

CONEXANT SYSTEMS INC

Form 10-K405

December 04, 2001

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

[X] **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended September 30, 2001*

Commission file number: 000-24923

CONEXANT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

25-1799439
(I.R.S. Employer Identification No.)

4311 Jamboree Road, Newport Beach, California
(Address of principal executive offices)

92660-3095
(Zip code)

Registrant's telephone number, including area code: (949) 483-4600

Securities registered pursuant to Section 12(b) of the Act: NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$1.00 Par Value Per Share
(including associated Preferred Share Purchase Rights)

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 [X] No []

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

The aggregate market value of the Registrant's voting stock held by non-affiliates of the Registrant (based on the closing price as reported on the Nasdaq National Market on November 23, 2001) was approximately \$3.5 billion. Shares of voting stock held by each officer and director and by each shareowner affiliated with a director have been excluded from this calculation because such persons may be deemed to be affiliates. This determination of officer or affiliate status is not necessarily a conclusive determination for other purposes. The number of outstanding shares of the Registrant's Common Stock as of November 23, 2001 was 254,814,295.

Documents Incorporated by Reference

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Portions of the Registrant's Proxy Statement for the 2002 Annual Meeting of Shareowners to be held on February 27, 2002, are incorporated by reference into Part III of this Form 10-K.

* For presentation purposes of this Form 10-K, references made to the September 30, 2001 period relate to the actual fiscal year ended September 28, 2001.

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CAUTIONARY STATEMENT

This Annual Report on Form 10-K contains statements relating to future results of Conexant Systems, Inc. (including certain projections and business trends) that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by those sections. Our actual results may differ materially from those projected as a result of certain risks and uncertainties. These risks and uncertainties include, but are not limited to: the cyclical nature of the semiconductor industry and the markets addressed by our products and our customers products; demand for and market acceptance of new and existing products; successful development of new products; the timing of new product introductions; the successful integration of acquisitions; the availability and extent of utilization of manufacturing capacity and raw materials; pricing pressures and other competitive factors; changes in our product mix; fluctuations in manufacturing yields; product obsolescence; our ability to develop and implement new technologies and to obtain protection of the related intellectual property; the successful implementation of our strategic manufacturing realignment, expense reduction and restructuring initiatives; the successful separation of our Mindspeed Technologies and Personal Networking businesses; our labor relations and those of our customers and suppliers; our ability to attract and retain qualified personnel; the safety and security of our employees and of our facilities; and the uncertainties of litigation, as well as other risks and uncertainties, including those set forth herein and those detailed from time to time in our filings with the Securities and Exchange Commission. These forward-looking statements are made only as of the date hereof, and we undertake no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise.

Mindspeed Technologies , AccessRunner , AnyPort , iScale , ZipWireMulti and ZipWirePlus are trademarks of Conexant Systems, Inc. Other brands, names and trademarks contained in this Annual Report are the property of their respective owners.

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PART I

Item 1. Business

General

Conexant Systems, Inc. (we , Conexant or the Company) is a worldwide leader in semiconductor system solutions for communications applications. Our expertise in mixed-signal processing allows us to deliver integrated systems and semiconductor products which facilitate communications worldwide through wireline voice and data communications networks, cellular telephony systems and emerging cable, satellite and fixed wireless broadband communications networks. We operate in two business segments: the Personal Networking business and Mindspeed Technologies , our Internet infrastructure business.

On December 31, 1998, we became an independent publicly-held company when Rockwell International Corporation (Rockwell) spun off the Company, then a wholly-owned subsidiary of Rockwell, by means of a distribution (the Distribution) of all the outstanding shares of our common stock to the shareholders of Rockwell in a tax-free spin-off. Prior to the Distribution, the Company (formerly named Rockwell Semiconductor Systems, Inc.), together with certain other subsidiaries of Rockwell, operated Rockwell 's semiconductor systems business (Semiconductor Systems). As part of the Distribution, Rockwell transferred to us the assets and liabilities of Semiconductor Systems not already owned by us, including the stock of certain subsidiaries, and we transferred to Rockwell all assets and liabilities not constituting part of Semiconductor Systems, including all assets and liabilities of Rockwell 's electronic commerce business. We were incorporated as Rockwell Semiconductor Systems, Inc. in Delaware on September 16, 1996, and changed our name to Conexant Systems, Inc. on October 14, 1998. All references herein to us, Conexant or the Company for periods prior to the Distribution include Semiconductor Systems.

During fiscal 2001, we like many of our customers and competitors were adversely impacted by a broad slowdown affecting the technology sector, including most of the communications electronics end-markets that our products address. Our net revenues for fiscal 2001 were \$1.1 billion compared to \$2.1 billion for fiscal 2000. We incurred a net loss of \$1.4 billion for fiscal 2001.

Fiscal 2001 net revenues for our Personal Networking business reflect deterioration in the digital cellular handset market resulting from excess channel inventories due to a slowdown in demand for cellular phones and a slower transition to next-generation phones. Sales of broadband solutions were affected by slower than anticipated deployment of broadband services by system providers. Moreover, weak consumer demand for PCs and related peripheral devices, facsimile machines and satellite set-top boxes led to lower sales of our products for these applications. Net revenues in our Mindspeed Technologies business were affected by slowing investment in communications network capacity expansion by Internet service providers (ISPs), competitive local exchange carriers (CLECs) and incumbent local exchange and inter-exchange carriers. In most cases, the effect of weakened end-customer demand was compounded by higher than normal levels of equipment and component inventories among our original equipment manufacturer (OEM), subcontractor and distributor customers.

In response to these weak market fundamentals, during fiscal 2001 we implemented a number of strategic initiatives to focus investment and resources in the areas that best support our strategic growth drivers the mobile communications, broadband access and Internet infrastructure markets. We have undertaken a realignment of our manufacturing and procurement strategies to accelerate our transition from volume digital complementary metal-oxide semiconductor (CMOS) manufacturing to a fabless CMOS business model. We have discontinued advanced CMOS process technology development efforts beyond 0.13-micron capability, as well as further investments in CMOS manufacturing capacity. To facilitate our transition to a fabless CMOS business model, we have entered into long-term supply agreements with major foundry partners to obtain additional external CMOS wafer fabrication capacity. We recently sold our photomask operations to a major manufacturer of photomasks and entered into a long-term supply agreement with the buyer for access to advanced photomask process technologies and services. We also sold our global positioning system (GPS) business, while retaining rights to use certain GPS technology in mobile communications applications. In addition, we are in negotiations to sell our board-level sub-assembly business and the related module assembly plant in El Paso, Texas.

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We also implemented a number of expense reduction and restructuring initiatives to more closely align our cost structure with the current business environment. The cost reduction initiatives include a worldwide workforce reduction, temporary shutdowns of our manufacturing facilities, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for our senior management team until we return to profitability.

In March 2001, our Board of Directors approved in principle a revised plan for the separation of our Personal Networking and Mindspeed Technologies businesses. The separation would now be accomplished by the spin-off of the Personal Networking business to our shareholders as a new company which will have the Conexant name. Although current business conditions have delayed the separation, we remain committed to completing the separation as soon as business and market conditions permit. The separation is also subject to the approval of our shareholders and receipt of a ruling from the Internal Revenue Service (IRS) that the spin-off will qualify as a tax-free distribution. The IRS ruling has been received. While the ruling is generally binding on the IRS, the continuing validity of the ruling is subject to certain factual representations and assumptions. As of the date of this Annual Report, we are not aware of any facts or circumstances that would cause these representations and assumptions to be untrue. We cannot assure you that shareholder approval of the separation will be obtained, or that we will successfully complete the separation.

Our Strategy

To enhance our position as a leading global provider of semiconductor system solutions for a variety of communications applications, we pursue the following major strategies:

Target High-Growth Communications Markets

As the communications electronics markets evolve beyond narrowband wireline connectivity, we have significantly diversified and expanded our business in three sectors: mobile communications, broadband access and Internet infrastructure. Our strategy is to identify rapidly growing communications markets and to develop semiconductor system solutions for applications in these markets. Within mobile communications, we focus on providing our customers components, subsystems and complete system solutions that support the most widely-adopted wireless standards. For the broadband access markets, our semiconductor system solutions target new methods of connectivity through emerging digital subscriber line (DSL), cable and fixed wireless networks. Our Mindspeed Technologies business offers semiconductor networking solutions for Internet infrastructure applications that enable high-speed communications from the edge of the Internet to linked metropolitan area networks and long-haul networks.

Focus on System Solutions

We seek to capitalize on our design capabilities and communications systems knowledge by providing suppliers of communications electronics products with complete semiconductor system solutions. High levels of integration enhance the benefits of our products by reducing production costs through fewer external components, reduced board space and improved system assembly yields. These semiconductor system solutions provide our OEM customers with hardware and software, and in some cases a complete reference design. By combining all of the necessary communication functions for a complete system solution, we can deliver additional semiconductor content, thereby offering our existing and potential customers more compelling and cost-effective solutions.

Leverage Our Core Technology

Our strategy is to deploy technology building blocks, such as digital signal processors, radio-frequency integrated circuits, mixed-signal processing cores and software across multiple product platforms. We believe that executing this core technology strategy is fundamental to our growth objectives. This strategy enables creation of economies of scale in research and development and facilitates a reduction in the time-to-market for key products. We intend to extend our core technology portfolio and, in parallel, seek alliances to gain access to critical intellectual property, thereby ensuring continued agility and flexibility to meet changing market and technology requirements.

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Accelerate Time-to-Market

Through integrated marketing, product development and manufacturing teams, we pursue the rapid design and cost-effective production of semiconductor system solutions for our target markets. By combining our design expertise with our internal manufacturing capabilities and third party manufacturing partnerships, we seek to achieve a shorter, more direct path from concept to production. We seek to minimize the time to develop prototype products and begin production so as to enable our customers to introduce new, advanced products ahead of their competitors.

Build Upon Strategic Customer Relationships

We believe a business partnership approach yields maximum value to the customer through multi-level organizational engagement and product roadmap alignment. Further, we believe that the strength of our relations with leading customers in each of our markets is a competitive advantage that enables us to more effectively target our research and development investments. We have established important customer relationships with leading system and service providers in each of our addressed markets and we seek to build upon our existing market positions, and to gain market share in new high-growth markets, by continuing to work closely with these customers. This strategy provides us with rapid feedback from our customers during the design process and increases the likelihood that our products will meet our customers' cost and performance requirements for high-volume applications.

Personal Networking Business

Our Personal Networking business designs, develops and sells semiconductor system solutions for mobile communications and broadband access applications. Our mobile communications products are comprised of components, subsystems and system-level semiconductor solutions for wireless voice and data communication applications, including digital cellular handsets and base stations, as well as advanced mobile terminals that support next-generation multimedia and high-speed web browsing. Our broadband access products include semiconductor solutions that perform communications and media processing functions within a variety of information and entertainment platforms, such as PCs, asymmetric digital subscriber line (ADSL) modems, cable modems, set-top boxes, gaming consoles, facsimile machines and personal digital assistants (PDAs).

Mobile Communications

The market for mobile communications semiconductor system solutions is driven by increased demand for digital cellular handsets as a result of lower prices and the availability of feature-rich wireless phones. In addition, we expect the replacement market for digital cellular handsets to grow as OEMs continue to introduce wireless phones with improved battery life and new feature sets. We also expect Internet applications to contribute to growth in the mobile communications market. Internet-ready wireless phones are now shipping in volume and soon, we believe, virtually all new wireless phones sold will be Internet-enabled and pre-loaded with mini-browsers.

Our mobile communications product portfolio is comprised of components, subsystems and system-level semiconductor solutions for wireless voice and data communications applications. Our products support the world's most widely-adopted wireless standards, including:

CDMA, or Code Division Multiple Access;

TDMA, or Time Division Multiple Access; and

GSM, or Global System for Mobile Communications.

A wireless phone's power amplifier provides the signal to reach a base station, and is the most important factor in determining a mobile phone's battery life and talk time. Based on our gallium arsenide (GaAs) heterojunction bipolar transistor (HBT) process and packaged in state-of-the-art modules, our power amplifiers are compact, efficient, highly-integrated solutions that enable digital cellular handsets with extended talk and standby times. In order to provide our customers with design flexibility, our power amplifiers meet or exceed stringent performance requirements and may be used with a variety of handset battery voltages.

Our power amplifiers enabled the first CDMA handsets and our CDMA solutions continue to lead the market in packaging, efficiency and performance. In addition, we have developed a complete family of TDMA and GSM

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power amplifier modules, including the world's first quad-band solution supporting GSM handset operation in more than 150 countries.

Further, during fiscal 2001 we introduced a suite of power amplifiers for next generation mobile phones enabling Internet access based on the CDMA2000, general packet radio services (GPRS) and enhanced data for GSM evolution (EDGE) wireless standards. Broadly supported around the world, these emerging standards provide easy migration paths from the current CDMA, TDMA and GSM standards to future third-generation (3G) standards, including wideband CDMA (WCDMA), for even higher speed wireless multimedia voice and data services.

We also offer radio frequency subsystems for CDMA, TDMA and GSM, including a highly-integrated single-chip transceiver targeting GPRS applications. By eliminating intermediate frequency conversion steps, this direct-conversion solution significantly reduces the number of external components required to build a mobile phone. Proprietary design techniques employed in the transceiver also enable the device to be used with a variety of baseband processors. In addition, we have developed a portfolio of radio frequency components for wireless infrastructure applications such as cellular/personal communications service base stations.

Further, we have developed and launched complete system solutions combining all key hardware and software functions for GSM and GPRS cellular handsets. The hardware portion of these solutions implements digital and analog baseband processing, multi-band power amplification, power management and radio frequency transceiver functionality. Additionally, our system solution includes a worldwide, operator-qualified, network-approved protocol stack and other software required for a complete wireless phone solution. We also provide a reference design and a comprehensive suite of design support services and tools to aid our OEM customers through the development process. To date, a number of our customers' wireless phones have been type-certified by various network service providers around the world.

We have also developed a 2.4 GHz frequency-hopping spread spectrum radio frequency transceiver optimized for use in Bluetooth-enabled systems supporting short-range wireless connectivity. Our entire family of Bluetooth components and systems is compliant with the Bluetooth Special Interest Group specification 1.1 and is targeted for use in wireless handsets and PDAs that require extended battery life and small size.

Current research and development in the mobile communications area is focused on key components, radio frequency subsystems and cellular systems for emerging CDMA2000, GPRS and EDGE applications as well as 3G WCDMA systems that provide greater bandwidth and will enable new possibilities for accessing the Internet using mobile communications platforms.

Broadband Access

Our broadband access semiconductor system solutions enable new methods of connectivity through telephony, cable and fixed wireless networks. An increasing amount of network traffic is comprised of bandwidth-intensive content, such as voice, data, video and other multimedia applications, creating a need for faster communications processing. Factors propelling this trend include a significant increase in the number of telecommuters and small offices/home offices worldwide. As more bandwidth becomes available, the applications and uses of the external communications network encourage more online activities, such as shopping, downloading of music, watching and listening to sporting events on the PC and working from home. As these applications become more commonplace, we expect opportunities to emerge for vendors to offer cost-effective home networking solutions. Home networking allows multiple users to share bandwidth throughout the home, providing cost savings from sharing hardware, software and high-speed Internet access.

We are a leading supplier of Internet access solutions including V.90 and V.92 dial-up modem chipsets. We supply mixed-signal intensive, controllerless modem chipsets and software modem solutions that take advantage of the increasing power of PC central processors and use software to perform functions traditionally enabled by semiconductor components. In addition, we have extended sales of our modem portfolio beyond PC-related products to other end-user products and we are a leading supplier of embedded solutions for a host of emerging Internet appliances, including set-top boxes, Internet-connected televisions and game consoles, web phones and PDAs.

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During fiscal 2001, we increased unit shipments of our AccessRunner ADSL modem solution and recorded a number of design wins in support of service provider qualifications around the world. ADSL permits broadband transmission of data, voice and video over existing standard copper wire telephone lines at speeds of up to 8 megabits per second (Mbps). DSL technologies use a greater range of frequencies over copper wire than traditional telephone services, which in turn allows for greater bandwidth with which to send and receive information. ADSL modems based on our semiconductor solutions have earned key government certifications in China, and we were the first semiconductor supplier to ship certified ADSL chipsets into China for peripheral components interconnect (PCI), universal serial bus (USB) and Ethernet applications. Further, we have unveiled a complete ADSL router-on-a-chip that can replace up to four devices, often obtained from multiple vendors. An ADSL router can support home networking through the shared use of high-speed Internet access and connectivity of multiple PCs and peripherals. Our scalable system architecture integrates all of the functions of a high speed ADSL router, including a high-speed network processor, an ADSL discrete multi-tone engine, an analog front-end and a line driver as well as the routing protocol stack.

Also during fiscal 2001, we increased shipments of our single-chip cable modem, the only solution to include an embedded microprocessor-based media access control for North American Data Over Cable Service Interface Specification (DOCSIS), European DOCSIS and digital video broadcasting applications. Cable modem technology is capable of delivering data, video, telephony and Internet access over existing coaxial cable networks at speeds up to 1,000 times faster than a standard voice-band analog modem. Our solution supports the USB, Ethernet and PCI interfaces for connection with a PC and has successfully completed the rigorous North American CableLabs and European tComLabs certifications with numerous customers. These certifications give consumers and cable operators the assurance that systems comply with DOCSIS specifications and will be interoperable among multiple cable modem vendors.

To support the distribution of broadband content throughout the home, we offer home networking products that enable personal communications devices to share data, voice and video using existing telephone line, coaxial cable, power line and wireless links. We have developed a home network processor which can be used at the core of a variety of devices, such as residential gateways, that consumers may use to access the Internet and share content using a wide range of existing and emerging connectivity technologies to link a network of home PCs and peripheral devices.

Finally, we offer an extensive portfolio enabling digital cable, satellite and terrestrial set-top boxes. Our complete reference design incorporates a silicon tuner, a demodulator, a high-integration media processor and a back-channel telephony modem. We have also unveiled a single-chip demodulator addressing the personal video recording market. This device processes two channels of video streams within satellite set-top boxes, PC receivers and residential gateways enabling the user to record one channel while simultaneously watching a second channel.

Our research and development efforts in the broadband access area include building a comprehensive portfolio of products for the variety of access, delivery and display technologies converging on the television, PC and other consumer electronics platforms. Key products in the design stage include next-generation ADSL routers, cable modems, home network processors and set-top box systems.

Mindspeed Technologies

Our Mindspeed Technologies business designs, develops and sells semiconductor networking solutions that facilitate the aggregation, transmission and switching of data, video and voice from the edge of the Internet to linked metropolitan area networks and long-haul networks.

During the past decade there has been dramatic growth in the number of Internet users, which has driven increased consumer and business demand for more bandwidth-intensive data, video and voice applications and services. Although the pace of the growth of this demand has slowed in 2001, communication service providers, or carriers, are continually upgrading and expanding their voice and data network infrastructure. Network infrastructure OEMs are enabling this expansion and upgrade process by developing and delivering to their carrier customers increasingly higher-bandwidth and lower-cost equipment solutions.

Semiconductors play a critical role in allowing network infrastructure OEMs to meet their customers' networking

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equipment needs in terms of system performance, functionality and time-to-market. Semiconductors are key to enabling network infrastructure OEMs to offer products with improved bandwidth, speed, reliability, flexibility, power efficiency, size, scalability and adherence to industry standards. In addition to these general requirements that all network equipment must satisfy, equipment designed for the *access* and *transport* segments of communications networks have specific semiconductor requirements.

Access encompasses the last mile of the network infrastructure between a carrier and the end user, which is typically a residence or business. For access equipment applications, semiconductors must provide reliable, high-speed connectivity capable of aggregating or disaggregating data, voice and video traffic. *Transport* includes the network infrastructure that prepares the diverse data, voice and video traffic for transport within various metropolitan and long distance networks and then transmits the traffic throughout those networks. For transport equipment applications, semiconductors must provide physical-layer connectivity, information segmentation and classification, traffic management, switching and routing functionality. These features and functions require signal conversion and signal processing capabilities that are best addressed by highly-integrated mixed signal devices that combine analog and digital functions with high performance digital circuitry and application software.

We provide network infrastructure OEMs a broad portfolio of advanced semiconductor networking solutions, ranging from physical-layer devices to higher layer network processors, for their access and transport equipment. Our products can be classified into two general categories: wide area network (WAN) access products and WAN transport products. WAN access products include multi-service access gateway solutions, such as voice-over-Internet protocol (VoIP), and a broad family of multi-megabit DSL products that are used in a variety of network access platforms such as remote access concentrators, voice gateways, digital loop carriers, DSL access multiplexers and integrated access devices. Our WAN transport products, focused on packet-based optical networks, include T/E carrier, asynchronous transfer mode (ATM) and synchronous optical networking (SONET)/synchronous digital hierarchy (SDH) transceivers, switch products, network processors and software subsystems. These solutions are used in a variety of network equipment, including high-speed routers, ATM switches, optical switches, add-drop multiplexers, digital cross-connect systems and dense wave division multiplexer equipment.

WAN Access Products

We have developed one of the industry's broadest lines of multi-megabit DSL transceivers for symmetrical DSL (SDSL) connectivity in commercial applications. Our symmetrical high-bit rate DSL (HDSL) products facilitate deployments of high-speed T/E transmission lines by eliminating the need for repeaters and other line conditioning equipment. Our family of SDSL products provides incumbent and competitive local exchange carriers the ability to deliver Internet access at various rates and to support telecommuting and branch office functions. We recently introduced a family of low-power single port (ZipWirePlus) and multi-port (ZipWireMulti) DSL products utilizing the next generation DSL standard called G.shdsl. G.shdsl enables simultaneous voice and data communications for worldwide DSL applications over longer distances than SDSL-based solutions. These variable rate products are compatible with pre-existing transport systems based on prevailing SDSL modulation standards. In addition, our ZipWireMulti central-office solution incorporates innovative line testing software that enables service providers to remotely diagnose line problems and reduce the amount of labor required to establish and service DSL installations.

Our current research and development efforts in the DSL arena include developing higher-density, lower-power semiconductor solutions for central office equipment applications and expanding our portfolio to include very high speed DSL (VDSL) products that support downstream data rates up to 50 Mbps to deliver integrated digital television and high-speed Internet access to residential customers over twisted copper wire. In addition, we are developing voice-over-DSL solutions for voice gateways and integrated access equipment.

We are a leading supplier of multi-service access (MSA) processor devices which are used in a variety of network access equipment, including remote access concentrators, voice gateways, private branch exchanges, digital loop carriers and integrated access devices. Our AnyPort MSA processor devices are software configurable and implement a variety of services including dial-up and dedicated Internet access and wholesale Internet access provisioned for ISPs. AnyPort MSA processor devices also implement VoIP, voice-over-ATM, voice-over-DSL, Internet fax, wireless and multicast-based services. Our AnyPort device architecture combines the performance of

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a digital signal processor device core with the flexibility of ARM Limited's microcontroller device core to support our extensive suite of field-proven modulation techniques, echo cancellers, speech coders and communications protocols.

Our current research and development efforts in the MSA area include developing next generation multi-service access processor devices to offer increased performance, higher density and lower power for specific network access equipment. In addition, we continue to expand our suite of data modulation techniques, speech coders and protocol processing software.

WAN Transport Products

We offer one of the industry's broadest portfolios of physical- and link-layer communications device solutions to aggregate and transport data, video and voice from network access to the optical backbone of the telecommunications networks, including T1/E1 and T3/E3 carrier, ATM and SONET/SDH products.

Our T1/E1 and T3/E3 carrier devices enable digital communications over twisted copper wire and include framers and line interface units (LIUs) for 1.5 Mbps to 45 Mbps data transmission, as well as multi-channel high-level data link channel (HDLC) protocol controllers.

We also provide ATM physical layer and segmentation and reassembly (SAR) devices supporting 155 and 622 Mbps applications. As our customers move toward greater levels of product integration, our ATM technology is being increasingly combined with our T/E carrier chipsets, HDLC devices, multi-service access processor devices and DSL transceiver devices to create complete semiconductor networking solutions.

For metropolitan and long haul network applications, we are expanding our broad portfolio of end-to-end transmission and switching products used in fiber-optic network equipment. Our portfolio of optical networking solutions spans the entire range of transceiver products from the 155 Mbps data rate called OC-3 to the 10 gigabits per second (Gbps) data rate called OC-192, in support of SONET/SDH and packet-over-SONET applications. Our optical transceiver products include laser drivers, transimpedance amplifiers, post amplifiers, clock and data recovery circuits, serializers and deserializers and very short reach converters and high speed channel transceivers. Our optical switch portfolio includes high-density cross-point switches for digital cross connect systems applications, and the recently introduced switch fabric family. The iScale switch fabric chipset, configurable up to 32 OC-192 ports or 128 OC-48 ports, enables data to be transferred between line cards in high-capacity, high-speed network equipment. Target equipment applications include high-density Internet protocol (IP) switches, 10 Gbps Ethernet switches, storage routers and digital cross-connect systems.

Our physical- and link-layer products are complemented by our high performance network processor devices, which are designed to offer advanced switching and routing capabilities normally performed by complex and costly application-specific integrated circuits (ASICs). These software-programmable devices operate at data rates from 155 Mbps (OC-3) to 2.4 Gbps (OC-48) and are designed to combine the real-time control and management capabilities of an embedded processor to support scalable system designs. The advanced capabilities offered by our network processor devices include multi-protocol switching to enable integrated local area network (LAN) and WAN systems. Our network processor devices also offer multi-layer programmable switching and routing capabilities to support policy-based traffic management and programmable quality of service for traffic prioritization across disparate networks.

In addition, we have expanded our optical networking portfolio with the introduction of 2.4 Gbps (OC-48) and 10 Gbps (OC-192) framers/mappers for organizing and identifying packets for transport over high speed SONET-based networks. System designers can combine these framers/mappers with our switch fabrics and network processors to provide semiconductor system solutions for terabit routers, ATM multiservice switches and voice and data gateways to handle increasing volumes of data traffic in a scalable, cost-effective manner.

We also offer a comprehensive set of software subsystems that support next-generation, carrier-class network infrastructure equipment. These software subsystems span the technologies of IP, ATM, multi-protocol label switching (MPLS) and voice-over-ATM. In addition to protocol systems, we also offer several software infrastructure modules that improve time-to-market for OEMs.

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Our current research and development initiatives in the WAN transport area center on expanding our family of network processors and cross-point switches, developing multi-rate and 40 Gbps transceivers, integrating framing/mapping functionality with transceiver solutions and expanding our scalable switch fabric product family.

Research and Development

We have significant research, development, engineering and product design capabilities. At September 30, 2001, we employed approximately 1,800 engineers in research and development activities at 26 design centers worldwide. Our design centers provide design engineering and product application support as well as after-sales customer service. The design centers are strategically located around the world to be in close proximity to our OEM customers and to take advantage of key technical and engineering talent worldwide.

We incurred research and development expenses of \$483.0 million, \$414.5 million and \$310.0 million in fiscal 2001, 2000 and 1999, respectively.

Manufacturing

We currently operate two wafer fabrication facilities and an integrated circuit (IC) assembly and test facility. We also have arrangements with third parties, including entities outside the United States, for the production, assembly and testing of certain semiconductor products. Our assembly and test facility in Mexicali, Mexico and international subcontract manufacturing arrangements are subject to a number of risks of operating abroad.

We are currently realigning our manufacturing and procurement strategies to accelerate our transition from volume digital CMOS manufacturing to a fabless CMOS business model. We have discontinued advanced CMOS process technology development efforts beyond 0.13 micron capability, as well as further investments in CMOS manufacturing capacity. To facilitate our transition to a fabless CMOS business model, we have entered into long-term supply agreements with major foundry partners to obtain additional external CMOS wafer manufacturing capacity. Specialty-process wafer manufacturing remains an important component of our strategy.

Our principal manufacturing facilities and wafer manufacturing processes include:

Facility	Function
Newport Beach, California	Silicon wafer fabrication facility CMOS and specialty processes 8-inch wafers Class 1 and Class 10 clean rooms 0.18 - 0.5 micron CMOS processes Bipolar CMOS (BiCMOS) Radio frequency BiCMOS (RF BiCMOS) Silicon germanium (SiGe)
Newbury Park, California	Gallium arsenide wafer fabrication facility 4-inch wafers Heterojunction bipolar transistor (HBT) Indium gallium phosphide (InGaP) HBT Metal-semiconductor field effect transistor (MESFET)
Mexicali, Mexico	Assembly and test facility High-volume/low-cost multi-chip modules

Our primary wafer fabrication facility, located in Newport Beach, California, consists of approximately 123,000 square feet and is ISO 9002 certified. We are resizing our manufacturing operations at this facility to match our expected specialty-process demand over the next several years, which will be increasingly concentrated on silicon germanium process technology. Silicon germanium, which enables integrated circuits featuring higher performance and lower power consumption while retaining the cost and integration benefits of conventional silicon, is an emerging process technology for mobile communications and Internet infrastructure applications.

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We will also continue to operate and invest in next-generation technology at our existing gallium arsenide wafer fabrication facility (consisting of approximately 30,000 square feet) in Newbury Park, California. Gallium arsenide is particularly well suited for mobile communications products such as power amplifiers. This facility is also ISO 9002 certified.

We own an approximately 298,000 square foot assembly and test facility in Mexicali, Mexico, which has been in operation for over 25 years. The Mexicali facility assembles semiconductor die from our wafer fabrication facilities and outside foundry sources into various types of finished semiconductor products and tests the products using automatic test equipment with a full range of analog, digital and radio frequency capability. This facility is ISO 9002 certified and focuses on high-volume, industry-standard plastic packaging but has the capability to manufacture a wide variety of high- and low-volume and specialized packages using conventional and proprietary assembly techniques.

We are in negotiations to sell our board-level sub-assembly business and the related module assembly plant in El Paso, Texas. We expect the sale to be completed by December 31, 2001.

Raw Materials and Supplies

We believe we have adequate sources for the supply of raw materials and components for our manufacturing needs with suppliers located around the world. Raw wafers and other raw materials used in the production of our CMOS products are available from several suppliers.

Customers, Marketing and Sales

We market and sell our semiconductor products and system solutions directly to leading OEMs of communication electronics products and third-party electronic manufacturing service providers, and indirectly through electronic components distributors. Selected direct and indirect OEM customers include the following:

Personal Networking

Acer Incorporated	Hewlett-Packard Company	NEC Corporation
Apple Computer, Inc.	International Business Machines Corporation	Nokia Corporation
Compaq Computer Corporation	L.G. International Corporation	Pace Micro Technology plc
Dell Computer Corporation	Matsushita Electric Industrial Co. Ltd.	Samsung Electronics Co., Ltd.
EchoStar Communications Corporation	Microsoft Corporation	Sharp Corporation
Ericsson Inc.	Mitsubishi Wireless Communications, Inc.	Sony Corporation
Gateway, Inc.	Motorola, Inc.	Thomson Corporation

Mindspeed Technologies

3Com Corporation	ECI Telecommunications	Nortel Networks Corporation
ADC Telecommunications, Inc.	Ericsson, Inc.	Redback Networks Inc.
Alcatel Data Networks, S.A.	Fujitsu Limited	Siemens A.G.
Agilent Technologies, Inc.	JDS Uniphase Corporation	Sonus Networks, Inc.
Avaya, Inc.	Juniper Networks, Inc.	Sycamore Networks, Inc.
CIENA Corporation	Lucent Technologies, Inc.	Tellabs, Inc.
Cisco Systems, Inc.	Nokia Corporation	Tellium, Inc.

We have a worldwide sales organization comprised of approximately 300 employees as of September 30, 2001, with 13 domestic and 16 international sales offices. To complement our direct sales and customer support efforts, we also sell our products through approximately 26 independent manufacturers representatives and approximately 35 distributors and dealers. In addition, our design and applications engineering staff is actively involved with customers during all phases of design and production and provides customer support through our worldwide sales offices, which are generally in close proximity to customers facilities.

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Backlog

Our sales are made primarily pursuant to standard purchase orders for delivery of products, with such purchase orders officially acknowledged by us according to our own terms and conditions. Due to industry practice, which allows customers to cancel orders with limited advance notice to us prior to shipment, we believe that backlog as of any particular date is not a reliable indicator of our future revenue levels.

Competition

The communications semiconductor industry in general, and the markets in which we compete in particular, are intensely competitive. We compete worldwide with a number of U.S. and international suppliers that are both larger and smaller than us in terms of resources and market share. We anticipate that additional competitors will enter our markets and expect intense product competition to continue.

The specific bases on which we compete vary by market. We believe that the principal competitive factors for semiconductor suppliers in each of our addressed markets are:

- time-to-market;
- product performance;
- level of integration;
- price and total system cost;
- compliance with industry standards;
- design and engineering capabilities;
- strategic relationships with customers;
- customer support;
- new product innovation; and
- quality.

We believe we compete favorably with respect to these factors.

In the Personal Networking business, our competitors in the mobile communications market include Agere Systems, Inc., ANADIGICS, Inc., Analog Devices, Inc., Hitachi Ltd., Infineon Technologies A.G., Motorola, Inc., Philips Electronics N.V., RF Micro Devices, Inc. and Texas Instruments Incorporated. In the broadband access market, we compete primarily with Agere Systems, Inc., Alcatel, Broadcom, Inc., Centillium Communications, Inc., GlobeSpan, Inc., LSI Logic Corporation, Microtune, Inc., PC-Tel, Inc., Philips Electronics N.V., STMicroelectronics N.V. and Texas Instruments Incorporated.

In our Mindspeed Technologies business, our competitors include Agere Systems, Inc., Analog Devices, Inc., Applied Micro Circuits Corporation, Broadcom, Inc., Exar Corporation, GlobeSpan, Inc., IBM Microelectronics Division, Infineon Technologies A.G., Intel Corporation, Metalink Ltd., Motorola, Inc., PMC-Sierra, Inc., Texas Instruments Incorporated, TranSwitch Corporation and Vitesse Semiconductor Corporation.

Intellectual Property and Proprietary Rights

We own or license numerous United States and foreign patents and patent applications related to our manufacturing operations and other activities. We have filed federal and international trademark applications seeking registered protections of the Conexant and Mindspeed names and logos. In addition, we own a number of other trademarks applicable to certain of our products. We believe that intellectual property, including patents, patent applications and licenses, and trademarks are of material importance to our business. In addition to protecting our proprietary technologies and processes, we strive to strengthen our intellectual property portfolio to enhance our ability to obtain cross-licenses of intellectual property from others, to obtain access to intellectual property we do not possess or to more favorably resolve potential intellectual property claims against us.

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Various claims of patent infringement have been made against us. We believe that none of these claims will have a material adverse effect on our financial position or results of operations. In connection with our spin-off from Rockwell, we assumed all liabilities in respect of intellectual property matters related to current and former operations of Semiconductor Systems. See Item 3 Legal Proceedings .

Environmental Regulation

Federal, state and local requirements relating to the discharge of substances into the environment, the disposal of hazardous wastes, and other activities affecting the environment have had, and will continue to have, an impact on our manufacturing operations. Thus far, compliance with environmental requirements and resolution of environmental claims have been accomplished without material effect on our liquidity and capital resources, competitive position or financial condition.

In connection with our spin-off from Rockwell, we assumed all liabilities in respect of environmental matters related to current and former operations of the Company. We have been designated as a potentially responsible party and are engaged in ground water remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by us. In addition, we are engaged in remediations of groundwater contamination at our Newport Beach and Newbury Park, California facilities. We currently estimate the remaining costs for these remediations to be approximately \$3.7 million and have accrued for these costs as of September 30, 2001.

We believe that our expenditures for environmental capital investment and remediation necessary to comply with present regulations governing environmental protection and other expenditures for the resolution of environmental claims will not have a material adverse effect on our liquidity and capital resources, competitive position or financial condition. We cannot assess the possible effect of compliance with future requirements.

Cyclicality; Seasonality

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving technical standards, short product life cycles and wide fluctuations in product supply and demand. From time to time these and other factors, together with changes in general economic conditions, cause significant upturns and downturns in the industry, and in our business in particular. Periods of industry downturns as we experienced in fiscal 2001 and continue to experience have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. These factors cause substantial fluctuations in our revenues and our results of operations. We have experienced these cyclical fluctuations in our business in the past, are currently experiencing a significant downturn, and may experience cyclical fluctuations in the future.

Sales of our mobile communications and broadband access products are subject to seasonal fluctuation related to the increase in sales of end-user products which include our products, such as PCs, cellular telephones and facsimile machines, generally associated with the holiday season in December. Our sales of semiconductor products and system solutions used in these products generally increase beginning in August and September and continue at a higher level through the end of the calendar year.

Employees

As of September 30, 2001, we had approximately 6,900 full-time employees, of whom approximately 2,200 are engineers. Approximately 300 employees in the United States and approximately 2,000 employees in Mexico are covered by collective bargaining agreements. In July 1998, following a 50-day strike by members of the International Brotherhood of Electrical Workers Local 2295, we entered into a collective bargaining agreement with that union covering the union employees at our Newport Beach, California facility. The agreement will expire in May 2003. No other significant work stoppages have occurred in the past five years.

We believe our future success will depend in large part upon our continued ability to attract, motivate, develop and retain highly skilled and dedicated employees.

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Certain Business Risks

Our business, financial condition and operating results can be impacted by a number of factors including, but not limited to, those set forth below, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results.

You should carefully consider and evaluate all of the information in this Annual Report, including the risk factors listed below. Any of these risks could materially and adversely affect our business, financial condition and results of operations, which in turn could materially and adversely affect the price of our common stock or other securities.

We have recently incurred substantial operating losses and we anticipate additional future losses.

Our net revenues for fiscal 2001 were \$1.1 billion compared to \$2.1 billion for fiscal 2000 due to sharply reduced end-customer demand in many of the communications electronics end-markets which our products address. We incurred a net loss of \$1.4 billion for fiscal 2001.

During fiscal 2001, we implemented a number of expense reduction and restructuring initiatives to more closely align our cost structure with the current business environment. The cost reduction initiatives include a worldwide workforce reduction, temporary shutdowns of our manufacturing facilities, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for our senior management team until we return to profitability. However, these expense reduction initiatives alone will not return us to profitability. We expect that reduced end-customer demand, underutilization of our manufacturing capacity, changes in our revenue mix and other factors will continue to adversely affect our operating results in the near term and we anticipate incurring additional losses in fiscal 2002. In order to return to profitability, we must achieve substantial revenue growth and we currently face an environment of uncertain demand in the markets our products address. We cannot assure you as to whether or when we will return to profitability or whether we will be able to sustain such profitability, if achieved.

We operate in the highly cyclical semiconductor industry, which is subject to significant downturns.

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving technical standards, short product life cycles and wide fluctuations in product supply and demand. From time to time these and other factors, together with changes in general economic conditions, cause significant upturns and downturns in the industry, and in our business in particular. Periods of industry downturns as we experienced in fiscal 2001 and continue to experience have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. These factors cause substantial fluctuations in our revenues and our results of operations. We have experienced these cyclical fluctuations in our business in the past, are currently experiencing a significant downturn, and may experience cyclical fluctuations in the future.

During the late 1990 s and extending into 2000, the semiconductor industry in general, and communications applications in particular, enjoyed unprecedented growth, benefiting from the rapid expansion of the Internet and other communication services worldwide. During fiscal 2001, we like many of our customers and competitors were adversely impacted by a global economic slowdown and an abrupt decline in demand for many of the end-user products that incorporate our communications semiconductor products and system solutions. The impact of weakened end-customer demand has been compounded by higher than normal levels of equipment and component inventories among our OEM, subcontractor and distributor customers. As a result of this sharply reduced demand across our product portfolio, we recorded \$245.1 million of inventory write-downs in fiscal 2001. We expect that reduced end-customer demand, underutilization of our manufacturing capacity, changes in our revenue mix and other factors will continue to adversely affect our operating results in the near term.

In addition, the current environment of weak end-customer demand and high levels of channel inventories has, in some cases, led to delays in payments for our products. During fiscal 2001, we recorded \$22.6 million of additional provisions for uncollectible accounts receivable from slow-paying customers. In the event that our customers delay payments to us, or are unable to pay amounts owed to us, we may incur additional losses on our accounts receivable.

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Demand for our products in each of the communications electronics end-markets which we address is subject to a unique set of factors, and a downturn in demand affecting one market may be more pronounced, or last longer, than a downturn affecting another of our markets. In particular, we expect that demand for the products sold by our Mindspeed Technologies business, which are incorporated into telecommunications and data communications infrastructure equipment, may recover more slowly than demand for products offered by our Personal Networking business, which are ultimately sold to individual consumers in products such as PCs and digital cellular handsets.

We are subject to intense competition.

The semiconductor industry in general and the markets in which we compete in particular are intensely competitive. We compete worldwide with a number of United States and international semiconductor manufacturers that are both larger and smaller than us in terms of resources and market share. We currently face significant competition in our markets and expect that intense price and product competition will continue. This competition has resulted and is expected to continue to result in declining average selling prices for our products. We also anticipate that additional competitors will enter our markets as a result of growth opportunities in communications electronics, the trend toward global expansion by foreign and domestic competitors, technological and public policy changes and relatively low barriers to entry in certain markets of the industry. Moreover, as with many companies in the semiconductor industry, customers for certain of our products offer other products that compete with similar products offered by us.

We believe that the principal competitive factors for semiconductor suppliers in our market are:

- time-to-market;
- product performance;
- level of integration;
- price and total system cost;
- compliance with industry standards;
- design and engineering capabilities;
- strategic relationships with customers;
- customer support;
- new product innovation; and
- quality.

The specific bases on which we compete vary by market. We cannot assure you that we will be able to successfully address these factors.

Many of our current and potential competitors have certain advantages over us, including:

- longer presence in key markets;
- greater name recognition;
- access to larger customer bases; and

significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources.

As a result, these competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or may be able to devote greater resources to the development, promotion and sale of their products than we can.

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Current and potential competitors also have established or may establish financial or strategic relationships among themselves or with our existing or potential customers, resellers or other third parties. These relationships may affect customers' purchasing decisions. Accordingly, it is possible that new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current and potential competitors.

A number of our competitors have combined with each other and consolidated their businesses, including the consolidation of competitors with our customers. This is attributable to a number of factors, including the historically high-growth nature of the communications electronics industry and the time-to-market pressures on suppliers to decrease the time required for product conception, research and development, sampling and production launch before a product reaches the market. This consolidation trend is expected to continue, since investments, alliances and acquisitions may enable semiconductor suppliers, including us and our competitors, to augment technical capabilities or to achieve faster time-to-market for their products than would be possible solely through internal development.

Consolidation by industry participants, including in some cases, acquisitions of certain of our customers by our competitors, are creating entities with increased market share, customer base, technology and marketing expertise in markets in which we compete. These developments may significantly and adversely affect our current markets, the markets we are seeking to serve and our ability to compete successfully in those markets.

Our success is dependent upon our ability to timely develop new products and reduce costs.

Our operating results will depend largely on our ability to continue to introduce new and enhanced semiconductor products on a timely basis. Successful product development and introduction depends on numerous factors, including, among others:

our ability to anticipate customer and market requirements and changes in technology and industry standards;

our ability to accurately define new products;

our ability to timely complete development of new products and bring our products to market on a timely basis;

our ability to differentiate our products from offerings of our competitors; and

overall market acceptance of our products.

Furthermore, we are required to continually evaluate expenditures for planned product development and to choose among alternative technologies based on our expectations of future market growth. We cannot assure you that we will be able to develop and introduce new or enhanced products in a timely and cost-effective manner, that our products will satisfy customer requirements or achieve market acceptance, or that we will be able to anticipate new industry standards and technological changes. We also cannot assure you that we will be able to respond successfully to new product announcements and introductions by competitors.

In addition, prices of established products may decline, sometimes significantly, over time. We believe that in order to remain competitive we must continue to reduce the cost of producing and delivering existing products at the same time that we develop and introduce new or enhanced products. We cannot assure you that we will be able to continue to reduce the cost of our products to remain competitive.

We may be unable to make the substantial research and development investments required to remain competitive in our business.

The semiconductor industry requires substantial investment in research and development in order to develop and bring to market new and enhanced products. We cannot assure you that we will have sufficient resources to develop new and enhanced technologies and competitive products.

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We may not be able to keep abreast of the rapid technological changes in our markets.

The demand for our products can change quickly and in ways we may not anticipate because our markets generally exhibit the following characteristics:

rapid technological developments;

evolving industry standards;

changes in customer requirements;

frequent new product introductions and enhancements; and

short product life cycles with declining prices over the life cycle of the product.

Our products could become obsolete sooner than anticipated because of a faster than anticipated change in one or more of the technologies related to our products or in market demand for products based on a particular technology, particularly due to the introduction of new technology that represents a substantial advance over current technology. Currently accepted industry standards are also subject to change, which may contribute to the obsolescence of our products.

We may not be able to attract and retain qualified personnel necessary for the design, development, manufacture and sale of our products. Our success could be negatively affected if key personnel leave.

Our future success depends on our ability to continue to attract, retain and motivate qualified personnel, including executive officers and other key management and technical personnel. As the source of our technological and product innovations, our key technical personnel represent a significant asset. The competition for such personnel is intense in the semiconductor industry. We cannot assure you that we will be able to continue to attract and retain qualified management and other personnel necessary for the design, development, manufacture and sale of our products.

We may have particular difficulty attracting and retaining key personnel during periods of poor operating performance, given, among other things, the significant use of equity-based compensation by our competitors and us. The loss of the services of one or more of our key employees, including Dwight W. Decker, our Chairman and Chief Executive Officer, or certain key design and technical personnel, or our inability to attract, retain and motivate qualified personnel could have a material adverse effect on our ability to operate our business.

If OEMs of communications electronics products do not design our products into their equipment, we will have difficulty selling those products. Moreover, a design win from a customer does not guarantee future sales to that customer.

Our products are not sold directly to the end-user but are components of other products. As a result, we rely on OEMs of communications electronics products to select our products from among alternative offerings to be designed into their equipment. Without these design wins from OEMs, we would have difficulty selling our products. Once an OEM designs another supplier's semiconductors into its products, it will be more difficult for us to achieve future design wins with that OEM's product platform because changing suppliers involves significant cost, time, effort and risk. Achieving a design win with a customer does not ensure that we will receive significant revenues from that customer. Even after a design win, the customer is not obligated to purchase our products and can choose at any time to stop using our products, for example, if its own products are not commercially successful or for any other reason. We may be unable to achieve design wins or to convert design wins into actual sales.

Because of the lengthy sales cycles of many of our products, we may incur significant expenses before we generate any revenues related to those products.

Our customers may need six months or longer to test and evaluate our products and an additional six months or more to begin volume production of equipment that incorporates our products. The lengthy period of time required also increases the possibility that a customer may decide to cancel or change product plans, which could reduce or

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eliminate sales to that customer. As a result of this lengthy sales cycle, we may incur significant research and development, and selling, general and administrative expenses before we generate the related revenues for these products, and we may never generate the anticipated revenues if our customer cancels or changes its product plans.

Uncertainties involving the ordering and shipment of our products could adversely affect our business.

Our sales are typically made pursuant to individual purchase orders and we generally do not have long-term supply arrangements with our customers. Generally, our customers may cancel orders until 30 days prior to shipment. In addition, we sell a portion of our products through distributors, some of whom have rights to return unsold products to us. Sales to distributors accounted for approximately 22% and 19% of our net revenues for fiscal 2001 and 2000, respectively. We routinely purchase and manufacture inventory based on estimates of customer demand for their products, which is difficult to predict. This difficulty may be compounded when we sell to OEMs indirectly through distributors or contract manufacturers, or both, as our forecasts of demand are then based on estimates provided by multiple parties. In addition, our customers may change their inventory practices on short notice for any reason. The cancellation or deferral of product orders, the return of previously sold products or overproduction due to the failure of anticipated orders to materialize could result in our holding excess or obsolete inventory, which could result in write-downs of inventory.

During fiscal 2001, the communications electronics markets which we address were characterized by dramatic changes in end-user demand and continued high levels of channel inventories which reduced visibility into future demand for our products. We expect that these and other factors will continue to affect our revenues in the near term. As a result of sharply reduced demand across our product portfolio, we recorded \$245.1 million of inventory write-downs in fiscal 2001.

Our manufacturing processes are extremely complex and specialized.

Our manufacturing operations are complex and subject to disruption due to causes beyond our control. The fabrication of integrated circuits is an extremely complex and precise process consisting of hundreds of separate steps. It requires production in a highly controlled, clean environment. Minute impurities, errors in any step of the fabrication process, defects in the masks used to print circuits on a wafer or a number of other factors can cause a substantial percentage of wafers to be rejected or numerous die on each wafer not to function.

Our operating results are highly dependent upon our ability to produce integrated circuits at acceptable manufacturing yields. Our operations may be affected by lengthy or recurring disruptions of operations at any of our production facilities or those of our subcontractors. These disruptions may include labor strikes, work stoppages, electrical power outages, fire, earthquake, flooding or other natural disasters. Certain of our manufacturing facilities are located near major earthquake fault lines, including our California and Mexico facilities. We maintain no earthquake insurance coverage on these facilities. Disruptions of our manufacturing operations could cause significant delays in shipments until we could shift the products from an affected facility or subcontractor to another facility or subcontractor.

In the event of these types of delays, we cannot assure you that the required alternate capacity, particularly wafer production capacity, would be available on a timely basis or at all. Even if alternate wafer production capacity is available, we may not be able to obtain it on favorable terms, which could result in a loss of customers. We may be unable to obtain sufficient manufacturing capacity to meet demand, either at our own facilities or through foundry or similar arrangements with others.

We recently decided to realign our manufacturing and procurement strategies, accelerating our transition from volume digital CMOS manufacturing to a fabless CMOS business model. Over time, it is expected that the majority of our requirements for CMOS wafers, previously manufactured internally, will be sourced from third-party foundries. Specialty-process wafer manufacturing (such as gallium arsenide and silicon germanium processes) will remain an important component of our strategy. Under a fabless CMOS business model, our long-term revenue growth will be dependent on our ability to obtain sufficient external manufacturing capacity, including wafer production capacity. During times when the semiconductor industry is experiencing a shortage of wafer fabrication capacity, we may experience delays in shipments or increased manufacturing costs. To facilitate our transition to a fabless CMOS business model, we have entered into long-term supply arrangements with major foundry partners to

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obtain additional external CMOS wafer manufacturing capacity. We cannot assure you that we will have access to sufficient external CMOS wafer manufacturing capacity on favorable terms, or at all.

Due to the highly specialized nature of the gallium arsenide semiconductor manufacturing process, in the event of a disruption at our Newbury Park, California wafer fabrication facility, alternate gallium arsenide production capacity would not be readily available from third-party sources. Although we have a multi-year agreement with a foundry that guarantees us access to additional gallium arsenide wafer production capacity, a disruption of operations at our Newbury Park wafer fabrication facility or the interruption in the supply of epitaxial wafers used in our gallium arsenide process could have a material adverse effect on our business, financial condition and results of operations, particularly with respect to our mobile communications products.

Other wafer manufacturing processes we use, including the silicon germanium process, are also highly specialized. In the event of a disruption at our Newport Beach, California wafer fabrication facility, we may be required to seek alternate production capacity from third-party sources. These processes are available from a limited number of third-party sources, including a foundry partner to whom we recently licensed our silicon germanium process technology. We cannot assure you that we would be able to obtain adequate external wafer manufacturing capacity on favorable terms, or at all.

We may not be able to achieve manufacturing yields that contribute positively to our gross margin and profitability.

Minor deviations in the manufacturing process can cause substantial manufacturing yield loss, and in some cases, cause production to be suspended. Manufacturing yields for new products initially tend to be lower as we complete product development and commence volume manufacturing, and will typically increase as we ramp to full production. Our forward product pricing includes this assumption of improving manufacturing yields and, as a result, material variances between projected and actual manufacturing yields have a direct effect on our gross margin and profitability. The difficulty of forecasting manufacturing yields accurately and maintaining cost competitiveness through improving manufacturing yields will continue to be magnified by the ever-increasing process complexity of manufacturing semiconductor products. Our manufacturing operations also face pressures arising from the compression of product life cycles which requires us to bring new products on line faster and for shorter periods while maintaining acceptable manufacturing yields and quality without, in many cases, reaching the longer-term, high-volume manufacturing conducive to higher manufacturing yields and declining costs.

Under our realigned manufacturing strategy, we will be increasingly dependent upon third parties for the manufacture, assembly and test of our products.

As we transition to a fabless CMOS business model, we will obtain an increasing portion of our CMOS wafer requirements from outside wafer fabrication facilities, known as foundries. To a lesser extent, we also rely upon third-party foundries to supplement our specialty-process wafer manufacturing capacity. There are significant risks associated with our reliance on third-party foundries, including:

the lack of ensured wafer supply, potential wafer shortages and higher wafer prices;

limited control over delivery schedules, manufacturing yields, production costs and product quality; and

the unavailability of, or delays in obtaining, access to key process technologies.

Although we have entered into long-term supply arrangements with major foundry partners to obtain additional external CMOS wafer manufacturing capacity, these and other third-party foundries we use may allocate their limited capacity to the production requirements of other customers that are larger and better financed than we. If we choose to use a new foundry, it typically takes several months to complete the qualification process before we can begin shipping products from the new foundry. The foundries we use may experience financial difficulties or suffer damage or destruction to their facilities, particularly since many of them are located in earthquake zones. If these events or any other disruption of wafer fabrication capacity occur, we may not have a second manufacturing source immediately available. We may therefore experience difficulties or delays in securing an adequate supply of our products, which could impair our ability to meet our customers' needs and have a material adverse effect on our operating results.

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In addition, the highly complex and technologically demanding nature of semiconductor manufacturing has caused foundries to experience from time to time lower than anticipated manufacturing yields, particularly in connection with the introduction of new products and the installation and start-up of new process technologies. Lower than anticipated manufacturing yields may affect our ability to fulfill our customers' demands for our products on a timely and cost-effective basis.

Third-party subcontractors also assemble and test a substantial portion of our products. Because we rely on others to assemble and test our products, we are subject to many of the same risks as are described above with respect to independent wafer fabrication facilities.

We are dependent upon third parties for the supply of raw materials and components.

We believe we have adequate sources for the supply of raw materials and components for our manufacturing needs with suppliers located around the world. Although we currently purchase wafers used in the production of our CMOS products from one major supplier, such wafers are available from several other suppliers. We are currently dependent on two suppliers for epitaxial wafers used in the gallium arsenide semiconductor manufacturing processes at our Newbury Park, California facility. The number of qualified alternative suppliers for wafers is limited and the process of qualifying a new wafer supplier could require a substantial lead-time. Although we historically have not experienced any significant difficulties in obtaining an adequate supply of raw materials and components necessary for our manufacturing operations, we cannot assure you that we may not lose a significant supplier or that a supplier may be unable to meet performance and quality specifications or delivery schedules.

Our success depends, in part, on our ability to effect suitable investments, alliances and acquisitions; we may have difficulty integrating companies we acquire.

Although we invest significant resources in research and development activities, the complexity and rapidity of technological changes make it impractical for us to pursue development of all technological solutions on our own. On an ongoing basis, we review investment, alliance and acquisition prospects that would complement our existing product offerings, augment our market coverage or enhance our technological capabilities. However, we cannot assure you that we will be able to identify and consummate suitable investment, alliance or acquisition transactions in the future.

Moreover, if we consummate such transactions, they could result in:

- issuances of equity securities dilutive to our existing shareholders;
- large one-time write-offs;
- the incurrence of substantial debt and assumption of unknown liabilities;
- the potential loss of key employees from the acquired company;
- amortization expenses related to intangible assets; and
- the diversion of management's attention from other business concerns.

Additionally, in periods subsequent to an acquisition, we must evaluate goodwill and acquisition-related intangible assets for impairment. When such assets are found to be impaired, they will be written down to estimated fair value, with a charge against earnings.

Integrating acquired organizations and their products and services may be expensive, time-consuming and a strain on our resources. We could face several challenges integrating acquisitions, including:

- the difficulty of integrating acquired technology into our product offerings;
- the impairment of relationships with employees and customers;
- the difficulty of coordinating and integrating overall business strategies and worldwide operations;

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the inability to maintain brand recognition of acquired businesses;

the inability to maintain corporate controls, procedures and policies;

the failure of acquired features, functions, products or services to achieve market acceptance; and

the potential unknown liabilities associated with acquired businesses.

We cannot assure you that we will be able to address these challenges successfully.

We face a risk that capital needed for our business will not be available when we need it.

We believe that cash flows from operations, existing cash reserves and available-for-sale marketable securities will be sufficient to satisfy our research and development, capital expenditure, working capital and other financing requirements for at least the next twelve months. However, we cannot assure you that this will be the case and we may need to obtain alternate sources of financing in the future. We cannot assure you that we will have access to additional sources of capital on favorable terms or at all.

In addition, any strategic investments and acquisitions that we may make to help us grow our business may require additional capital resources. We cannot assure you that the capital required to fund these investments and acquisitions will be available in the future.

We are subject to the risks of doing business internationally.

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