and 83,153,674 shares in favor of James G. Roseland, with 69,073 shares withheld.

Election of two Class III Directors. Eugene Delaney and J. Michael Norris were elected to serve for a term of office that expires at the annual meeting of stockholders to be held in 2002. The result of the voting was as follows: 83,155,674 shares in favor of Eugene Delaney, with 67,073 shares withheld, and 82,008,836 shares in favor of J. Michael Norris, with 1,213,911 shares withheld. The terms of office of our other directors, Richard Severns, Ferdinand Kuznik and John McCartney continue until the 2003 Annual Meeting of Stockholders and Peter W. Keeler is serving a term expiring at the annual meeting of stockholders to be held in 2002. We currently have one open board seat.

APPROVE AN AMENDMENT TO THE 1999 EQUITY INCENTIVE PLAN:

Approval of the Amendment to the 1999 Equity Incentive Plan which increased the number of shares available for issuance under the plan. The result of the vote was 69,209,527 shares in favor, 7,802,484 shares against and 10,212 shares abstaining.

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RATIFICATION OF THE SELECTION OF DELOITTE & TOUCHE:

Ratification of the selection of Deloitte & Touche LLP as our independent auditors for our current fiscal year ending December 31, 2001. The result of the vote was 83,193,771 shares in favor, 14,250 shares against and 14,726 shares abstaining.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

The following exhibit is included as part of this report:

| Exhibit No. ----- | Description of Exhibit ----- |
|-------------------------|--|
| 10.1 | Amendment No. 1 (dated July 25, 2001) to Credit Agreement, dated as of May 16, 2001 between Next Level Communications, Inc. and Motorola, Inc. |

(b) Reports on Form 8-K:

Form 8-K, filed with the Securities and Exchange Commission on May 29, 2001.

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SIGNATURES

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

NEXT LEVEL COMMUNICATIONS, INC.

Date: August 2, 2001

By: /s/ J. MICHAEL NORRIS

J. Michael Norris
Chief Executive Officer and President

Date: August 2, 2001

By: /s/ JAMES F. IDE

James F. Ide
Chief Financial Officer

EXHIBIT INDEX

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