NEXT LEVEL COMMUNICATIONS INC
Form 10-Q
November 14, 2001

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, 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	94-3342408
(State or Other Jurisdiction of Incorporation or Organization)	(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. [X] Yes [ ] No

The number of shares of our common stock, par value $0.01 per share, outstanding as of October 31, 2001 was approximately 85,590,077.

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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 nine months ended September 30, 2001
and September 30, 2000
(In Thousands, except per share data) (Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS E SEPTEMBER
	2001	2000	2001
Revenues			
Equipment	$ 19,495	$ 47,126	$ 78,587
Software	703	1,144	2,253
Total Revenues	20,198	48,270	80,840
Cost of Revenues			
Equipment	17,551	36,132	66,008
Software	18	7	127
Inventory charge	0	0	72,016
Total Cost of Revenue	17,569	36,139	138,151
GROSS PROFIT (LOSS)	2,629	12,131	(57,311)
OPERATING EXPENSES			
Research & development	11,788	13,053	38,742
Selling, general and administrative	12,931	13,705	42,279
Non-cash compensation charge			
Total operating expenses	24,719	26,758	81,021
OPERATING LOSS	(22,090)	(14,627)	(138,332)
INTEREST INCOME (EXPENSE), NET	(5,441)	1,264	(8,525)
OTHER INCOME (EXPENSE), NET	(236)	(30)	(5,445)
NET LOSS	$ (27,767)	$ (13,393)	$(152,302)
BASIC AND DILUTED NET LOSS PER			

COMMON SHARE	($0.32)	($0.16)	($1.79)
SHARES USED TO COMPUTE BASIC AND DILUTED NET LOSS PER COMMON SHARE	85,473	83,483	85,115

See notes to condensed consolidated financial statements.

Next Level Communications, Inc.
Condensed Consolidated Balance Sheets
September 30, 2001 and December 31, 2000
(In Thousands, except share data) (Unaudited)

	SEPTEMBER 30, 2001	DECEMBER 31, 2000
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 12,272	$ 35,863
Restricted marketable securities	--	25,000
Trade receivables, less allowance for doubtful accounts of $1,332 and $1,332, respectively	18,311	32,993
Other receivables	5,946	4,489
Inventories, net	76,238	86,764
Prepaid expenses and other	2,286	2,123
Total current assets	115,053	187,232
Property and equipment, net	49,124	53,593
Long-term investments	16,997	15,000
Goodwill, net of accumulated amortization of $11,903 and $6,879, respectively	12,790	17,813
Other assets	2,078	2,078
Total Assets	$ 196,042	$ 275,716
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 38,508	$ 53,367
Accrued liabilities	19,210	17,609
Note payable to vendor	24,340	--
Note payable - other	--	25,000
Note payable - Motorola	4,000	--
Deferred revenue	1,939	5,661
Current portion of capital lease obligations	91	330
Total current liabilities	88,088	101,967
Long-term obligations		
Due to Motorola:		
Note payable, net of discount	35,199	--
Tax sharing agreement liability	32,300	15,000

Total long term liabilities	67,499	15,000
Total Liabilities	155,587	116,967
Stockholders' Equity		
Common stock - $.01 par value, 400,000,000 shares authorized, 85,559,000 and 84,443,000 shares issued and outstanding, respectively	788	776
Additional paid-in-capital	471,879	438,123
Accumulated deficit	(432,212)	(279,910)
Unearned compensation	--	(240)
Total Stockholders' Equity	40,455	158,749
Total Liabilities and Stockholders' Equity	$ 196,042	$ 275,716

See notes to condensed consolidated financial statements.

Next Level Communications, Inc.
Condensed Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2001 and September 30, 2000
(In Thousands, Unaudited)

	SEPTEMBER 30,	
	2001	2000
OPERATING ACTIVITIES:		
Net loss	$(152,302)	$ (46,455)
Adjustments to reconcile net loss to net cash used in operating activities:		
Inventory charge	72,016	--
Write-down of investments and property and equipment	6,586	--
Loss on disposal of assets	--	62
Non-cash compensation charge	592	2,384
Depreciation and amortization	12,451	9,474
Amortization of discount on note payable	6,433	--
Equity in net loss of investee	536	--
Changes in assets and liabilities:		
Trade receivables	14,682	(21,818)
Inventories	(51,490)	(33,313)
Other assets	(3,139)	(3,389)
Accounts payable	(519)	30,649
Accrued liabilities and deferred revenue	(2,121)	1,952
Net cash used in operating activities	(96,275)	(60,454)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(4,059)	(11,093)
Proceeds from sale of marketable securities	--	3,814
Long-term investments	(6,500)	(10,000)

Net cash used in investing activities	(10,559)	(17,279)
FINANCING ACTIVITIES		
Issuance of common stock	2,182	5,108
Proceeds from Motorola financing	64,000	--
Proceeds from Tax Sharing Agreement	17,300	--
Proceeds from borrowings, net	--	147
Repayment of capital lease obligations	(239)	(482)
Initial public offering expenses, net	--	(899)
Net cash provided by financing activities	83,243	3,874
Net Decrease in Cash and Cash Equivalents	(23,591)	(73,859)
Cash and Cash equivalents, Beginning of Period	35,863	128,752
Cash and Cash equivalents, End of Period	$ 12,272	$ 54,893

See notes to condensed consolidated financial statements.

NEXT LEVEL COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

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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 5) 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 nine months ended September 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 long-term investment and property and equipment write-downs (see Note 5). Actual results could differ from those estimates.

New Accounting Standard - In June 2001, the Financial Accounting 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. At September 30, 2001, the Company's recorded goodwill, net of accumulated amortization, was approximately $12.8 million. 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 $72.0 million. 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 estimates of actual sales, as well as the Company's forecasted sales, 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 and (iii) the Company's estimates of salvage or recovery value for each raw material or finished good on an item by item basis. Such write-down was included in cost of revenues in the nine months ended September 30, 2001 and consisted of the following (in millions):

Excess quantities of raw materials on hand and under purchase commitments at June 30, 2001, net of salvage	$34.8
Excess quantities of finished goods on hand at June 30, 2001, net of salvage	10.8
Obsolescence	13.2
Cancellation charges on purchase commitments	5.2
Lower of cost or market write-down on current generation product platform	8.0

Total	$72.0

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 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 (as amended July 25, 2001), the Company entered into a $60.0 million loan agreement with Motorola, Inc. Under the terms of the agreement, Motorola, which currently owns approximately 75% of Next Level Communications, Inc., made a $60.0 million loan commitment to the Company over a two-year period, with a maturity of May 17, 2003. 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%.

On September 28, 2001, the Company amended the $60.0 million loan agreement with Motorola, Inc. to include $4.0 million of bridge financing which was received by the Company on September 28, 2001. Under the terms of the amended agreement, the Company was required to repay the $4.0 million subsequent to the funding of the mortgage (see Note 10). Consequently, the Company repaid Motorola $4.0 million on November 2, 2001. As of September 30, 2001, the Company had an outstanding obligation under the loan agreement of $64.0 million.

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On October 15, 2001, the Company amended the $64.0 million loan agreement with Motorola to include an additional $3.0 million which resulted from a revised calculation performed relative to the Tax Sharing and Allocation Agreement between the Company and Motorola (see Note 4). As of October 15, 2001, the company had an outstanding obligation under the loan agreement of $67.0 million.

As of November 2, 2001, subsequent to the $4.0 million repayment, the Company had an outstanding obligation under the loan agreement of $63.0 million.

The loan agreement with Motorola has the following terms and conditions:

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 the Company; 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 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 $25.0 million of such proceeds (between $50.0 million and $75.0 million) 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 $75.0 million 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 7.5 million shares of the Company's common stock, all at an exercise price of $7.39 per share. Warrants to purchase 4.5 million shares of the Company's common

stock were issued and exercisable at September 30, 2001. 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. Additional warrants become exercisable as follows:

- 1.0 million 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;

- 1.0 million 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

- 1.0 million 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.

Effective July 1, 2001, the Company determined that the loan agreement with Motorola would not be repaid until its maturity date, and accordingly, reclassified the obligation to a long-term liability. As a result, the additional 3.0 million warrants referenced above, were recorded at the estimated fair value of $5.3 million 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 4.89% and an expected term of four years. The estimated fair value of the additional 3.0 million warrants will be adjusted in subsequent periods up to their respective measurement dates, to reflect changes in the Company's stock price. As a result, at September 30, 2001, the borrowings from Motorola with a stated value of $64.0 million were recorded at $39.2 million ($4.0 million of which is classified as a current liability) net of the unamortized discount related to the fair value of the warrants of $24.8 million. In the quarter and nine months ended September 30, 2001, non-cash discount amortization of $3.8 million and $6.4 million respectively, was recorded; non-cash

interest expense will be recorded through May 2003 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 September 30, 2001, the Company was in compliance with all covenants.

4. TAX SHARING AND ALLOCATION AGREEMENT WITH MOTOROLA

In December 2000, the Company received a $15.0 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 of $32.3 million was 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. On October 10, 2001, the Company received a revised calculation of the estimated present value of income tax benefits to Motorola based upon actual net losses that were included in Motorola's 2000 tax return. The revised amount was $29.3 million. Under the original agreement, the Company was required to repay the $3.0 million

difference by October 15, 2001. On October 15, 2001, the Loan Agreement between the Company and Motorola was amended to include such $3.0 million (see Note 3).

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 this liability as a long term liability at September 30, 2001.

5. SECOND QUARTER 2001 LONG-TERM INVESTMENTS 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. As of September 30, 2001, the Company's long-term investments totaled $17.0 million, consisting of $11.5 million related to Virtual Access, $3.0 million related to Expanse Networks and $2.5 million related to OutReach. If the estimated fair value of such investments are less than the carrying amount, and the decline is considered other than temporary, the carrying amount is reduced to fair value and a loss is recognized. Additional investment write-downs may be necessary in future periods.

In addition, the Company wrote off $1.1 million of property and equipment related to the second quarter closure of a small research and development facility in Vietnam.

6. LEGAL PROCEEDINGS

On August 15, 2001, a complaint entitled CMC Industries, Inc., d/b/a CMC Mississippi, Inc., d/b/a ACT Mississippi v. Next Level Communications, Inc. was filed in the Superior Court for the State of California, County of Sonoma. The complaint alleged that the Company was delinquent in payment relating to certain purchase orders issued by the Company to the plaintiff, and sought damages in the amount of $22.5 million, plus interest and attorneys' fees. On October 24, 2001, plaintiff and the Company entered into a Settlement Agreement and Mutual Release, pursuant to which the complaint was dismissed and the Company agreed to pay to plaintiff the total amount of

$21.3 million (of which amount $13.4 million had been paid as of November 12, 2001) on an agreed-upon schedule, until all amounts owed by the Company are paid in full.

7. INVENTORIES

Inventories at September 30, 2001 and December 31, 2000 consisted of (in millions):

	September 30, 2001	December 31, 2000
Raw materials	$ 26.8	$ 22.7
Work-in-process	2.9	2.0

Finished goods	46.5	62.1
Total	$ 76.2	$ 86.8

8. NET LOSS PER SHARE

Basic net loss per share excludes dilution and is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed based on the weighted average number of common shares outstanding plus the dilutive effect of outstanding stock options and warrants. Diluted net loss per common share was the same as basic net loss per common share for all periods presented. As of September 30, 2001 and 2000, the Company had securities outstanding that could potentially dilute basic earnings per share in the future, but were excluded from the computation of diluted net loss per share, as their effect would have been anti-dilutive, given the Company's losses. Such outstanding securities consist of the following (in millions):

	September 30,	
	2001	2000
Motorola warrants	7.5	--
Other shareholder warrants	5.6	6.0
Outstanding employee stock options	16.2	20.7
Total	29.3	26.7

During the quarter ended September 30, 2001, the Company implemented a stock option exchange program in which certain employees could exchange options with an exercise price of $40.00 or higher per share for new options to be granted at least six months and one day from the date of cancellation at the then fair market value. Total shares cancelled under this program were 5.5 million. Eligible employees will receive a one-for-one option re-grant on or about February 11, 2002 at an exercise price equal to the market price on the replacement grant date. The Company does not expect to incur any compensation expense relative to this stock option exchange program.

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9. COMPREHENSIVE LOSS

The following table sets forth the calculation of comprehensive loss (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000

Net loss	$ (27.80)	$ (13.40)	$(152.30)	$ (46.50)
Unrealized gains (losses) on marketable securities	--	0.03	--	(0.04)
Total comprehensive loss	$ (27.80)	$ (13.37)	$(152.30)	$ (46.54)

10. SUBSEQUENT EVENTS

SALE OF TELENETWORKS

On October 11, 2001, the Company completed the sale of its software division, Telenetworks, to Wind River Systems, Inc. for approximately $5.8 million, of which approximately $5.2 million was received in cash and approximately $0.6 million remains in escrow. The Company expects to record a gain on sale of approximately $2.0 million in the fourth quarter of 2001.

REDUCTION IN WORK FORCE

On October 29, 2001, the Company terminated approximately 60 employees. Severance and related charges of approximately $0.5 million will be recognized in the fourth quarter of 2001.

MORTGAGE FINANCING

On October 30, 2001, the Company received $20.0 million under a mortgage loan for a Company-owned office building. The loan is amortized over a 12 year period with a ten year term and bears interest at an annual fixed rate of 7.51%. The entire unpaid principal balance, plus accrued interest thereon is due and payable on November 1, 2011.

The mortgage was guaranteed by Motorola. In consideration for the guarantee, the Company issued to Motorola warrants to purchase up to 0.4 million shares of common stock with an exercise price of $3.82 per share. Accordingly, the warrants were recorded at the fair value of $0.7 million as a discount to the mortgage loan 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 4.3% and an expected term of four years. As a result, non-cash interest expense will be recorded through 2011 to reflect amortization of the discount.

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 21% of our total revenues for the quarter ended September 30, 2001 and 47% of our total revenues for the quarter ended September 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 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. We sold Telenetworks, our data communications software division, on October 11, 2001 (see Note 10 to the condensed consolidated financial statements).

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 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 September 30, 2001 decreased to $20.2 million from $48.3 million in the third quarter of 2000. Total revenues in the first nine months of 2001 decreased to $80.8 million from $118.9 million in the nine-month period ended September 30, 2000. The decrease was primarily due to a decrease in equipment sales to Qwest. An equipment revenue analysis by channel is detailed in the following chart. Our equipment revenue is analyzed using three channels: Major carriers which currently include Qwest and other North American regional bell operating companies (MAJOR CARRIERS), independent operating companies (IOC), and other customers which include, among others, multiple service organizations and international customers (OTHER).

(In millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
CHANNEL	2001	2000	2001	2000
MAJOR CARRIERS	$ 4.2	$ 26.0	$ 37.6	$ 78.3
IOC	14.5	21.1	37.3	36.4
OTHER	0.8	--	3.7	1.5
TOTAL EQUIPMENT REVENUE	$ 19.5	$ 47.1	$ 78.6	$ 116.2

Sales to Qwest slowed in the current period due to an overall reduction in capital spending by Qwest. Additionally, Qwest has 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 IOC's and our other customers slowed in the current period due to a general slowdown in the telecommunications industry and the resulting reduction of our customers' capital expenditures.

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. Equipment revenue levels in future quarters will depend significantly upon Qwest's future decisions 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 September 30, 2001 and 2000 was $0.7 million and $1.1 million. Software revenue was $2.3 million and $2.8 million in the nine-month periods ended September 30, 2001 and 2000. Due to the sale of our Telenetworks software division (see Note 10 to the condensed consolidated financial statements), we do not anticipate material software revenue in the fourth quarter.

Cost of Revenues. Total cost of revenues decreased to $17.6 million in the quarter ended September 30, 2001 from $36.1 million in the quarter ended September 30, 2000 primarily because of lower sales of equipment. Total cost of revenues in the first nine months of 2001 increased to $138.2 million from $93.2 million in the nine-month period ended September 30, 2000.

The increase in our cost of revenues in the nine-month period is primarily attributable to a $72.0 million charge related to excess inventory, obsolescence and lower of cost or market adjustments taken in the second quarter of 2001. 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. 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 30, 2001, our actual sales, as well as our estimates of forecasted sales for our 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 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 and (iii) our estimates of salvage or recovery value for each raw material or finished good on an item by item basis. Such write-down was included in costs of revenues in the nine months ended September 30, 2001 and consisted of the following (in millions):

Excess quantities of raw materials on hand and under purchase commitments at June 30, 2001, net of salvage	$34.8
Excess quantities of finished goods on hand at June 30, 2001, net of salvage	10.8
Obsolescence	13.2
Cancellation charges on purchase commitments	5.2
Lower of cost or market write-down on current generation product platform	8.0
Total	$72.0

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 decreased to 13.0% in the third quarter of 2001 from 25.1% in the third quarter of 2000. Our gross margin percentage, excluding the $72.0 million inventory charge and $0.4 million of manufacturing overhead charges, decreased to 18.7% in the nine-month period ended September 30, 2001 from 21.6% in the comparable 2000 period. Excluding the inventory charges, the decline in our gross margin percentage was primarily related to spreading the manufacturing overhead elements of product cost over reduced sales volumes. In the future, gross margin percentage 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. Our overhead reduction plans and the improved product cost attributes of our new standards compliant product platform are intended to improve the gross margin percentage in future periods.

Research and development. Research and development expenses decreased to $11.8 million in the quarter ended September 30, 2001 from $13.1 million in the quarter ended September 30, 2000. Research and development expenses in the first nine months of 2001 and 2000 were $38.7 million and $40.5 million, respectively. The decrease in the 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 expense all of our research and development costs as incurred.

Selling, general and administrative. Selling, general and administrative expenses decreased to $12.9 million in the quarter ended September 30, 2001 from $13.7 million in the quarter ended September 30, 2000. The decrease was primarily due to cost-cutting measures implemented in the third quarter. Selling, general and administrative expenses increased to $42.3 million in the nine-month period ended September 30, 2001 from $34.2 million in the comparable 2000 period. The increase in the nine-month expenses was primarily attributable to increased goodwill amortization arising from the purchase of SoftProse in July 2000. In addition, we generated higher sales expenses by hiring new sales representatives in the first half of the year in our efforts to increase the number and size of our customer accounts. We also generated higher recruiting and relocation expenses in the first half of the year. Subsequent to September 30, 2001, we reduced our workforce by approximately 15% and expect to achieve related overhead cost reductions in future periods.

Non-cash compensation charge. Substantially all of our employees in 1999 were holders of 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 nine-month period ended September 30, 2000 was $2.4 million. There was no such expense in 2001, and we do not expect any such expenses to be material in the future.

Interest income (expense), net. Interest expense, net in the three-month

period and nine-month period ended September 30, 2001 was $5.4 million and $8.5 million. Interest expense in the

current period primarily constitutes cash and non-cash interest expense related to our loan agreement with Motorola (see Note 3 to the condensed consolidated financial statements). Interest income, net in the quarter and nine-month period ended September 30, 2000 was $1.3 million and $5.1 million, respectively. 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 nine-month period ended September 30, 2001 was $0.2 million and $5.4 million, respectively. Other expense in the nine-month period is primarily related to the write-down of certain investments and certain property, plant and equipment (see Note 5 in the condensed consolidated financial statements). Other income (expense) in the prior comparable periods was not significant.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $96.3 million in the nine months ended September 30, 2001 and $60.5 million in the nine months ended September 30, 2000. In the current period, the use of cash in operating activities was primarily due to our net losses ($152.3 million less non-cash charges of $78.6 million) and an increase in inventory of $51.5 million partially off-set by a reduction in accounts receivable of $14.7 million. During the nine-month period ended September 30, 2000, the cash used in operating activities was primarily due to net losses of $46.5 million and an increase in inventory of $33.3 million.

Net cash used in investing activities was $10.6 million in the nine months ended September 30, 2001 and $17.3 million in the nine months ended September 30, 2000. The current period amount was attributable to capital expenditures made to support our engineering and testing activities as well as an additional $6.5 million investment in Virtual Access, a network access company. In the prior period, the amount was primarily attributable to capital expenditures and investments in OutReach and Expanse Networks, partially off-set by the sale of marketable securities.

Net cash provided by financing activities was $83.2 million in the nine months ended September 30, 2001 and $3.9 million in the nine months ended September 30, 2000. The current period amount is primarily related to borrowings of $64.0 million from Motorola and $17.3 million in proceeds related to our Tax Sharing Agreement with Motorola. The prior period amount was primarily attributable to the sale of common stock pursuant to the exercise of employee stock options, partially off-set by the payment of expenses related to our initial public offering.

On May 16, 2001 (as amended July 25, September 28 and October 15, 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, with a maturity of May 17, 2003. 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%.

On September 28, 2001, we amended the $60.0 million loan agreement with

Motorola, Inc. to include $4.0 million of bridge financing which was received by us on September 28, 2001. Under the terms of the amended agreement, we were required to repay the $4.0 million subsequent to the funding of the building mortgage discussed below. This amount was repaid on November 2, 2001.

As of September 30, 2001, we had an outstanding obligation under the loan agreement of $64.0 million.

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On October 15, 2001, we amended the $64.0 million loan agreement with Motorola to include an additional $3.0 million, which resulted from a revised calculation performed relative to the Tax Sharing and Allocation Agreement between us and Motorola (see Note 4 to the condensed consolidated financial statements). As of October 15, 2001, we had an outstanding obligation under the loan agreement of $67.0 million.

As of November 2, 2001, subsequent to the $4.0 million repayment, we had an outstanding obligation under the loan agreement with Motorola of $63.0 million.

The loan agreement with Motorola contains various covenants, including compliance with net worth requirements, and restrictions on additional indebtedness, capital expenditures, and dividends. As of September 30, 2001, we were in compliance with all of the covenants. See Note 3 to the condensed consolidated financial statements for a discussion of other terms and conditions of the loan agreement.

At September 30, 2001, we had $12.3 million of cash and cash equivalents and working capital of $27.0 million. At November 7, 2001, we had $22.8 of cash and cash equivalents. We have instituted and continue to pursue initiatives intended to increase liquidity.

From December 2000 through November 7, 2001, we have instituted the following measures to improve liquidity:

- Obtained on October 30, 2001 $20.0 million in financing through the mortgage of our largest office building (see note 10 to the condensed consolidated financial statements);

- Completed on October 11, 2001 the sale of a non-core asset for approximately $5.8 million (see note 10 to the condensed consolidated financial statements);

- Made a reduction in our workforce of approximately 15% on October 29, 2001, thereby reducing the number of employees from approximately 490 at February 28, 2001 to approximately 365 at November 8, 2001;

- Obtained $32.3 million from Motorola pursuant to the existing Tax Sharing and Allocation Agreement;

- Obtained a $60.0 million loan from Motorola, due in May 2003; and

- Extended payment terms until May 2002 for $24.3 million of vendor payables.

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

- Continue our active discussions with several investors regarding different financing alternatives;

- Continue to renegotiate payment terms under vendor payables and purchase commitments;

- Dispose of excess inventories;

- Continue to accelerate cash collections; and

- Continue to decrease discretionary spending on general and administrative items.

We need to obtain additional external equity or debt financing during the first quarter of 2002 in order to maintain our current operations. We cannot assure that we will be

successful in any of these initiatives or that external equity or debt financing will be available on favorable terms, or at all.

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.

We need to obtain additional external equity or debt financing during the first quarter of 2002 in order to maintain current operations. We cannot assure that we will be successful in any of these initiatives or that external equity or debt financing will be available on favorable terms, or at all.

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 $152.3 million in the nine months ended September 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 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 reduced. Qwest accounted for 21% and 47% of total revenues in the quarters ended September 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. Any continued significant reduction in purchases of our equipment by Qwest could have a material adverse effect on us.

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; RECENT RELUCTANCE OF TELEPHONE COMPANIES TO MAKE SIGNIFICANT CAPITAL EXPENDITURES MAY HEIGHTEN THIS ISSUE.

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. In addition, telephone companies have recently been reluctant to make significant capital expenditures.

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;
- 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 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.

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

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 21% of our revenues in the quarter ended September 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;

- 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.

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.

WE INCURRED A SIGNIFICANT WRITE-DOWN OF OUR INVENTORY IN THE NINE MONTHS ENDED SEPTEMBER 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 $72.0 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. In the quarter ended June 30, 2001, our actual sales, as well as our estimates of forecasted sales, 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,

- the inventory levels in excess of forecasted demand and

- our estimates of salvage or recovery value for each raw material of finished good on an item by item basis.

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.

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, such as local "loop" or last-mile facilities.

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 certain equipment with the local switching equipment of the incumbents. The FCC's collocation rules 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 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 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 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.

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

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 one large contract manufacturers: SCI Systems. The efficient operation of our business will depend, in large part, on our ability to have SCI and other companies manufacture our products in a timely manner, cost-effectively and in sufficient volumes while maintaining consistent quality. As our business grows, SCI and other contracted manufacturing companies 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.

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 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 September 30, 2001. 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 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 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 November 5, 2001, Motorola owned 64.1 million shares of our common stock and warrants to purchase an additional 4.5 million shares of our common stock, and Kevin Kimberlin Partners, LP and its affiliates owned 2.9 million shares of our common stock and its affiliates held warrants to purchase an additional 4.3 million shares of our common stock; as of June 30, 2001, FMR Corporation owned 4.8 million shares of our common stock. If Motorola, Kevin Kimberlin Partners LP and its affiliates, FMR, 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 November 5, 2001, there were outstanding options to purchase 15.7 million 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.

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 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.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Securities Litigation. In July 2001 a class action complaint entitled Zichron Yakov Menachem Inc. v. Next Level Communications, Inc., et al, was filed in the United States District Court for the Southern District of New York, 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. Plaintiff seeks to represent a class comprised of all persons who purchased our common stock during the period from November 9, 1999 through December 6, 2000. 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.

On August 15, 2001, a complaint entitled CMC Industries, Inc., d/b/a CMC Mississippi, Inc., d/b/a ACT Mississippi v. Next Level Communications, Inc. was filed in the Superior Court for the State of California, County of Sonoma. The complaint alleged that the Company was delinquent in payment relating to certain purchase orders issued by the Company to the plaintiff, and sought damages in the amount of $22.5 million, plus interest and attorneys' fees. On October 24, 2001, plaintiff and the Company entered into a Settlement Agreement and Mutual Release, pursuant to which the complaint was dismissed and the Company agreed to

pay to plaintiff the total amount of $21.3 million (of which amount $13.4 million had been paid as of November 12, 2001) on an agreed-upon schedule.

Other Matters. From time to time, we are a party to other actions which arise 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 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. 2 (dated September 28, 2001) to Credit Agreement dated as of May 16, 2001 between Next Level Communications, Inc. and Motorola, Inc.
10.2	Amendment No. 3 (dated October 15, 2001) to Credit Agreement dated as of May 16, 2001 between Next Level Communications, Inc. and Motorola, Inc.
10.3	Amendment No. 1 (dated October 24, 2001) to Registration Rights Agreement dated as of May 16, 2001 between Next Level Communications, Inc. and Motorola, Inc.

(b) Reports on Form 8-K:

none.

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: November 14, 2001 By: /s/ J. MICHAEL NORRIS

J. Michael Norris
Chief Executive Officer
and President

Date: November 14, 2001 By: /s/ JAMES F. IDE

James F. Ide
Chief Financial Officer

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