NEXT LEVEL COMMUNICATIONS INC
Form 10-Q
May 15, 2001

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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 QUARTER ENDED MARCH 31, 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 quarter 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 May 1, 2001 was approximately 85,028,029.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NEXT LEVEL COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
Three Months Ended March 31, 2001 and 2000
(In thousands, except share data, unaudited)

	MARCH 31, 2001	MARCH 31, 2000
REVENUES		
Equipment	$ 28,063	$ 29,689
Software	675	790
Total revenues	28,738	30,479
COST OF REVENUES		
Equipment	22,532	24,891
Software	108	57
Total cost of revenues	22,640	24,948
Gross profit	6,098	5,531
OPERATING EXPENSES		
Research and development	14,095	13,844
Selling, general and administrative	14,510	9,565
Non-cash compensation charge	--	2,384
Total operating expenses	28,605	25,793
Operating loss	(22,507)	(20,262)

Interest income, net	109	1,832
Net loss	$ (22,398)	$ (18,430)
Basic and diluted net loss per share	$ (0.26)	$ (0.23)
Shares used to compute basic and diluted net loss per share	84,628,471	79,767,349

See notes to condensed consolidated financial statements.

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

ASSETS

	MARCH 31, 2001
Current Assets:	
Cash and cash equivalents	$ 8,707
Restricted marketable securities	5,625
Trade receivables, less allowance for doubtful accounts of $1,332 and $1,332	28,879
Other receivables	1,929
Inventories, net	106,801
Prepaid expenses and other	2,025
Total current assets	153,966
Property and equipment, net	52,842
Long-term investments	16,750
Goodwill, less accumulated amortization of $8,558 and $6,883, respectively	16,138
Other assets	2,078
Total Assets	$ 241,774

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:	
Accounts payable	$ 49,644
Accrued liabilities	47,349
Notes payable	5,000
Deferred revenue	2,532
Current portion of capital lease obligations	253
Total current liabilities	$ 104,778
Long-term obligations	--
Stockholders' Equity:	

Common stock - $.01 par value, 400,000,000 shares authorized, 84,838,000 and 84,443,000 shares issued and outstanding, respectively	780
Additional paid-in-capital	$ 438,654
Accumulated deficit	(302,308)
Unearned compensation	(130)
Total Stockholders' Equity	136,996
Total Liabilities and Stockholders' Equity	$ 241,774

See notes to condensed consolidated financial statements.

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NEXT LEVEL COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
Three Months Ended March 31, 2001 and 2000
(In thousands, unaudited)

	MARCH 31, 2001
OPERATING ACTIVITIES:	
Net loss	$ (22,398)
Adjustments to reconcile net loss to net cash used in operating activities:	
Non-cash compensation charge	--
Depreciation and amortization	4,650
Equity in net loss of investee	250
Changes in assets and liabilities:	
Trade receivables	5,767
Inventories	(20,037)
Other assets	1,005
Accounts payable	(3,723)
Accrued liabilities and deferred revenue	11,611
Net cash used in operating activities	(22,875)
INVESTING ACTIVITIES:	
Purchases of property and equipment	(2,114)
Proceeds from sale of marketable securities	19,375
Long-term investments	(2,000)
Proceeds from notes receivable	--
Net cash used in investing activities	15,261
FINANCING ACTIVITIES:	
Issuance of common stock	535
Repayments of borrowings	(20,000)
Repayment of capital lease obligations	(77)
Initial public offering expenses, net	--
Net cash used in financing activities	(19,542)
Net Decrease in Cash and Cash Equivalents	(27,156)
Cash and Cash Equivalents, Beginning of Period	35,863

Cash and Cash Equivalents, End of Period	$ 8,707

See notes to condensed consolidated financial statements.

NEXT LEVEL COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. While these financial statements reflect all adjustments (consisting of normal recurring items) 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 months ended March 31, 2001 are not necessarily indicative of the operating results for the full year.

2. INVENTORIES

Inventories at March 31, 2001 and December 31, 2000 consist of (in thousands):

	March 31, 2001	December 31, 2000
Raw materials	$ 47,468	$ 29,525
Work-in-process	852	1,935
Finished goods	70,886	68,101
Total	119,206	99,561
Less reserves and allowances	(12,405)	(12,797)

Inventories, net	$ 106,801	$ 86,764
	=========	=========

3. NOTES PAYABLE

The Company had entered into a revolving bank line of credit ("Line"), which was due to expire on October 1, 2001, under which the Company could have borrowed up to the lesser of $50 million or the value of pledged collateral. At March 31, 2001, the balance outstanding was $5.0 million. Interest on the Line was at IBOR plus .7%. The line was secured by $5.0 million of marketable securities held by a custodian. On May 7, 2001, the balance on the line was 0, and the Company terminated the line.

4. TAX SHARING AND ALLOCATION AGREEMENT WITH MOTOROLA

In December 2000, the Company received a $15 million advance from Motorola related to a tax sharing and allocation agreement. The Company received an additional $17.3 million in January 2001 and the tax agreement was finalized in February 2001. The amount advanced to the Company is based on an estimate of the present value of income tax benefits to Motorola from the inclusion of the Company's operating losses for the period from January 6, 2000 to May 17, 2000 in Motorola's consolidated tax return. To the extent Motorola does not achieve the expected tax benefits by September 30, 2006, the Company must repay any difference. In addition, should the Company obtain certain specified levels of financing from independent third parties, it must also repay all or a portion of the advance. The Company has included such $32.3 million in accrued liabilities at March 31, 2001.

5. 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 since the effect of any potentially dilutive common stock equivalents is excluded, as they are anti-dilutive because of the Company's losses. As of March 31, 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. Such outstanding securities consist of the following (in thousands):

	March 31,	
	2001	2000
General Partner's warrants	5,592	8,480
Outstanding employee options	22,897	15,262
	------	------
Total	28,489	23,742
	======	======

6. COMPREHENSIVE LOSS

The following table sets forth the calculation of comprehensive loss:

	Three Months Ended March 31,	
	2001	2000
Net Loss	$(22,398)	$(18,430)
Unrealized losses on marketable securities	--	(88)
Total comprehensive loss	$(22,398)	$(18,518)

7. RECENTLY ISSUED ACCOUNTING STANDARD

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, was effective for the Company beginning January 1, 2001. SFAS No. 133 requires that all derivative instruments be measured at fair value and recognized in the balance sheet as either assets or liabilities. The initial adoption of FAS 133 did not have a material effect on the Company's financial statements.

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" 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 52% of our total revenues for the quarter ended March 31, 2001 and 84% of our total revenues for the quarter ended March 31, 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 noncancelable license agreement has been signed, delivery has occurred, the fees are fixed and determinable and collection is probable. The portion of revenues from new software license agreements that relates to our obligations to provide customer support is deferred and recognized ratably over the maintenance period.

Cost of revenues. Cost of equipment revenues includes direct material and labor, depreciation and amortization expense on property and equipment, warranty expenses, license fees and manufacturing and service

overhead. Cost of software revenues primarily includes the cost of the media the software is shipped on, which is usually CDs, and documentation costs.

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 period ended March 31, 2001 decreased to $28.7 million from $30.5 million in the first quarter of 2000. The decrease was primarily due to a decrease in equipment sales to Qwest, partially offset by an increase in equipment sales to independent operating companies. Total revenues for the current period included $28.1 million of equipment sales, compared to $29.7 million in the first quarter of 2000. Qwest accounted for $15.1 million of equipment revenue in the first quarter of 2001 as compared to $25.5 million in the first quarter of 2000. As a result of the merger between U S WEST and Qwest, Qwest slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product. Sales to independent operating companies were $11.8 million in the first quarter of 2001, compared to $4.1 million in the first quarter of 2000. 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. The growth in equipment revenue in future quarters will depend upon 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 remained comparable in both quarters decreasing slightly in the period ended March 31, 2001 to $675,000 from $790,000 in the period ended March 31, 2000. We expect demand for our software to remain relatively flat in the near term because the market for these products is mature.

Cost of Revenues. Total cost of revenues decreased to $22.6 million in the period ended March 31, 2001 from $24.9 million in the period ended March 31, 2001. Our gross margin percentage increased to 21.2% in the first quarter of 2001 from 18.1% in the first quarter of 2000. The increase in our gross margin percentage was primarily the result of an increase in sales of our higher margin products. We currently expect gross margin improvements in the latter part of 2001 as we increase sales of our higher margin products, and continue implementing cost reductions. In the future, cost of revenues as a percent of revenues may fluctuate due to a wide variety of factors, including the customer mix, the product mix, the timing and size of orders which are received, the availability of adequate supplies of key components and assemblies, our ability to introduce new products and technologies on a timely basis, the timing of new product introductions or announcements by us or our competitors, price competition and unit volume.

Research and development. Research and development expenses increased to $14.1 million in the period ended March 31, 2001 from $13.8 million in the period ended March 31, 2000. The increase was primarily due to an increase in research and development personnel. We believe that continued investment in research and development is critical to attaining our strategic product development and cost reduction objectives and, as a result, expect these expenses to continue to increase in absolute dollars. We expense all of our research and development costs as incurred.

Selling, general and administrative. Selling, general and administrative expenses increased to $14.5 million in the period ended March 31, 2001 from $9.6 million in the period ended March 31, 2000. The increase was primarily attributable to increased goodwill amortization, and the increase in the scale of our operations including additional personnel in our operations, administration, sales and marketing organizations, promotional expenses, consulting expenses and other administrative expenses. We have generated higher sales expenses by hiring new sales representatives in our efforts to increase the number and size of our customer accounts. We expect selling, general and administrative expenses to increase as required to support potential future revenue growth.

Non-cash compensation charge. Substantially all of our employees had been granted contingently exercisable stock options that became options to purchase our common stock upon our recapitalization in 1999. In addition, tandem stock options were granted in January 1997 to some of our employees. As a result, non-cash compensation expense was recognized upon the completion of our initial public offering based on the difference between the exercise price of these options and the initial public offering price of our common stock. The non-cash compensation expense related to these option grants in the period ended March 31, 2000 was $2.4 million. There was no such expense in 2001.

Interest income, net. Interest income, net, in the period ended March 31, 2001 decreased to $109,000 from $1.8 million in the period ended March 31, 2000 due primarily to lower cash balances. In 2001, the amount represents interest earned on cash balances in a money market account, and in 2000, the amount represents interest earned on proceeds from our initial public offering.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $22.9 million in the quarter ended March 31, 2001 and $24.2 million in the quarter ended March 31, 2000. In the current quarter, the use of cash in operating activities was primarily due to our net losses and a $20 million increase in our inventories, partially offset by a $14.7 million increase in accrued liabilities. The increase in inventory is due to amounts purchased related to commitments we had with our suppliers. The increase in accrued liabilities is primarily related to amounts received from Motorola in connection with a tax sharing agreement, which we must repay to the extent certain tax benefits are not realized by Motorola or we obtain specified levels of third party financing. During the quarter ended March 31, 2000, the cash used in operating activities was primarily due to net losses; additionally, $12.7 million was used to pay taxes associated with the exercise of Motorola options by our employees.

Net cash provided by investing activities of $15.3 million in the period ended March 31, 2001 and $27.6 million in the period ended March 31, 2000 was primarily attributable to the sale of marketable securities, partially offset by capital expenditures to support our engineering and testing activities. As we increase the scope of our operations, we expect that our capital expenditures will increase. In accordance with our agreement with Virtual Access, we made an additional $2.0 million investment in that company in the period ended March 31, 2001.

Net cash used in financing activities was $19.5 million in the period ended March 31, 2001 and $25.9 million in the period ended March 31, 2000. In both periods, substantially all cash used was used to repay borrowings on our line of credit.

At March 31, 2001, we had $8.7 million of cash and cash equivalents and $49.2 million of working capital.

We have commitments with suppliers to purchase a total of approximately $64 million of components in 2001.

In December 1999, we entered into a revolving bank line of credit under which we had the ability to borrow up to the lesser of $50 million or the value of pledged collateral. At March 31, 2001, the balance outstanding was $5.0 million and the line was secured by $5.0 million of marketable securities. On May 7, 2001, the balance on the line was 0 and we terminated the line.

We anticipate that operating expenses, as well as planned capital expenditures, will constitute a material use of our cash resources. In addition, we may use cash resources to fund acquisitions or investments in complementary businesses, technologies or product lines. Our long-term operating and capital lease obligations are generally less than $3.0 million per year. Other than capital lease commitments, we have no material commitments

for capital expenditures. As we increase the scope of our operations, we expect that our capital expenditures will increase.

We are in the process of negotiating the terms of a financing from Motorola, which we expect will provide us with sufficient cash on hand to meet our working capital and capital expenditure requirements for at least the next 12 months. However, it may still be necessary to obtain additional equity or debt financing either during or after the next 12 months if we are not able to generate sufficient cash from operating activities to meet our working capital and capital expenditure needs. In the event additional financing is required, we may not be able to raise it on acceptable terms, or at all.

RECENTLY ISSUED ACCOUNTING STANDARDS

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, was effective for us beginning January 1, 2001. SFAS No. 133 requires that all derivative instruments be measured at fair value and recognized in the balance sheet as either assets or liabilities. The initial adoption of SFAS No. 133 did not have a material effect on our financial statements.

RISK FACTORS

You should carefully consider the risk factors set forth below.

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 $22.4 million in the quarter ended March 31, 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 continue to incur significant product development, sales and marketing, and administrative expenses. In addition, we depend in part on cost reductions to improve gross profit margins because the fixed-price nature of most of our long-term customer agreements prevents us from increasing prices. As a result, we will need to generate significant revenues and improve gross profit margins to achieve and maintain profitability. We may not be successful in reducing our costs or in selling our products in sufficient volumes to realize cost benefits from our manufacturers. We cannot be certain that we can achieve sufficient revenues or gross profit margin improvements to generate profitability.

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

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 52% of our revenues in the quarter ended March 31, 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.

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 52% and 84% of total revenues in the quarters ended March 31, 2001 and 2000. Our agreements with our customers are cancelable by these customers on short notice, without penalty, do not obligate the customers to purchase any products and are not exclusive. As a result of the merger between U S WEST and Qwest, Qwest slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon their decision regarding the deployment of our product. A significant reduction in purchases of our equipment by Qwest could have a material adverse effect on us.

WE MAY NOT BE ABLE TO OBTAIN SUFFICIENT FINANCING TO FUND OUR BUSINESS AND, AS A RESULT, WE MAY NOT BE ABLE TO GROW AND COMPETE EFFECTIVELY.

We are currently negotiating the terms of a financing from Motorola. In addition, we may need to raise additional funds if our estimates of revenues or capital requirements change or prove inaccurate. If we cannot secure the financing with Motorola or cannot raise these additional funds, we may not be able to grow our business. We may need additional capital if we need to respond to unforeseen technological or marketing hurdles or if we desire to take advantage of unanticipated opportunities. In addition, we expect to review potential acquisitions that would complement our existing product offerings or enhance our technical capabilities that could require potentially significant amounts of capital. Funds may not be available at the time or times needed on terms acceptable to us, if at all. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to make acquisitions, to develop new products or to otherwise respond to competitive pressures effectively.

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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- to pay substantial damages, including paying treble damages if we are held to have willfully infringed;

- to halt the manufacture, use and sale of infringing products;

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

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

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

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

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers or we fail to obtain components in sufficient quantities when required, delivery of our

products could be delayed resulting in decreased revenues. Additional sole-sourced components may be incorporated into our equipment in the future. We do not have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

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 76% of the outstanding shares of our common stock as of March 31, 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 May 1, 2001, Motorola owned 64,103,724 shares of our common stock, FMR Corporation owned 5,601,500 shares of our common stock and Kevin Kimberlin Partners, LP and its affiliates owned 2,933,128 shares of our common stock and its affiliates held warrants to purchase an additional 4,288,764 shares of our common stock. If Motorola, FMR, Kevin Kimberlin Partners LP and its affiliates or any of our other stockholders sells substantial amounts of common stock, including shares issued upon exercise of outstanding options and warrants, in the public market, the market price of the common stock could fall. In addition, any distribution of shares of our common stock by Motorola to its stockholders could also have an adverse effect on the market price.

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

In addition, as of May 1, 2001, there were outstanding options to purchase 22,593,364 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

We are not currently involved in any pending legal proceedings that individually, or in the aggregate, are material to us.

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	Severance agreement between Mr. Keeler and us effective as of December 4, 2000.

10.2	Tax allocation and sharing agreement between Motorola Inc., and us effective February, 2001.

(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: May 14, 2001

By: /s/ J. MICHAEL NORRIS

J. Michael Norris
Chief Executive Officer and President

Date: May 14, 2001

By: /s/ JAMES T. WANDREY

James T. Wandrey
Chief Financial Officer and Treasurer

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