AXT INC
Form 10-Q
May 12, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC. 20549

FORM 10-Q

(Mark One)

ý **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the quarterly period ended March 31, 2006

or

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the transition period from to

Commission File Number 000-24085

AXT, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**94-3031310**
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)

4281 Technology Drive, Fremont, California 94538

(Address of principal executive offices) (Zip code)

(510) 683-5900

(Registrant s telephone number, including area code)

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 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 ý NO o

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer ý

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO ý

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at April 28, 2006**
Common Stock, $0.001 par value	23,053,521

AXT, INC.
FORM 10-Q
TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements (unaudited)
Condensed Consolidated Balance Sheets as of March 31, 2006 and December 31, 2005
Condensed Consolidated Statements of Operations for the three month periods ended March 31, 2006 and 2005
Condensed Consolidated Statements of Cash Flows for the three month periods ended March 31, 2006 and 2005
Notes To Condensed Consolidated Financial Statements
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Item 3. Quantitative and Qualitative Disclosures About Market Risk
Item 4. Controls and Procedures
PART II. OTHER INFORMATION
Item 1. Legal Proceedings
Item 1A. Risk Factors
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Item 3. Defaults Upon Senior Securities
Item 4. Submission of Matters to a Vote of Security Holders
Item 5. Other Information
Item 6. Exhibits
Signatures

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AXT, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands, except per share data)

	March 31, 2006	December 31, 2005
Assets:		
Current assets		
Cash and cash equivalents	$ 12,853	$ 17,472
Investments	9,163	5,555
Accounts receivable, net of allowance of $628 and $619 as of March 31, 2006 and December 31, 2005, respectively	5,917	5,226
Inventories, net	15,802	16,156
Prepaid expenses and other current assets	2,859	1,801
Total current assets	46,594	46,210
Property, plant and equipment, net	16,359	17,306
Restricted deposits	7,450	7,450
Other assets	3,685	3,832
Total assets	$ 74,088	$ 74,798
Liabilities and stockholders equity:		
Current liabilities		
Accounts payable	$ 2,463	$ 3,070
Accrued liabilities	2,792	3,533
Accrued restructuring	128	465
Current portion of long-term debt	450	300
Income taxes payable	2,966	2,495
Total current liabilities	8,799	9,863
Long-term debt, net of current portion	7,102	7,420
Other long-term liabilities	1,643	1,897
Total liabilities	17,544	19,180
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, $0.001 par value per share; 2,000 shares authorized; 883 shares issued and outstanding	3,532	3,532
Common stock, $0.001 par value per share; 70,000 shares authorized; 23,007 and 22,977 shares issued and outstanding as of March 31, 2006 and December 31, 2005, respectively	23	23
Additional paid-in capital	155,764	155,441
Accumulated deficit	(106,979)	(104,776)
Accumulated other comprehensive income	4,204	1,398
Total stockholders equity	56,544	55,618
Total liabilities and stockholders equity	$ 74,088	$ 74,798

See accompanying notes to condensed consolidated financial statements.

AXT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited, in thousands, except per share data)

	Three Months Ended March 31,	
	2006	**2005**
Revenue	$ 8,471	$ 6,634
Cost of revenue	6,961	6,355
Gross profit	1,510	279
Operating expenses:		
Selling, general and administrative	3,230	4,252
Research and development	534	362
Restructuring charges	(2)	125
Total operating expenses	3,762	4,739
Loss from operations	(2,252)	(4,460)
Interest income, net	128	119
Other income (expense), net	238	(105)
Loss before provision for income taxes	(1,886)	(4,446)
Provision for incomes taxes	318	35
Loss from continuing operations	(2,204)	(4,481)
Discontinued operations:		
Gain from discontinued operations, net of tax	1	58
Gain on disposal, net of tax		300
Net loss	$ (2,203)	$ (4,123)
Basic and diluted loss per share:		
Loss from continuing operations	$ (0.10)	$ (0.20)
Gain from discontinued operations		0.01
Net loss	$ (0.10)	$ (0.18)
Shares used in computing basic and diluted net loss per share	22,986	23,147

See accompanying notes to condensed consolidated financial statements.

AXT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Three Months Ended March 31,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,203)	$ (4,123)
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation	838	1,312
Amortization of marketable securities premium/discount	(9)	87
Non-cash restructuring charge		125
Loss on disposal of property, plant and equipment	48	175
Stock based compensation	257	(5)
Realized gain on sale of investments	(376)	
Changes in assets and liabilities:		
Accounts receivable, net	(691)	(428)
Inventories, net	354	478
Prepaid expenses	(1,058)	(828)
Other assets	147	30
Accounts payable	(607)	(116)
Accrued liabilities	(1,078)	96
Income taxes	471	104
Other long-term liabilities	(254)	(117)
Net cash used in operating activities	(4,161)	(3,210)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(98)	(217)
Proceeds from sales of property, plant and equipment	159	
Purchases of investments	(3,670)	(2,200)
Proceeds from sale of investments	3,382	8,354
Net cash provided by (used in) investing activities	(227)	5,937
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from (payments of):		
Issuance of common stock	66	60
Repurchase of common stock		(29)
Long-term debt payments	(168)	(150)
Net cash used in financing activities	(102)	(119)
Effect of exchange rate changes	(129)	(144)
Net increase (decrease) in cash and cash equivalents	(4,619)	2,464
Cash and cash equivalents at the beginning of the period	17,472	12,117
Cash and cash equivalents at the end of the period	$ 12,853	$ 14,581

See accompanying notes to condensed consolidated financial statements.

AXT, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation

The accompanying condensed consolidated financial statements of AXT, Inc. (AXT , Company , we, us, and our refer to AXT, Inc. and all of consolidated subsidiaries) are unaudited, and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, considered necessary to present fairly the financial position, results of operations and cash flows of AXT and its subsidiaries for all periods presented.

Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ materially from those estimates.

The results of operations are not necessarily indicative of the results to be expected in the future or for the full fiscal year. It is recommended that these condensed consolidated financial statements be read in conjunction with our consolidated financial statements and the notes thereto included in our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2006.

Certain reclassifications have been made to the prior years condensed consolidated financial statements to conform to current period presentation.

Note 2. Discontinued Operations and related Assets Held for Sale

In June 2003, we announced the discontinuation of our opto-electronics division, which we had established as part of our acquisition of Lyte Optronics, Inc. in May 1999. The discontinued opto-electronics division manufactured blue, cyan, and green high-brightness light emitting diodes (HBLEDs) for the illumination markets, including full-color displays, wireless handset backlighting and traffic signals, and also manufactured vertical cavity surface emitting lasers (VCSELs) and laser diodes for fiber optic communications and storage area networks. Accordingly, the results of operations of the opto-electronics division have been segregated from continuing operations and are reported separately as discontinued operations in our consolidated statements of operations for all periods presented.

In September 2003, we completed the sale of substantially all of the assets of our opto-electronics business to Lumei Optoelectronics Corp. (Lumei) and Dalian Luming Science and Technology Group, Co., Ltd. for the Chinese Renminbi (RMB) equivalent of $9.6 million.

In June 2005, we completed the sale of a building located in Monterey Park, California. This asset had been classified as assets held for sale in the amount of $1.25 million on the consolidated balance sheet as of December 31, 2004. We received net proceeds on the sale of the property of approximately $1.3 million and accordingly recorded a gain on disposal of $53,000.

Our condensed consolidated financial statements have been presented to reflect the opto-electronics business as a discontinued operation for all periods presented. Operating results of the discontinued operation are as follows (in thousands):

	Three Months Ended March 31,	
	2006	2005
Revenue	$	$
Cost of revenue		
Gross loss		
Operating expenses:		
Selling, general and administrative	(1)	(58)
Research and development		
Impairment costs		
Total operating expenses	(1)	(58)
Gain from operations, net of tax	1	58
Gain on disposal, net of tax		300
Net income	$ 1	$ 358

The carrying value of the assets and liabilities of the discontinued opto-electronics business included in the condensed consolidated balance sheets are as follows (in thousands):

	March 31, 2006	December 31, 2005
Current assets:		
Cash	$ 449	$ 472
Accounts receivable, net		
Assets held for sale		
Total current assets	449	472
Other assets		
Total assets	$ 449	$ 472
Current liabilities:		
Accrued liabilities	$ 71	$ 95
Total liabilities	71	95
Net assets	378	377
Total liabilities and net assets	$ 449	$ 472

Note 3. Accounting for Stock-Based Compensation

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* , (SFAS 123(R)). SFAS 123(R) establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee requisite service period. All of the Company s stock compensation is accounted for as an equity instrument. The Company previously applied Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and provided the required pro forma disclosures of SFAS No. 123, Accounting for Stock-Based Compensation .

We have elected the modified prospective transition method for adopting SFAS 123(R). Under this method, the provisions of SFAS 123(R) apply to all awards granted or modified after the date of adoption. The unrecognized expense of awards not yet vested at the date of adoption will be recognized in net income (loss) in the periods after the date of adoption using the same Black-Scholes valuation method and assumptions determined under the original provisions of SFAS 123, *Accounting for Stock-Based Compensation,* as disclosed in our previous quarterly and annual reports.

Prior to the Adoption of SFAS 123(R)

Prior to the adoption of SFAS 123 (R), we provided the disclosures required under SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosures. SFAS 123(R) requires us to present pro forma information for the comparative period prior to adoption as if we had accounted for all our employee stock options under the fair value method of the original SFAS 123. The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation to the prior-year period (in thousands, except per-share data):

		Three Months Ended March 31, 2005
Stock-based compensation in the form of employee stock options, included in:		
Net loss as reported	$	(4,123)
Selling, general and administrative		(5)
Stock-based employee compensation expense included in reported net loss		(235)
Total stock-based compensation expense determined under fair value based methods for all awards	$	(4,363)
Basic and diluted net loss per common share		
As reported	$	(0.18)
Pro forma	$	(0.19)

Impact of the Adoption of SFAS No. 123 (R)

We elected to adopt the modified prospective application method as provided by SFAS 123(R), and we recorded $257,000 of stock compensation expense on our unaudited condensed consolidated statement of operations for the three months ended March 31, 2006. We elected not to capitalize any stock-based compensation to inventory at January 1, 2006 when the provisions of SFAS 123(R) were initially adopted. We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted both before and after the adoption of SFAS 123(R). In accordance with the modified prospective method, our condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). The following table summarizes compensation costs related to our stock-based compensation plan (in thousands, except per-share data):

	Three Months Ended March 31, 2006
Stock-based compensation in the form of employee stock options, included in:	
Cost of revenue	$ 28
Selling, general and administrative	173
Research and development	56
Total stock-based compensation	257
Tax effect on stock-based compensation	
Net effect on net loss	$ 257
Effect on basic and diluted net loss per share	$ (0.01)

At March 31, 2006, the total compensation cost related to unvested stock-based awards granted to employees under our stock option plan but not yet recognized was approximately $1.2 million, net of estimated forfeitures of $158,000. This cost will be amortized on a straight-line basis over a weighted-average period of approximately 1.3 years and will be adjusted for subsequent changes in estimated forfeitures.

The amortization of stock compensation under SFAS 123(R) for the period after our January 1, 2006 adoption is based on the single-option approach.

We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), SEC SAB No. 107 and our prior period pro forma disclosures of net loss, including stock-based compensation (determined under a fair value method as prescribed by SFAS No. 123). The fair value of our stock options granted to employees for the three months ended March 31, 2006 and 2005 was estimated using the following weighted-average assumptions:

	Three Months Ended March 31,	
	2006	2005
Expected term (in years)	5.0	5.0
Volatility	86.2%	95.4%
Expected dividend	0%	0%

Risk-free interest rate		4.82%		4.20%
Estimated forfeitures		9.59%		0%
Weighted-average fair value	$	1.53	$	0.86

The following table summarizes the stock option transactions during the three months ended March 31, 2006 (in thousands, except per share amounts):

	March 31, 2006				
	Shares	Weighted average exercise price	Weighted average remaining contractual life (in years)		Aggregate intrinsic value
Options outstanding at January 1, 2006	2,917	$ 2.30			
Granted	16	2.30			
Exercised	(30)	2.21			
Canceled	(68)	1.48			
Options outstanding at March 31, 2006	2,835	$ 2.32	7.2	$	5,613
Options vested and expected to vest at March 31, 2006	2,694	$ 2.37	7.1	$	5,261
Options exercisable at March 31, 2006	1,675	$ 2.91	6.0	$	2,813

The total intrinsic value of options exercised for the three months ended March 31, 2006 was $66,000. Cash received from option exercises for the three months ended March 31, 2006 was $66,000. The total fair value of options vested for the three months ended March 31, 2006 was $509,000.

Note 4. Cash, Cash Equivalents and Investments

Our cash, cash equivalents and investments are classified as follows (in thousands):

	March 31, 2006				December 31, 2005			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized (Loss)	Fair Value	Amortized Cost	Gross Unrealized Gain	Gross Unrealized (Loss)	Fair Value
Classified as:								
Cash	$ 5,812	$	$	$ 5,812	$ 12,803	$	$	$ 12,803
Cash equivalents:								
Money market fund	3,301			3,301	1,729			1,729
Commercial paper	3,740			3,740	2,940			2,940
Repurchase agreements								
Total cash equivalents	7,041			7,041	4,669			4,669
Total cash and cash equivalents	12,853			12,853	17,472			17,472
Investments:								
US Treasury and agency securities	4,473		(14)	4,459	4,460		(12)	4,448
Asset-backed securities	2,604		(9)	2,595	3,285		(11)	3,274
Corporate bonds	3,941		(16)	3,925	2,504		(13)	2,491
Corporate equity securities	1,372	4,262		5,634	1,468	1,324		2,792
Total investments	12,390	4,262	(39)	16,613	11,717	1,324	(36)	13,005
Total cash, cash equivalents and investments	$ 25,243	$ 4,262	$ (39)	$ 29,466	$ 29,189	$ 1,324	$ (36)	$ 30,477
Contractual maturities on investments:								
Due within 1 year	$ 6,478			$ 10,724	$ 8,384			$ 9,682
Due after 1 through 5 years	5,912			5,889	3,333			3,323
	$ 12,390			$ 16,613	$ 11,717			$ 13,005

The investments include $7.5 million recorded as restricted deposits on the condensed consolidated balance sheets as of March 31, 2006 and December 31, 2005.

We manage our investments as a single portfolio of highly marketable securities that is intended to be available to meet our current cash requirements. For the three months ended March 31, 2006, we had $376,000 gross realized gains on sales of our available-for-sale securities. For the three months ended March 31, 2005, we had no gross realized gains or losses on sales of our available-for-sale securities.

The gross unrealized losses related to our portfolio of available-for-sale securities were primarily due to a decrease in the fair value of debt and equity securities as a result of an increase in interest rates during 2005 and the first three months of 2006. We have determined that the gross unrealized losses on our available-for-sale securities as of March 31, 2006 are temporary in nature. We reviewed our investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality,

and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value. The following table provides a breakdown of our available-for-sale securities with unrealized losses as of March 31, 2006 (in thousands):

	In Loss Position < 12 months		In Loss Position > 12 months		Total In Loss Position	
	Fair Value	Gross Unrealized (Loss)	Fair Value	Gross Unrealized (Loss)	Fair Value	Gross Unrealized (Loss)
Short-term investments:						
US Treasury and agency securities	$ 1,377	$ (4)	$ 3,082	$ (10)	$ 4,459	$ (14)
Asset-backed securities	924	(2)	1,671	(7)	2,595	(9)
Corporate bonds	2,789	(12)	1,136	(4)	3,925	(16)
Total in loss position	$ 5,090	$ (18)	$ 5,889	$ (21)	$ 10,979	$ (39)

Note 5. Inventories, Net

The components of inventories are summarized below (in thousands):

	March 31, 2006	December 31, 2005
Inventories, net:		
Raw materials	$ 6,212	$ 6,667
Work in process	8,789	9,141
Finished goods	801	348
	$ 15,802	$ 16,156

Note 6. Restructuring Charges

Our restructuring accrual is as follows (in thousands):

For the three month period ended March 31, 2006	Restructuring Accrual as of December 31, 2005	Additions/ Reversals	Payments	Restructuring Accrual as of March 31, 2006
Future lease payments related to abandoned facilities	$ 250	$	$ (122)	$ 128
Workforce reduction	215	(2)	(213)	
Total	$ 465	$ (2)	$ (335)	$ 128

In December 2005, we reduced the workforce at our Fremont, California facility by approximately 15 positions that are no longer required to support production and operations, or approximately 29 percent. This measure was taken as part of our ongoing effort to downsize our Fremont, California facility headcount. Accordingly, we recorded a restructuring charge of approximately $273,000 related to the reduction in force for severance-related expenses, of which $215,000 was the balance as of December 31, 2005. As of March 31, 2006 we completed the reduction in force.

As of March 31, 2006 the remaining restructuring accrual for future lease payments related to abandoned U.S. facilities is $128,000, is expected to be paid out through 2006, and is included on the accompanying condensed consolidated balance sheet as accrued restructuring.

Note 7. Net Loss Per Share

Basic net loss per common share is calculated by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per common and common equivalent

shares include the dilutive effect of common stock equivalents outstanding during the period calculated using the treasury stock method. Common stock equivalents consist of the shares issueable upon the exercise of stock options.

A reconciliation of the numerators and denominators of the basic and diluted net loss per share calculations is as follows (in thousands, except per share data):

	Three Months Ended March 31,	
	2006	2005
Numerator:		
Net loss	$ (2,203)	$ (4,123)
Less: Preferred stock dividends	(44)	(44)
Net loss available to common stockholders	$ (2,247)	$ (4,167)
Denominator:		
Denominator for basic net loss per share - weighted average common shares	22,986	23,147
Effect of dilutive securities:		
Common stock options		
Denominator for dilutive net loss per common share	22,986	23,147
Basic and diluted net loss per share	$ (0.10)	$ (0.18)
Options excluded from diluted net loss per share as the impact is anti-dilutive	2,835	2,534

Note 8. Comprehensive Loss

The components of comprehensive loss are as follows (in thousands):

	Three Months Ended March 31,	
	2006	2005
Net loss	$ (2,203)	$ (4,123)
Foreign currency translation loss	(129)	(144)
Unrealized gain (loss) on available for sale investments	3,311	(1,221)
Less: reclassification adjustment for realized gain included in net loss	(376)	
Comprehensive gain (loss)	$ 603	$ (5,488)

Note 9. Segment Information and Foreign Operations

Segment Information

We operate in one segment for the design, development, manufacture and distribution of high-performance compound semiconductor substrates and sale of materials. In accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information,* (SFAS No. 131) our chief operating decision-maker has been identified as the Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the Company. All material operating units qualify for aggregation under SFAS No. 131 due to their identical customer base and similarities in economic characteristics, nature of products and services, and procurement, manufacturing and distribution processes. Since we operate in one segment, all financial segment and product line information required by SFAS No. 131 can be found in the condensed consolidated financial statements.

Geographical Information

The following table represents revenue amounts (in thousands) reported for products shipped to customers in the corresponding geographic region:

	Three Months Ended March 31,	
	2006	2005
Net revenues:		
North America*	$ 1,959	$ 972
Europe	1,406	1,782
Japan	666	240
Taiwan	1,514	1,660
Asia Pacific	2,926	1,980
Consolidated total	$ 8,471	$ 6,634

* Primarily the United States

Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Long-lived assets by geographic region were as follows (in thousands):

	As of	
	March 31, 2006	December 31, 2005
Long-lived assets:		
North America	$ 6,411	$ 6,547
Asia Pacific	9,948	10,759
	$ 16,359	$ 17,306

Significant Customers

Two customers represented 14.3% and 12.1%, respectively, of revenues for the three month period ended March 31, 2006. One customer represented 12.9% of revenues for the three month period ended March 31, 2005. Our top five customers represented 45.8% and 44.6% of revenue for the three month periods ended March 31, 2006 and 2005, respectively.

Note 10. Corporate Affiliates

We have made strategic investments in private companies located in China in order to gain access to raw materials at a competitive cost that are critical to our substrate business. Our investments in these private corporate affiliates are summarized below (in thousands):

Affiliate	Investment Balance as of March 31, 2006	Investment Balance as of December 31, 2005	Accounting Method	Ownership Percentage
Beijing Ji Ya Semiconductor Material Co., Ltd	$ 996	$ 1,071	Consolidated	46%
Nanjing Jin Mei Gallium Co., Ltd	592	616	Consolidated	83
Beijing BoYu Manufacturing Co., Ltd	410	409	Consolidated	70
Xilingol Tongli Ge Co. Ltd	838	847	Equity	25
Emeishan Jia Mei High Pure Metals Co., Ltd	606	584	Equity	25

The investment balances for the two affiliates accounted for under the equity method are included in other assets in the condensed consolidated balance sheets. We own 25% of the ownership interests in each of these affiliates. These two affiliates are not considered variable interest entities because:

both affiliates have sustainable businesses of their own;

our voting power is proportionate to our ownership interests;

we only recognize our respective share of the losses and/or residual returns generated by the affiliates if they

occur, or both; and

we do not have controlling financial interests in either affiliate, do not maintain operational or management control, nor control of the board of directors, and are not required to provide additional investment or financial support to either affiliate.

Undistributed retained earnings relating to our corporate affiliates were $2.9 million and $1.6 million as of March 31, 2006 and 2005, respectively. Net income recorded from our corporate affiliates were $269,000 and $88,000 for the three month periods ended March 31, 2006 and 2005, respectively.

The minority interest for those affiliates that are consolidated is included within Other long-term liabilities in the condensed consolidated balance sheets and within Other expense (income) on the condensed consolidated statements of operations.

Note 11. Commitments and Contingencies

Legal Matters

On October 15, 2004, a purported securities class action lawsuit was filed in the United States Court for the Northern District of California. City of Harper Woods Employees Retirement System v. AXT, Inc. et al., No. C 04 4362 MJJ. The Court consolidated the case with a subsequent related case and appointed a lead plaintiff. On April 5, 2005, the lead plaintiff filed a consolidated complaint, captioned as Morgan v. AXT, Inc. et al., No. C 04 4362 MJJ. The lawsuit complaint names AXT, Inc. and our chief technology officer, as defendants, and is brought on behalf of a class of all purchasers of our securities from February 6, 2001 through April 27, 2004. The complaint alleges that we announced financial results during this period that were false and misleading. No specific amount of damages is claimed. We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. On September 23, 2005, the Court granted our motion to dismiss the complaint, with leave to amend. Lead plaintiff filed an amended complaint, which we have moved to dismiss. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition and results of operations.

On June 1, 2005, a lawsuit was filed in the Superior Court of California, County of Alameda, *Zhao et. Al. vs. American Xtal Technology, et. al.*, No. R 605215713. The lawsuit complaint names as defendants AXT, its chief technology officer, its former interim chief executive officer, a former safety department employee and a supplier to AXT. The lawsuit is brought on behalf of two former employees and their minor child. The complaint alleges personal injury, general negligence, intentional tort, wage loss and other damages, including punitive damages, as a result of exposure to the child while in utero to high levels of gallium arsenide and methanol used in the production of gallium arsenide wafers.

We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. AXT s commercial general liability insurance carrier has agreed to fund AXT s defense of the case, but has reserved the right to deny coverage, in whole or in part, in the future under selected policy provisions and applicable law. There is $21 million in available limits under the policies in question. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition and results of operations.

Indemnification Agreements

We enter into standard indemnification arrangements in the ordinary course of business. Pursuant to these arrangements, we indemnify, hold harmless, and agree to reimburse the indemnified parties for losses suffered or incurred by the indemnified party, generally their business partners or customers, in connection with any U.S. patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual anytime after the execution of the agreement. The maximum potential amount of future payments we could be required to make under these agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal.

We have entered into indemnification agreements with our directors and officers that may require us to indemnify our directors and officers against liabilities that may arise by reason of their status or service as directors or officers, other than liabilities arising from willful misconduct of a culpable nature; to advance their expenses incurred as a result of any proceeding against them as to which they could be indemnified; and to obtain directors and officers insurance if

available on reasonable terms, which we currently have in place.

Product Warranty

We warrant our products for a specific period of time, generally twelve months, against material defects. We provide for the estimated future costs of warranty obligations in cost of sales when the related revenue is recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that we expect to incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. On a quarterly basis, we review the accrued balances and update these based on the historical warranty cost trends. The following table reflects the change in our warranty accrual during the three months ended March 31, 2006 and 2005 (in thousands):

	Three Months Ended March 31,	
	2006	**2005**
Beginning accrued warranty and related costs	$ 120	$ 135
Charged to cost of revenue	105	
Actual warranty expenditures	(41)	
Ending accrued warranty and related costs	$ 184	$ 135

Sales Returns

In March 2004, we increased our reserve for repair and replacement costs by $745,000. As of March 31, 2006, this reserve is zero since approximately $487,000 had been utilized and approximately $258,000 had been reversed to revenue as we favorably resolved an outstanding matter with a customer.

Note 12. Foreign Exchange Transaction Gains/Losses

We incurred foreign currency transaction exchange losses of $36,000 and $20,000 for the three month periods ended March 31, 2006, and 2005, respectively. These amounts are included in other income (expense), net on the condensed consolidated statements of operations.

Note 13. Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151 (SFAS 151), *Inventory Costs*, *an amendment of ARB No. 43, Chapter 4.* SFAS 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges.... SFAS 151 requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 did not have a material effect on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153 (SFAS 153), *Exchanges of Nonmonetary Assets An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions.* SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for the fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154 (SFAS 154), *Accounting Changes and Error Corrections* , which will require entities that voluntarily make a change in accounting principle to apply that change retrospectively to prior periods financial statements, unless this would be impracticable. SFAS 154 supersedes APB No. 20 (APB 20), Accounting Changes, which previously required that most voluntary changes in accounting principle be recognized by including in the current period s net income the cumulative effect of changing to the new accounting principle. SFAS 154 also makes a distinction between retrospective application of an accounting principle and the restatement of financial statements to reflect the correction of an error. Another significant change in practice under SFAS 154 will be

that if an entity changes its method of depreciation, amortization, or depletion for long-lived, non-financial assets, the change must be accounted for as a change in accounting estimate. Under APB 20, such a change would have been reported as a change in accounting principle. SFAS 154 applies to accounting changes and error corrections that are made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on our consolidated financial position, results of operations, or cash flows.

In February 2006, the FASB issued SFAS No. 155 (SFAS 155), *Accounting for Certain Hybrid Instruments an amendment of FASB Statements No. 133 and 140* . SFAS 155 amends SFAS No. 133, Accounting for derivative Instruments and Hedging Activities (SFAS 133) and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140). SFAS 155 gives entities the option of applying fair value accounting to certain hybrid financial instruments in their entirety if they contain embedded derivatives that would otherwise require bifurcation under SFAS 133. SFAS 155 will be effective for us as of January 1, 2007. We are currently assessing the impact that SFAS 155 may have on our consolidated financial statements.

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations includes a number of forward-looking statements made pursuant to the provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based upon management s current views with respect to future events and financial performance, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated. Such risks and uncertainties include those set forth under Risks Related to our Business below. Forward-looking statements may be identified by the use of terms such as anticipates, believes, estimates, expects, intends, and similar expressions. Statements concerning our future or expected financial results and condition, business strategy and plans or objectives for future operations are forward-looking statements.

These forward-looking statements are not guarantees of future performance. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. This discussion should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2005 and the condensed consolidated financial statements included elsewhere in this report.

Overview

We design, develop, manufacture and distribute high-performance compound and single element semiconductor substrates comprising gallium arsenide (GaAs), indium phosphide (InP) and germanium (Ge). Our substrate products are used primarily in lighting display applications, wireless communications, and fiber optic communications. We believe our vertical gradient freeze, or VGF, technique for manufacturing semiconductor substrates provides significant benefits over other methods and has enabled us to become a leading manufacturer of such substrates. We pioneered the commercial use of VGF technology to manufacture GaAs substrates and subsequently used VGF technology to manufacture substrates from InP and Ge.

We also manufacture and sell raw materials related to our substrate business through five joint ventures located in China. These joint ventures produce products including 99.99% pure gallium (4N Ga), high purity gallium, arsenic, germanium, germanium dioxide, paralytic boron nitride (pBN) crucibles, and boron oxide. AXT s ownership interest in these entities ranges from 25 percent to 83 percent. We consolidate the three ventures in which we own a majority interest and employ equity accounting for the two joint ventures in which we have a 25 percent interest. We purchase the materials produced by these ventures for our use and sell other portions of their production to third parties.

Revenues from continuing operations increased $1.8 million, or 27.7%, to $8.5 million for the three month period ended March 31, 2006 compared to $6.6 million for the same period of fiscal 2005 primarily due to our improved quality and higher demands for six-inch diameter wafers. As of March 31, 2006, we had available cash, cash equivalents and short-term investments of $22.0 million, excluding restricted deposits.

Discontinued Opto-Electronics Business

In June 2003, we announced the discontinuation of our opto-electronics division, which we had established as part of our acquisition of Lyte Optronics, Inc. in May 1999. The discontinued opto-electronics division manufactured blue, cyan, and green high-brightness light emitting diodes (HBLEDs) for the illumination markets, including full-color displays, wireless handset backlighting and traffic signals, and also manufactured vertical cavity surface emitting lasers (VCSELs) and laser diodes for fiber optic communications and storage area networks. Accordingly, the results of operations of the opto-electronics division have been segregated from continuing operations and are reported separately as discontinued operations in our consolidated statements of operations for all periods presented. See Note 2 to our condensed consolidated financial statements for details regarding the accounting for discontinued operations.

In September 2003, we completed the sale of substantially all of the assets of our opto-electronics business to Lumei Optoelectronics Corp. (Lumei) and Dalian Luming Science and Technology Group, Co., Ltd. for the Chinese Renminbi (RMB) equivalent of $9.6 million.

In June 2005, we completed the sale of a building located in Monterey Park, California. This asset had been classified as assets held for sale in the amount of $1.25 million on the consolidated balance sheet as of December 31, 2004. We received net proceeds on the sale of the property of approximately $1.3 million and accordingly recorded a gain on disposal of $53,000.

Restructuring Charges

In December 2005, we further reduced the workforce at our Fremont, California facility by approximately 15 positions that are no longer required to support production and operations, or approximately 29 percent. This measure was taken as part of our ongoing effort to downsize our Fremont, California facility headcount and we expect to save $0.9 million annually in payroll and related expenses. Accordingly, we recorded a restructuring charge of approximately $273,000 related to the reduction in force for severance-related expenses, of which $215,000 was the balance as of December 31, 2005. As of March 31, 2006 we completed the reduction in force.

As of March 31, 2006 the remaining restructuring accrual for future lease payments related to abandoned U.S. facilities located in California that are no longer required to support production is $128,000, is expected to be paid out through 2006, and is included on the accompanying condensed consolidated balance sheet as accrued restructuring.

Critical Accounting Policies and Estimates

We have prepared our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. As such, we have had to make estimates, assumptions and judgments that affect the amounts reported on our financial statements. These estimates, assumptions and judgments about future events and their effects on our results cannot be determined with certainty, and are made based upon our historical experience and on other assumptions that are believed to be reasonable under the circumstances. These estimates may change as new events occur or additional information is obtained, and we may periodically be faced with uncertainties, the outcomes of which are not within our control and may not be known for a prolonged period of time. The discussion and analysis of our results of operations and financial condition are based upon these condensed consolidated financial statements. We have identified the policies below as critical to our business operations and understanding of our financial condition and results of operations. A critical accounting policy is one that is both material to the presentation of our financial statements and requires us to make difficult, subjective or complex judgments that could have a material effect on our financial condition and results of operations. They may require us to make assumptions about matters that are highly uncertain at the time of the estimate, and different estimates that we could have used, or changes in the estimate that are reasonably likely to occur, may have a material impact on our financial condition or results of operations.

We believe that the following are our critical accounting policies:

Revenue Recognition

We manufacture and sell high-performance compound semiconductor substrates and sell certain raw materials including gallium, germanium dioxide, and pBN crucibles. After we ship our products, there are no remaining obligations or customer acceptance requirements that would preclude recognition of the revenue earned on the sale. Our products are typically sold pursuant to a purchase order placed by our customers, and our terms and conditions of sale do not require customer acceptance. We recognize revenue upon shipment and transfer of title of products to our customers, which is either upon shipment from our dock, receipt at the customer s dock, or removal from consignment inventory at the customer s location, provided that we have received a signed purchase order, the price is fixed or determinable, title and risk of ownership have transferred, collection of resulting receivables is probable, and product returns are reasonably estimable. We do not provide training, installation or commissioning services. Additionally, we do not provide discounts or other incentives to customers except for one customer with whom we agreed in the fourth quarter of 2004 to provide a certain amount of cumulative discounts on future product purchases from us. We will recognize these discounts in future periods as a reduction in revenue as products are sold to this customer.

We provide for future returns based on historical experience, current economic trends and changes in customer demand at the time revenue is recognized. In the first quarter of 2004, we recorded a specific reserve for sales returns of $745,000 related to our failure to follow certain testing requirements and provision of testing data and information to certain customers. This reserve was based on discussions with some of the affected

customers and review of specific shipments. As of March 31, 2006, this reserve is zero since approximately $487,000 had been utilized and approximately $258,000 had been reversed to revenue as we favorably resolved an outstanding matter with a customer.

Allowance for Doubtful Accounts

We periodically review the likelihood of collection on our accounts receivable balances and provide an allowance for doubtful accounts receivable primarily based upon the age of these accounts. We provide a 100% allowance for U.S. receivables in excess of 90 days and for foreign receivables in excess of 120 days. We assess the probability of collection based on a number of factors, including the length of time a receivable balance has been outstanding, our past history with the customer and their credit worthiness.

As of March 31, 2006 and December 31, 2005, our accounts receivable balance was $5.9 million and $5.2 million, respectively, which was net of an allowance for doubtful accounts of $0.6 million and $0.6 million, respectively. If actual uncollectible accounts differ substantially from our estimates, revisions to the estimated allowance for doubtful accounts would be required, which could have a material impact on our financial results for the period.

Warranty Reserve

We maintain a warranty reserve based upon our claims experience during the prior twelve months. Warranty costs are accrued at the time revenue is recognized. As of March 31, 2006, and December 31, 2005 accrued product warranties totaled $184,000 and $120,000, respectively. If actual warranty costs differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material impact on our financial condition and results of operations.

Inventory Valuation

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average cost method. Our inventory consists of raw materials as well as finished goods and work-in-process that include material, labor and manufacturing overhead costs. Given the nature of our substrate products, and the materials used in the manufacturing process, the wafers and ingots comprising work-in-process may be held in inventory for up to two years and three years, respectively, as the risk of obsolescence for these materials is low. We routinely evaluate the levels of our inventory in light of current market conditions in order to identify excess and obsolete inventory and provide a valuation allowance for certain inventories based upon the age and quality of the product and the projections for sale of the completed products. As of March 31, 2006, and December 31, 2005 we had an inventory reserve of $16.2 million and $16.9 million for excess and obsolete inventory, respectively. The majority of this inventory has not been scrapped. If actual demand for our products were to be substantially lower than estimated, additional inventory adjustments for excess or obsolete inventory might be required, which could have a material impact on our business, financial condition and results of operations.

Impairment of Investments

We classify our investments in debt and equity securities as available-for-sale securities as prescribed by Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* All available-for-sale securities with a quoted market value below cost (or adjusted cost) are reviewed in order to determine whether the decline is other-than-temporary. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.

We invest in equity instruments of privately-held companies for business and strategic purposes. These investments are classified as other assets and are accounted for under the cost method as we do not have the ability to exercise significant influence over their operations. We monitor our investments for impairment and record reductions in carrying value when events or changes in circumstances indicate that the carrying value may not be recoverable. Determination of impairment is highly subjective and is based on a number of factors, including an assessment of the strength of investee s management, the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the investee, fundamental changes to the business prospects of the investee, share prices of subsequent offerings, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in our carrying value.

Impairment of Long-Lived Assets

We evaluate the recoverability of property, equipment, and intangible assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* When events and circumstances indicate that long-lived assets may be impaired, we compare the carrying value of the long-lived assets to the projection of future undiscounted cash flows attributable to such assets. In the event that the carrying value exceeds the future undiscounted cash flows, we record an impairment charge against income equal to the excess of the carrying value over the asset s fair value.

Employee Stock Options

We grant options to substantially all management employees and believe that this program helps us to attract, motivate, and retain high quality employees, to the ultimate benefit of our stockholders. Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* , (SFAS 123(R)) using the modified-prospective transition method. Under this transition method, stock-based compensation cost was recognized in the condensed consolidated financial statements for all share based payments after January 1, 2006. Compensation cost recognized includes the estimated expense for the portion of the vesting period after January 1, 2006 for share based payments prior to, but not vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Results for prior periods have not been restated, as provided for under the modified-prospective method. See Note 3 to our condensed consolidated financial statements.

Income Taxes

We account for income taxes in accordance with SFAS No. 109 (SFAS 109), *Accounting for Income Taxes,* which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized.

We provide for income taxes based upon the geographic composition of worldwide earnings and tax regulations governing each region, particularly China. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws, particularly in foreign countries such as China.

Results of Operations

Revenue

	Three Months Ended March 31,			
	2006	2005	Increase (Decrease)	% Change
	($ in thousands)			
GaAs	$ 6,755	$ 5,193	$ 1,562	30.1%
InP	296	137	159	116.1%
Ge	36	5	31	620.0%
Raw Materials	1,384	1,296	88	6.8%
Other		3	(3)	NM
Total revenue	$ 8,471	$ 6,634	$ 1,837	27.7%

NM = % not meaningful

Revenues increased $1.8 million, or 27.7%, to $8.5 million for the three month period ended March 31, 2006 compared with $6.6 million for the three month period ended March 31, 2005. Total GaAs substrate revenue increased $1.6 million, or 30.1%, to $6.8 million for the three month period ended March 31, 2006 compared with $5.2 million for the three month period ended March 31, 2005.

Sales of 5 inch and 6 inch diameter GaAs substrates were $2.8 million for the three month period ended March 31, 2006 compared with $0.5 million for the three month period ended March 31, 2005. The increase in larger diameter substrate revenue is due to an increase in orders from customers who have now qualified our China-grown products. Sales of 2 inch and 3 inch diameter GaAs substrates were $2.8 million for the three month period ended March 31, 2006 compared with $3.8 million for the three month period ended March 31, 2005. The decrease in smaller diameter substrate revenue is due to the continuing pricing pressures causing average sales prices to decline, and overall lower demand from our wireless application customers.

InP substrate revenue increased $159,000, or 116.1%, to $296,000 for the three month period ended March 31, 2006 compared with $137,000 for the three month period ended March 31, 2005. The increase in InP substrate revenue was due to an increase in orders from customers who qualified our China-grown products.

Ge substrate revenue increased $31,000, or 620.0%, to $36,000 for the three month period ended March 31, 2006 compared with $5,000 for the three month period ended March 31, 2005. The germanium market is still relatively small, but we are in the process of qualifying our Ge substrates with some of our customers.

Raw material sales revenue increased $88,000, or 6.8%, to $1.4 million for the three month period ended March 31, 2006 compared with $1.3 million for the three month period ended March 31, 2005. The increase in raw material sales revenue was due to sales of gallium to a new customer.

Revenue by Geographic Region

	Three Months Ended March 31,		Increase (Decrease)	% Change
	2006	2005		
	($ in thousands)			
North America *	$ 1,959	$ 972	$ 987	101.5%
% of total revenue	23%	15%		
Europe	1,406	1,782	(376)	(21.1)%
% of total revenue	17%	27%		
Japan	666	240	426	177.5%
% of total revenue	8%	4%		
Taiwan	1,514	1,660	(146)	(8.8)%
% of total revenue	18%	25%		
Asia Pacific (excluding Japan and Taiwan)	2,926	1,980	946	47.8%
% of total revenue	34%	29%		
Total revenue	$ 8,471	$ 6,634	$ 1,837	27.7%

* Primarily the United States

The North America revenue increased by $1.0 million or 101.5%, to $2.0 million for the three month period ended March 31, 2006 compared with $1.0 million for the three month period ended March 31, 2005. Our quality has improved as shown by customers who have qualified our China-grown products as sales to existing customers increased by $0.9 million, while we gained $0.1 million in sales to new customers.

The Europe revenue decreased by $376,000 or 21.1%, to $1.4 million for the three month period ended March 31, 2006 compared with $1.8 million for the three month period ended March 31, 2005. This decrease was predominantly from one customer in the United Kingdom that we lost in the second half of 2005 due to quality problems in our product. This customer is slowly coming back as it has begun placing orders again in the first quarter of 2006.

The Japan revenue increased by $426,000 or 177.5%, to $666,000 for the three month period ended March 31, 2006 compared with $240,000 for the three month period ended March 31, 2005. Raw material sales to a new customer accounted for $288,000 of this increase, while $287,000 was from substrate sales to new customers who have qualified our China-grown products, offset by $149,000 of lost or reduced sales to existing customers.

The Taiwan revenue decreased by $146,000 or 8.8%, to $1.5 million for the three month period ended March 31, 2006 compared with $1.7 million for the three month period ended March 31, 2005. The overall decrease is due to continuing pricing pressures causing average sales prices to decline, and overall lower demand.

The Asia Pacific (excluding Japan and Taiwan) revenue increased by $0.9 million or 47.8% to $2.9 million for the three month period ended March 31, 2006 compared with $2.0 million for the three month period ended March 31, 2005. This $0.9 million increase was predominantly from one customer s demand for the large diameter wafers. Our quality has improved as shown by customers who have qualified our China-grown products.

Gross Margin

	Three Months Ended March 31,			
	2006	2005	Increase (Decrease)	% Change
	($ in thousands)			
Gross profit	$ 1,510	$ 279	$ 1,231	441.2%
Gross Margin%	17.8%	4.2%		

Gross margin. Gross margin increased to 17.8% of total revenue for the three month period ended March 31, 2006 compared with 4.2% of total revenue for the three month period ended March 31, 2005. Gross margin in the three month period ended March 31, 2006 was positively impacted by sales of approximately $569,000 of gallium arsenide (GaAs) wafers which were previously fully reserved, and by approximately $53,000 as a result of a reversal of a sales return reserve established in 2004 as we favorably resolved an outstanding matter with a customer. In addition, we sold a greater amount of larger diameter wafers which contributed larger gross margin dollars. Gross margin was 4.2% of total revenue for the three months ended March 31, 2005 primarily due to the product mix where we sold a greater amount of smaller diameter wafers where there has been continuing pricing pressures causing average sales prices to decline which in turn contributes smaller gross margin dollars. Gross margin in the three month period ended March 31, 2005 was positively impacted by sales of approximately $152,000 of gallium arsenide (GaAs) wafers which were previously fully reserved.

Selling, General and Administrative Expenses

	Three Months Ended March 31, 2006	2005	Increase (Decrease)	% Change
	($ in thousands)			
Selling, general and administrative expenses	$ 3,230	$ 4,252	$ (1,022)	(24.0)%
% of total revenue	38.1%	64.1%		

Selling, general and administrative expenses decreased $1.0 million to $3.2 million for the three month period ended March 31, 2006 compared with $4.3 million for the three month period ended March 31, 2005. The decrease was primarily due to the March 2005 expenses of $1.3 million for decommissioning our Fremont, California facilities, and $0.1 million for recruiting fees partially offset by $0.2 million for stock based compensation costs, and $0.1 million for travel and related costs.

Research and Development

	Three Months Ended March 31,			
	2006	2005	Increase (Decrease)	% Change
	($ in thousands)			
Research and development	$ 534	$ 362	$ 172	47.5%
% of total revenue	6.3%	5.5%		

Research and development expenses increased $172,000, or 47.5%, to $534,000 for the three month period ended March 31, 2006 compared with $362,000 for the three month period ended March 31, 2005, as a result of our appointing Dr. Morris Young as our Chief Technology Officer to enhance our technology leadership, thereby causing the related compensation costs to be included in research and development expense rather than general and administrative expense, and for stock based compensation costs. We believe that continued investment in product development is critical to attaining our strategic objectives of maintaining and enhancing our technology leadership.

Restructuring Charges

	Three Months Ended March 31, 2006	2005	Increase (Decrease)	% Change
	($ in thousands)			
Restructuring charges	$ (2)	$ 125	$ (127)	(101.6)%
% of total revenue	(0.0)%	1.9%		

During the three month period ended March 31, 2006, the $2,000 was an adjustment to a prior accrual. During the three month period ended March 31, 2005, we recorded restructuring charges related to the reduction in work force effected in March 2005, and to lease costs associated with facilities located in California that are no longer required to

support production of $86,000 and $39,000, respectively.

Interest Income, net

	Three Months Ended March 31,			
	2006	2005	Increase (Decrease)	% Change
	($in thousands)			
Interest income, net	$ 128	$ 119	$ 9	7.6%
% of total revenue	1.5%	1.8%		

Interest income, net increased $9,000 to $128,000 for the three month period ended March 31, 2006 compared with $119,000 for the three month period ended March 31, 2005 as a result of higher interest rates earned on our investments, partially offset by higher interest rates on our debt on which we have continued to pay down.

Other Income and Expense, net

	Three Months Ended March 31,		Increase (Decrease)	% Change
	2006	2005		
	($ in thousands)			
Other income (expense) net	$ 238	$ (105)	$ 343	326.7%
% of total revenue	2.8%	(1.6)%		

Other income was $238,000 for the three month period ended March 31, 2006 due to a realized gain of $376,000 on the sale of investments, partially offset by minority interests in our joint ventures. Other expense was $105,000 for the three month period ended March 31, 2005 mainly due to foreign exchange losses related to the Japanese yen and minority interests in our joint ventures.

Provision for Income Taxes

	Three Months Ended March 31,		Increase (Decrease)	% Change
	2006	2005		
	($ in thousands)			
Provision for income taxes	$ 318	$ 35	$ 283	808.6%
% of total revenue	3.8%	0.5%		

We provided for income taxes of $318,000 for our overseas businesses for the three month period ended March 31, 2006 compared to $35,000 for the three month period ended March 31, 2005. The reason for the increase is a combination of higher income from processing fees from rates and volume in our overseas businesses at higher tax rates.

Gain from Discontinued Operations

	Three Months Ended March 31,		Increase (Decrease)	% Change
	2006	2005		
	($ in thousands)			
Gain from discontinued operations	$ 1	$ 358	$ (357)	(99.7%)
% of total revenue	0.0%	5.4%		

In the three month period ended March 31, 2006, the $1,000 was interest income on cash balances held in the discontinued operation. In February 2005, we received $300,000 which was the remaining portion of the first $750,000 held in escrow due to us and accordingly we recorded a gain on discontinued operations for the three month period ended March 31, 2005 of $300,000. We also recorded a gain on discontinued operations of $58,000 in property tax refunds for the same period.

Liquidity and Capital Resources

We consider cash and cash equivalents and short-term investments as liquid and available for use. Short-term investments are comprised of government bonds and high-grade commercial debt instruments. Also included in short-term investments is our investment in common stock of Finisar Corporation. As of March 31, 2006, our principal sources of liquidity were $22.0 million in cash and cash equivalents and short-term investments, excluding restricted deposits.

Cash and cash equivalents and short-term investments decreased $1.0 million to $22.0 million as of March 31, 2006 compared with $23.0 million as of December 31, 2005. Included in this decrease is a $2.8 million increase in our investment in Finisar common stock from $2.4 million as of December 31, 2005 to $5.2 million as of March 31, 2006. The sale of 100,000 shares of Finisar common stock brought in additional cash of $371,000 in the three month period ended March 31, 2006. We plan to sell additional Finisar stock for the remainder of 2006.

Net cash used by operating activities of $4.2 million for the three month period ended March 31, 2006 was comprised primarily of our net loss of $2.2 million, adjusted for non-cash items of depreciation of $0.8 million, and stock based compensation of $0.3 million, a realized gain on sale of investments of $0.4 million, and by a net decrease of $2.7 million in assets and liabilities. The net decrease in assets and liabilities resulted from a $1.1 million decrease in accrued liabilities, primarily for restructuring costs and decommissioning expenses, a $0.6 million decrease in accounts payable, a $1.1 million increase in prepaid expenses, mainly foreign taxes, and $0.7 million increase in accounts receivable, net and partially offset by a decrease in net inventory and income taxes.

Net accounts receivable increased by $0.7 million, or 13.2%, to $5.9 million as of March 31, 2006 compared with $5.2 million as of December 31, 2005. The increase was primarily a result of our increased sales. Our days sales outstanding is 63 days as of March 31, 2006 compared to 62 days as of December 31, 2005.

Net cash used by investing activities of $0.2 million for the three month period ended March 31, 2006 was primarily for the purchase of investments totaling $3.7 million, partially offset by proceeds from sale of investments of $3.4 million.

We expect to invest approximately $4.1 million in capital projects for the remainder of 2006. We believe that our existing and planned facilities and equipment are sufficient to fulfill current and expected future orders.

Net cash used in financing activities of $102,000 for the three month period ended March 31, 2006 consisted of payments of $168,000 related to long-term borrowings, partially offset by proceeds of $66,000 through our stock option program.

Our main Fremont, California manufacturing facility is financed by long-term borrowings, which were refinanced by taxable variable rate revenue bonds in 1998. These bonds mature in 2023 and bear interest at a variable rate that was 4.92% as of March 31, 2006. The bonds are traded in the public market. Repayment of principal and interest under the bonds is supported by a letter of credit from our bank and is paid on a quarterly basis. We have the option to redeem the bonds in whole or in part during their term. As of March 31, 2006, $7.5 million was outstanding under these bonds.

As of March 31, 2006, the credit facility maintained by us with a bank included a letter of credit supporting repayment of our industrial bonds with an outstanding amount of $7.5 million. We have pledged and placed certain investment securities with an affiliate of the bank as additional collateral for this facility.

We believe that we have adequate cash and investments to meet our needs over the next 12 months. If our performance fails to improve, we will continue to use cash and may at some time be forced to seek additional capital. There can be no assurance that such additional capital will be available or, if available it will be at terms acceptable to us. Cash from operations could be affected by various risks and uncertainties, including, but not limited to those set forth below under Item 1A Risks Factors.

Outstanding contractual obligations as of March 31, 2006 are summarized as follows (in thousands):

		Payments due by period			
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 - 5 years**	**More than 5 years**
Long-term debt	$ 7,552	$ 450	$ 1,452	$ 900	$ 4,750
Operating leases	5,218	811	2,106	1,541	760
Total	$ 12,770	$ 1,261	$ 3,558	$ 2,441	$ 5,510

We lease certain office space, manufacturing facilities and property under long-term operating leases expiring at various dates through March 2013. Total rent payments under these operating leases were approximately $0.3 million and $0.4 million for the three month periods ended March 31, 2006 and 2005, respectively.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151 (SFAS 151), *Inventory Costs*, *an amendment of ARB No. 43, Chapter 4.* SFAS 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges.... SFAS 151 requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 did not have a material effect on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153 (SFAS 153), *Exchanges of Nonmonetary Assets An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions.* SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for the fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154 (SFAS 154), *Accounting Changes and Error Corrections* , which will require entities that voluntarily make a change in accounting principle to apply that change retrospectively to prior periods financial statements, unless this would be impracticable. SFAS 154 supersedes APB No. 20 (APB 20), Accounting Changes, which previously required that most voluntary changes in accounting principle be recognized by including in the current period s net income the cumulative effect of changing to the new accounting principle. SFAS 154 also makes a distinction between retrospective application of an accounting principle and the restatement of financial statements to reflect the correction of an error. Another significant change in practice under SFAS 154 will be that if an entity changes its method of depreciation, amortization, or depletion for long-lived, non-financial assets, the change must be accounted for as a change in accounting estimate. Under APB 20, such a change would have been reported as a change in accounting principle. SFAS 154 applies to accounting changes and error corrections that are made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on our consolidated financial position, results of operations, or cash flows.

In February 2006, the FASB issued SFAS No. 155 (SFAS 155), *Accounting for Certain Hybrid Instruments an amendment of FASB Statements No. 133 and 140* . SFAS 155 amends SFAS No. 133, Accounting for derivative Instruments and Hedging Activities (SFAS 133) and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140). SFAS 155 gives entities the option of applying fair value accounting to certain hybrid financial instruments in their entirety if they contain embedded derivatives that would otherwise require bifurcation under SFAS 133. SFAS 155 will be effective for us as of January 1, 2007. We are currently assessing the impact that SFAS 155 may have on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exchange Rate Exposure

We operate in the United States, manufacture in China, and the substantial majority of our sales to date have been made in U.S. dollars. Certain expenses from our China operations are incurred in the Chinese Renminbi. As a result, currency fluctuations between the U.S. dollar and the Chinese Renminbi could cause foreign currency transaction gains or losses that we would recognize in the period incurred.

In July 2005, China uncoupled Renminbi from the U.S. dollar and will let it float in a narrow band against a basket of foreign currencies. The move revalued Renminbi by 2.1% against the U.S. dollar; however, it is uncertain what further adjustments will follow. The Renminbi-U.S. dollar exchange rate could float, and the Renminbi could appreciate relative to the U.S. dollar.

We expect our international revenues and expenses to continue to be denominated largely in U.S. dollars. We also believe that our China operations will likely expand in the future as our business continues to grow. As a result, we anticipate that we may experience increased exposure to the risks of fluctuating currencies and may choose to engage in

currency hedging activities to reduce these risks. However, we cannot be certain that any such hedging activities will be effective, or available to us at commercially reasonable rates.

Interest Rate Risk

Cash and cash equivalents earning interest and certain variable rate debt instruments are subject to interest rate fluctuations. The following table sets forth the probable impact of a 10% change in interest rates (in thousands):

Instrument	Balance as of March 31, 2006	Current Interest Rate	Projected Annual Interest Income/(Expense)	Proforma 10% Interest Rate Decline Income/(Expense)	Proforma 10% Interest Rate Increase Income/(Expense)
Cash	$ 5,812	0.50%	$ 29	$ 26	$ 32
Cash equivalents	7,041	4.56	321	289	353
Investment in debt and equity instruments	16,613	4.70	781	703	859
Long-term debt	(7,450)	4.92	(367)	(330)	(403)
			$ 764	$ 688	$ 841

Equity Risk

We also maintain minority investments in private and publicly traded companies. These investments are reviewed for other than temporary declines in value on a quarterly basis. Reasons for other than temporary declines in value include whether the related company would have insufficient cash flow to operate for the next twelve months, significant changes in the operating performance and changes in market conditions. For the three month period ended March 31, 2006, we recorded a $2.9 million unrealized gain in other comprehensive income to write up our investment in one public U.S. company. As of March 30, 2006, the minority investments we continue to hold amounted to $7.1 million.

ITEM 4. CONTROLS AND PROCEDURES

(a) Under the supervision and with the participation of our management, our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that the our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

(b) No change in our internal control over financial reporting was made during the quarter ended March 31, 2006, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

From time to time we may be involved in judicial or administrative proceedings concerning matters arising in the ordinary course of business. We do not expect that any of these matters, individually or in the aggregate, will have a material adverse effect on our business, financial condition, cash flows or results of operation.

On October 15, 2004, a purported securities class action lawsuit was filed in the United States Court for the Northern District of California. City of Harper Woods Employees Retirement System v. AXT, Inc. et al., No. C 04 4362 MJJ. The Court consolidated the case with a subsequent related case and appointed a lead plaintiff. On April 5, 2005, the lead plaintiff filed a consolidated complaint, captioned as Morgan v. AXT, Inc. et al., No. C 04 4362 MJJ. The lawsuit complaint names AXT, Inc. and our chief technology officer, as defendants, and is brought on behalf of a class of all purchasers of our securities from February 6, 2001 through April 27, 2004. The complaint alleges that we announced financial results during this period that were false and misleading. No specific amount of damages is claimed. On September 23, 2005, the Court granted our motion to dismiss the complaint, with leave to amend. *Lead plaintiff filed an amended complaint, which we have moved to dismiss*. We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition and results of operations.

On June 1, 2005, a lawsuit was filed in the Superior Court of California, County of Alameda, *Zhao et. Al. vs. American Xtal Technology, et. al.*, No. R 605215713. The lawsuit complaint names as defendants AXT, its chief technology officer, its former interim chief executive officer, a former safety department employee and a supplier to AXT. The lawsuit is brought on behalf of two former employees and their minor child. The complaint alleges personal injury, general negligence, intentional tort, wage loss and other damages, including punitive damages, as a result of exposure to the child while in utero to high levels of gallium arsenide and methanol used in the production of gallium arsenide wafers.

We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. AXT s commercial general liability insurance carrier has agreed to fund AXT s defense of the case, but has reserved the right to deny coverage, in whole or in part, in the future under selected policy provisions and applicable law. There is $21 million in available limits under the policies in question. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition and results of operations.

Item 1A. Risk Factors

We operate in a rapidly changing environment that involves many risks, some of which are beyond our control. The following is a discussion that highlights some of these risks, which are substantially the same as included in our Annual Report on Form 10-K for the year ended December 31, 2005. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business, operations or financial results.

Risks Related to Our Business

Our operating results depend in large part on further customer acceptance of our existing substrate products manufactured in China.

As we are now manufacturing only in China, if the shift of our substrate manufacturing operations to China is to be successful, we will need our customers to qualify products manufactured in China. If we are unable to continue to achieve qualifications for these products, our China facility will be underutilized, our investments in China will not be recouped and we will be unable to lower our costs by moving to China. We may lose sales of our products to competitors who are not manufacturing in China, or whose operations in China have already been qualified by customers. If customers do not fully qualify our China production, we may lose additional customers and fail to achieve revenue growth.

Furthermore, some customers reduced their orders from us until our surface quality is as good and consistent as that offered by competitors. As a result, some customers allocated their requirements for compound semiconductor substrates across more competitors and although our quality is improving, resulting in increased sales, we believe that we have lost revenue and market share as a result of these customer decisions, which we may be unable to recover. If we are unable to recover and retain our market share, we may be unable to grow our business.

Defects in our products could diminish demand for our products.

Our products are complex and may contain defects. We have experienced quality control problems with some of our products which caused customers to return products to us, reduce orders for our products, or both. Although our quality has improved, resulting in some increases in product sales, we believe that we continue to experience some reduction in orders as a result of our prior product quality problems. If we continue to experience quality control problems, or experience these or other problems in new products, customers may cancel or reduce orders or purchase products from our competitors, we may be unable to maintain or increase sales to our customers and sales of our products could decline. Defects in our products could cause us to incur higher manufacturing costs and suffer product returns and additional service expenses, all of which could adversely impact our operating results.

If new products developed by us contain defects when released, our customers may be dissatisfied and we may suffer negative publicity or customer claims against us, lose sales or experience delays in market acceptance of our new products.

We need to continue to improve or implement our systems, procedures and controls and may not receive a favorable attestation report on our internal control systems by our independent registered public accounting firm.

The requirements adopted by the Securities and Exchange Commission, or SEC, in response to the passage of the Sarbanes-Oxley Act of 2002 will require annual review and evaluation of our internal control systems, and an attestation of these systems by our independent registered public accounting firm beginning with our fiscal year ending December 31, 2007. This may be due earlier beginning with our fiscal year ending December 31, 2006 if our market capitalization increases above $75 million on the determining date on June 30, 2006. We are currently reviewing our internal control procedures and considering further documentation of such procedures that may be necessary. We are currently evaluating the extent to which any of our joint ventures may also be required to comply, if at all. We can give no assurances that our systems will satisfy the new requirements of the Securities and Exchange Commission, or if required, that any of the systems of our joint ventures will meet such requirements, or that we will receive a favorable review and attestation by our independent registered public accounting firm.

In addition, the shift of our manufacturing operations to China has placed and continues to place a significant strain on our operations and management resources. We have upgraded our inventory control systems and may implement additional systems relating to consolidation of our financial results, but continue to rely on certain manual processes in our operations and in connection with consolidation of our financial results. If we fail to manage these changes effectively, our operations may be disrupted.

To manage our business effectively, we may need to implement additional and improved management information systems, further develop our operating, administrative, financial and accounting systems and controls, add experienced senior level managers, and maintain close coordination among our executive, engineering, accounting, marketing, sales and operations organizations.

If we fail to comply with environmental and safety regulations, we may be subject to significant fines or cessation of our operations; in addition, we could be subject to suits for personal injuries caused by hazardous materials.

We are subject to federal, state and local environmental and safety laws and regulations in all of our operating locations, including laws and regulations of China, including, but not limited to, regulations related to the development, manufacture and use of our products, the operation of our facilities, and the use of our real property. These laws, rules and regulations govern the use, storage, discharge and disposal of hazardous chemicals during manufacturing, research and development, and sales demonstrations. If we fail to comply with applicable regulations, we could be subject to substantial liability for clean-up efforts, personal injury and fines or suspension or cessation of our operations, and/or the suspension or termination of development, manufacture or use of certain of our products, or may affect the operation of our facilities or use of our real property, each of which could have a material adverse effect on our business, financial condition and results of operations.

In March 2001, we settled a claim made by the California Occupational Safety and Health Administration, or Cal-OSHA, in an investigation primarily regarding impermissible levels of potentially hazardous materials in certain areas of our manufacturing facility in Fremont, California for $200,415, and during 2004 we were the target of press allegations and correspondence purportedly on behalf of current and/or former employees concerning our environmental compliance programs and exposure of our employees to hazardous materials. In June 2005, a complaint was filed against us and a

current and former officer, alleging personal injury, general negligence, intentional tort, wage loss and other damages, including punitive damages, as a result of exposure of defendants, who are former employees of AXT, including a minor child in utero, to high levels of gallium arsenide in gallium arsenide wafers, and methanol. There is a possibility that other current and/or former employees may bring additional litigation against us. Although we have put in place engineering, administrative and personnel protective equipment programs to address these issues, our ability to expand or continue to operate our present locations could be restricted or we could be required to acquire costly remediation equipment or incur other significant expenses. Existing or future changes in laws or regulations in the United States and China may require us to incur significant expenditures or liabilities, or may restrict our operations. In addition, our employees could be exposed to chemicals or other hazardous materials at our facilities and we may be subject to lawsuits seeking damages for wrongful death or personal injuries allegedly caused by exposure to chemicals or hazardous materials at our facilities.

Litigation is inherently uncertain and while we would expect to defend ourselves vigorously, it is possible that our business, financial condition, results of operations or cash flows could be affected in any particular period by such litigation now pending, and any additional litigation if brought against us.

Existing or future litigation could result in significant judgments against us, or cause us to incur costly settlements.

In June 2005, a complaint was filed against us and a current and former officer, alleging personal injury, general negligence, intentional tort, wage loss and other damages, including punitive damages, as a result of exposure of plaintiffs, who are former employees of AXT, including a minor child in utero, to high levels of gallium arsenide in gallium arsenide wafers, and methanol. In addition, we are defendants in an ongoing securities litigation matter. Litigation is inherently uncertain and while we would expect to defend ourselves vigorously, it is possible that our business, financial condition, results of operations or cash flows could be affected in any particular period by such litigation now pending, and any additional litigation if brought against us. In addition, response to such litigation could divert management s attention from our business and operations, causing our business and financial results to suffer. We could incur defense or settlement costs in excess of the insurance covering such litigation matters, or such litigation could result in significant judgments against us, in excess of our insurance limits.

Decreases in average selling prices of our products may reduce gross margins.

The market for compound semiconductor substrates is characterized by pressures on average selling prices resulting from factors such as increased competition or overcapacity. We have experienced and expect to continue to experience price pressures on our products, and if average selling prices decline in the future, our revenues and gross margins could decline. We may be unable to reduce the cost of our products sufficiently to counter the effect of lower selling prices and allow us to keep pace with competitive pricing pressures and our margins could be adversely affected.

The loss of one or more of our key substrate customers would significantly hurt our operating results.

A small number of substrate customers have historically accounted for a substantial portion of our total revenue. Our top five customers represented 45.8%, and 44.6% of revenue for the three months ended March 31, 2006, and 2005, respectively. We expect that a significant portion of our future revenue will continue to be derived from a limited number of substrate customers. Our customers are not obligated to purchase a specified quantity of our products or to provide us with binding forecasts of product purchases. In addition, our customers may reduce, delay or cancel orders at any time without any significant penalty, and during the past year, we have experienced slower bookings, significant push outs and cancellation of orders from some customers. If we lose a major customer or if a customer cancels, reduces or delays orders, our revenue would decline. In addition, customers that have accounted for significant revenue in the past may not continue to generate revenue for us in any future period. Any delay in scheduled shipments of our products could cause revenue to fall below our expectations and the expectations of market analysts or investors, causing our stock price to decline.

We may incur claims or other liabilities or obligations related to our failure to follow requirements for testing of products and provision of testing data and information relating to customer requirements. Additionally, customers may cancel or reduce future shipments in response to these failures, or require re-qualifications.

During the first quarter of 2004, we determined that we had not followed requirements for testing of products and provision of testing data and information relating to customer requirements. We notified affected customers concerning our findings, however, there can be no assurance that we will not incur customer claims or other liabilities or obligations in connection with this matter, nor, if we receive any such claims, that we will not have to restate results from prior

periods. In addition, revenue in future periods may be adversely impacted if customers decide not to order from us as a result of this disclosure. We experienced several cancellations of future orders by customers pending further information regarding enhancements to our product testing and quality control systems. In addition, some customers are requiring additional qualification of our China operations before placing future orders with us. We cannot be sure that we will not receive additional cancellations of orders by other customers, or fail to win expected future orders from customers, as a result of our disclosure of our investigation conclusions, or that our customers will qualify our China operations and place future orders with us.

Problems incurred by our joint ventures or venture partners could result in a material adverse impact on our financial condition or results of operations

We have invested in five joint venture operations in China that produce products including 99.99% pure gallium (4N Ga), high purity gallium, arsenic, germanium, germanium dioxide, paralytic boron nitride (pBN) crucibles, and boron oxide. We purchase the materials produced by these ventures for our use and sell other portions of their production to third parties. Our ownership interest in these entities ranges from 25 percent to 83 percent. We consolidate the three ventures in which we own a majority interest and employ equity accounting for the two joint ventures in which we have a 25 percent interest. Several of these ventures occupy facilities within larger facilities owned and/or operated by one of the other venture partners. Several of these venture partners are engaged in other manufacturing activities at or near the same facility. In some facilities, we share access to certain functions, including water, treatment of hazardous waste or air quality treatment. If any of our joint venture partners in any of these five ventures experience problems with their operations, disruptions of our joint venture operations could result, having a material adverse effect on the financial condition and results of operation of our joint ventures, and correspondingly on our financial condition or results of operations.

In addition, if any of our joint ventures or venture partners with whom our joint ventures share facilities are deemed to have violated applicable laws, rules or regulations governing the use, storage, discharge or disposal of hazardous chemicals during manufacturing, research and development, or sales demonstrations, the operations of our joint ventures could be adversely affected and we could be subject to substantial liability for clean-up efforts, personal injury and fines or suspension or cessation of our joint venture operations as a result of the actions of the joint ventures or other venture partners. Employees working at the operations of our joint ventures or the operations of any of the other venture partners could bring litigation against us as a result of actions taken at the joint venture or venture partner facilities, even though we are not directly controlling the operations, including actions for exposure to chemicals or other hazardous materials at the facilities of our joint ventures or the facilities of any venture partner that are shared by our joint ventures. If litigation is brought against us, litigation is inherently uncertain and while we would expect to defend ourselves vigorously, it is possible that our business, financial condition, results of operations or cash flows could be affected in any particular period by such litigation if brought against us, particularly if, as a non-Chinese company, litigation with us is deemed advantageous. Even if we are not deemed responsible for the actions of the joint ventures or venture partners, litigation could be costly, time consuming to defend and divert management attention; in addition, pursuit of us could occur if we are deemed to be the most financially viable of the partners.

Going forward, we believe that investing in additional joint ventures will be important to remaining competitive in our marketplace and ensuring a supply of critical raw materials. However, we may not be able to identify complementary joint venture opportunities or, even once opportunities are identified, we may not be able to reach agreement on the terms of the venture with the other venture partners. Additional joint ventures could cause us to incur contingent liabilities or other expenses, any of which could adversely affect our financial condition and operating results.

Since all of our joint venture activity is expected to occur in China, these activities could subject us to a number of risks associated with conducting operations internationally, including:

difficulties in managing geographically disparate operations;

difficulties in enforcing agreements through non-U.S. legal systems;

unexpected changes in regulatory requirements that may limit our ability to export the venture products or sell into particular jurisdictions or impose multiple conflicting tax laws and regulations;

political and economic instability, civil unrest or war;

31

terrorist activities that impact international commerce;

difficulties in protecting our intellectual property rights, particularly in countries where the laws and practices do not protect proprietary rights to as great an extent as do the laws and practices of the United States;

changing laws and policies affecting economic liberalization, foreign investment, currency convertibility or exchange rates, taxation or employment; and

nationalization of foreign owned assets, including intellectual property.

Intellectual property infringement claims may be costly to resolve and could divert management attention.

Other companies may hold or obtain patents on inventions or may otherwise claim proprietary rights to technology necessary to our business. The markets in which we compete are comprised of competitors who in some cases hold substantial patent portfolios covering aspects of products that could be similar to ours. We could become subject to claims that we are infringing patent, trademark, copyright or other proprietary rights of others. For example, we have previously been involved in two separate lawsuits alleging patent infringement, and could in the future be involved in similar litigation.

The compound semiconductor industry is cyclical and has experienced a downturn which has adversely impacted our operating results.

Our continuing business depends in significant part upon manufacturers of electronic and opto-electronic compound semiconductor devices, as well as the current and anticipated market demand for such devices and products using such devices. As a supplier to the compound semiconductor industry, we are subject to the business cycles that characterize the industry. The timing, length and volatility of these cycles are difficult to predict. The compound semiconductor industry has historically been cyclical because of sudden changes in demand, the manufacturing capacity and changes in the technology employed in compound semiconductors. The rate of changes in demand, including end demand, is high, and the effect of these changes upon us occurs quickly, exacerbating the volatility of these cycles. These changes have affected the timing and amounts of customers purchases and investments in new technology. These industry cycles create pressure on our revenue, gross margin and net income (loss).

The industry has in the past experienced periods of oversupply that result in significantly reduced demand and prices for compound semiconductor devices and components, including our products, both as a result of general economic changes and overcapacity. When these periods occur, our operating results and financial condition are adversely affected, and create pressure on our revenue, gross margins and net income (loss). Inventory buildups in telecommunications products and slower than expected sales of computer equipment resulted in overcapacity and led to reduced sales by our customers, and therefore reduced purchases of our products. During periods of weak demand such as those experienced over the past years, customers typically reduce purchases, delay delivery of products and/or cancel orders of component parts such as our products.

Increased price competition has resulted, causing pressure on our net sales, gross margin and net income (loss). We experienced cancellations, price reductions, delays and push outs of orders, which have resulted in reduced revenues. If the economic downturn occurred again, further order cancellations, reductions in order size or delays in orders could occur and would materially adversely affect our business and results of operations. Actions to reduce our costs, such as those we have recently taken, may be insufficient to align our structure with prevailing business conditions. We may be required to undertake additional cost-cutting measures, and may be unable to invest in marketing, research and development and engineering at the levels we believe are necessary to maintain our competitive position. Our failure to make these investments could seriously harm our business.

During periods of increasing demand for compound semiconductor devices, we must have sufficient manufacturing capacity and inventory to meet customer demand, and must be able to attract, hire, train and retain qualified employees to meet demand. If we are unable to effectively manage our resources and production capacity during an industry upturn, there could be a material adverse effect on our business, financial condition and results of operations.

Our results of operations may suffer if we do not effectively manage our inventory.

We must manage our inventory of component parts, work-in-process, and finished goods effectively to meet

changing customer requirements, while keeping inventory costs down and improving gross margins. Some of our products and supplies have in the past and may in the future become obsolete while in inventory due to changing customer specifications, or become excess inventory due to decreased demand for our products and an inability to sell the inventory within a foreseeable period. Furthermore, if current costs of production increase or sales prices drop below the standard prices at which we value inventory, we may need to take a charge for a reduction in inventory values. We have in the past, including during 2004, had to take inventory valuation and impairment charges. Any future unexpected changes in demand or increases in costs of production that cause us to take additional charges for un-saleable, obsolete or excess inventory, or to reduce inventory values, could adversely affect our results of operations.

The impact of changes in global economic conditions on our customers may cause us to fail to meet expectations, which would negatively impact the price of our stock.

Our operating results can vary significantly based upon the impact of changes in global economic conditions on our customers. The revenue growth and profitability of our business depends on the overall demand for our substrates, and we are particularly dependant on the market conditions for the wireless, solid-state illumination, fiber optics and telecommunications industries. Because our sales are primarily to major corporate customers whose businesses fluctuate with general economic and business conditions, a softening of demand for products that use our substrates, caused by a weakening economy may result in decreased revenues. Customers may find themselves facing excess inventory from earlier purchases, and may defer or reconsider purchasing products due to the downturn in their business and in the general economy.

If we have low product yields, or if there is a deliberate sabotage of our products, the shipment of our products may be delayed and our operating results may be adversely impacted.

Our products are manufactured using complex technologies, and the number of usable substrates we can produce can fluctuate as a result of many factors, including:

- impurities in the materials used;
- contamination of the manufacturing environment;
- substrate breakage;
- equipment failure, power outages or variations in the manufacturing process; and
- performance of personnel involved in the manufacturing process.

If our yields decrease, our revenue could decline if we are unable to produce needed product on time while our manufacturing costs remain fixed, or could increase. We have experienced product shipment delays and difficulties in achieving acceptable yields on both new and older products, and delays and poor yields have adversely affected our operating results. We may experience similar problems in the future and we cannot predict when they may occur or their severity. In particular, many of our manufacturing processes are new and are still being refined, which can result in lower yields.

If there is deliberate sabotage of our products making it unfit for use by our customers, our products would be rejected resulting in compensation costs paid to our customers, and possible disqualification, and could lead to revenue loss and market share loss.

If we do not successfully develop new products to respond to rapidly changing customer requirements, our ability to generate revenue, obtain new customers, and retain existing customers may suffer.

Our success depends on our ability to offer new products and product features that incorporate leading technology and respond to technological advances. In addition, our new products must meet customer needs and compete effectively on quality, price and performance. The life cycles of our products are difficult to predict because the markets for our products are characterized by rapid technological change, changing customer needs and evolving industry standards. If our competitors introduce products employing new technologies or performance characteristics, our existing products could become obsolete and unmarketable. During the past two years, we have seen our competitors selling more substrates manufactured using a crystal growth technology similar to ours, which has eroded our technological differentiation. Other companies, including Triquent, are actively developing substrate materials that could be used to

manufacture devices that could provide the same high-performance, low-power capabilities as GaAs- and InP-based devices at competitive prices. If these substrate materials or VGF-derived products are successfully developed and semiconductor device manufacturers adopt them, demand for our GaAs substrates could decline and our revenue could suffer.

The development of new products can be a highly complex process, and we may experience delays in developing and introducing new products. Any significant delays could cause us to fail to timely introduce and gain market acceptance of new products. Further, the costs involved in researching, developing and engineering new products could be greater than anticipated. If we fail to offer new products or product enhancements or fail to achieve higher quality products, we may not generate sufficient revenue to offset our development costs and other expenses or meet our customers requirements.

Intense competition in the markets for our products could prevent us from increasing revenue and sustaining profitability.

The markets for our products are intensely competitive. We face competition for our substrate products from other manufacturers of substrates, such as Freiberger, Hitachi Cable, Japan Energy and Sumitomo Electric and from semiconductor device manufacturers that produce substrates for their own use, and from companies, such as Triquent, that are actively developing alternative materials to GaAs and some semiconductor devices are being marketed using these materials. We believe that at least two of our competitors are shipping high volumes of GaAs substrates manufactured using a technique similar to our VGF technique. Other competitors may develop and begin using similar technology. If we are unable to compete effectively, our revenue may not increase and we may be unable to be profitable. We face many competitors that have a number of significant advantages over us, including:

- greater experience in the business;
- more manufacturing experience;
- extensive intellectual property;
- broader name recognition; and
- significantly greater financial, technical and marketing resources.

Our competitors could develop new or enhanced products that are more effective than our products are.

The level and intensity of competition has increased over the past year and we expect competition to continue to increase in the future. Competitive pressures caused by the current economic conditions have resulted in reductions in the prices of our products, and continued or increased competition could reduce our market share, require us to further reduce the prices of our products, affect our ability to recover costs or result in reduced gross margins.

Demand for our products may decrease if our customers experience difficulty manufacturing, marketing or selling their products.

Our products are used as components in our customers products. Accordingly, demand for our products is subject to factors affecting the ability of our customers to successfully introduce and market their products, including:

- the competition our customers face in their particular industries;
- the technical, manufacturing, sales and marketing and management capabilities of our customers;
- the financial and other resources of our customers; and
- the inability of our customers to sell their products if they infringe third party intellectual property rights.

If demand for the end user applications for which our products are used decreases, or our customers are unable to develop, market and sell their products, demand for our products will decrease.

The financial condition of our customers may affect their ability to pay amounts owed to us.

Many of our customers are facing business downturns that have reduced their cash balances and their prospects. We frequently allow our customers to pay for products we ship to them within 30 to 120 days after delivery. Subsequent to our shipping a product, some customers have been unable to make payments as due, reducing our cash balances and causing us to incur charges to allow for a possibility that some accounts might not be paid. During 2004, a customer of one agent filed for bankruptcy protection. We incurred a charge equal to the amount owed us and believe that there is a substantial likelihood that we will not be able to recoup any of this amount. Other customers may also be forced to file for bankruptcy. If our customers do not pay their accounts when due, we will be required to incur charges that would reduce our earnings.

We purchase critical raw materials and parts for our equipment from single or limited sources, and could lose sales if these sources fail to fill our needs.

We depend on a limited number of suppliers for certain raw materials, components and equipment used in manufacturing our products, including key materials such as quartz tubing, polishing solutions, and paralytic boron nitride. Although several of these raw materials are purchased from suppliers in whom we hold an ownership interest, we generally purchase these materials through standard purchase orders and not pursuant to long-term supply contracts and no supplier guarantees supply of raw materials or equipment to us. If we lose any of our key suppliers, our manufacturing efforts could be significantly hampered and we could be prevented from timely producing and delivering products to our customers. We have in the past experienced delays obtaining critical raw materials and spare parts, including gallium, due to shortages of these materials. Although we hope to alleviate some of these delays and shortages as a result of our interests in our joint ventures, we may experience delays due to shortages of materials and may be unable to obtain an adequate supply of materials. These shortages and delays could result in higher materials costs and cause us to delay or reduce production of our products. If we have to delay or reduce production, we could fail to meet customer delivery schedules and our revenue and operating results could suffer.

We have made and may continue to make strategic investments in raw materials suppliers, which may not be successful and may result in the loss of all or part of our investment.

We have made investments through our five joint ventures in raw material suppliers in China, that provide us with opportunities to gain supply of key raw materials that are important to our substrate business. These affiliates each have a market beyond that provided by us. We do not have influence over all of these companies, each of which is located in China, and in some we have made only a strategic, minority investment. We may not be successful in achieving the financial, technological or commercial advantage upon which any given investment is premised, and we could end up losing all or part of our investment.

Our substrate products have a long qualification cycle that makes it difficult to plan our expenses and forecast our results.

Customers typically place orders with us for our substrate products three months to a year or more after our initial contact with them. The sale of our products may be subject to delays due to our customers lengthy internal budgeting, approval and evaluation processes. During this time, we may incur substantial expenses and expend sales, marketing and management efforts while the customers evaluate our products. These expenditures may not result in sales of our products. If we do not achieve anticipated sales in a period as expected, we may experience an unplanned shortfall in our revenue. As a result, we may not be able to cover expenses, causing our operating results to vary. In addition, if a customer decides not to incorporate our products into its initial design, we may not have another opportunity to sell products to this customer for many months or even years. In the current competitive and economic climate, the average sales cycle for our products has lengthened even further and is expected to continue to make it difficult to accurately forecast our future sales. We anticipate that sales of any future substrate products will also have lengthy sales cycles and will, therefore, be subject to risks substantially similar to those inherent in the lengthy sales cycle of our current substrate products.

If we are unable to protect our intellectual property, we may lose valuable assets or incur costly litigation.

We rely on a combination of patents, copyrights, trademark and trade secret laws, non-disclosure agreements and other intellectual property protection methods to protect our proprietary technology. However, we believe that, due to the rapid pace of technological innovation in the markets for our products, our ability to establish and maintain a position of

technology leadership also depends on the skills of our development personnel.

Despite our efforts to protect our intellectual property, a third party could develop products or processes similar to ours. Our means of protecting our proprietary rights may not be adequate and our competitors may independently develop similar technology, duplicate our products or design around our patents. We believe that at least two of our competitors have begun to ship GaAs substrates produced using a process similar to our VGF technique. Our competitors may also develop and patent improvements to the VGF technology upon which we rely, and thus may limit any exclusivity we enjoy by virtue of our patents or trade secrets.

It is possible that pending or future United States or foreign patent applications made by us will not be approved, that our issued patents will not protect our intellectual property, or that third parties will challenge the ownership rights or the validity of our patents. In addition, the laws of some foreign countries may not protect our proprietary rights to as great an extent as do the laws of the United States and it may be more difficult to monitor the use of our intellectual property. Our competitors may be able to legitimately ascertain non-patented proprietary technology embedded in our systems. If this occurs, we may not be able to prevent the development of technology substantially similar to ours.

We may have to resort to costly litigation to enforce our intellectual property rights, to protect our trade secrets or know-how or to determine their scope, validity or enforceability. Enforcing or defending our proprietary technology is expensive, could cause us to divert resources and may not prove successful. Our protective measures may prove inadequate to protect our proprietary rights, and if we fail to enforce or protect our rights, we could lose valuable assets.

For example, we have been in the past been involved in litigation with Sumitomo Electric Industries, Ltd. (SEI) in Japan as well as interference actions in the United States. We and SEI approved a settlement of this litigation during the fourth quarter of 2004 and the litigation was withdrawn and we abandoned the interference proceeding. We incurred an initial charge of approximately $1.4 million and will have to pay ongoing royalties to SEI on certain of our products.

We derive a significant portion of our revenue from international sales, and our ability to sustain and increase our international sales involves significant risks.

Our revenue growth depends in part on the expansion of our international sales and operations. International sales represented 81% and 79% of our total revenue for the years ended December 31, 2005 and 2004, respectively, and 77% of our total revenue for the three month period ended March 31, 2006. We expect that sales to customers outside the U.S. will continue to represent a significant portion of our revenue, particularly sales to customers in Asia.

Currently, an increasing percentage of our sales are to customers headquartered in Asia. Certain manufacturing facilities and suppliers are also located outside the U.S. Managing our global operations presents challenges, including periodic regional economic downturns, trade balance issues, varying business conditions and demands, political instability, variations in enforcement of intellectual property and contract rights in different jurisdictions, differences in the ability to develop relationships with suppliers and other local businesses, changes in U.S. and international laws and regulations including U.S. export restrictions, fluctuations in interest and currency exchange rates, the ability to provide sufficient levels of technical support in different locations, cultural differences, shipping delays and terrorist acts or acts of war, among other risks. Many of these challenges are present in China, which represents a large potential market for semiconductor equipment and where we anticipate significant opportunity for growth. Global uncertainties with respect to: (i) economic growth rates in various countries; (ii) sustainability of demand for electronics products; (iii) capital spending by semiconductor manufacturers; (iv) price weakness for certain semiconductor devices; and (v) political instability in regions where we have operations may also affect our business, financial condition and results of operations.

Our dependence on international sales involves a number of risks, including:

changes in tariffs, import or export restrictions and other trade barriers;

unexpected changes in regulatory requirements;

longer periods to collect accounts receivable;

changes in export license requirements;

political and economic instability;

unexpected changes in diplomatic and trade relationships; and

foreign exchange rate fluctuations.

Our sales are denominated in U.S. dollars, except for sales to our Japanese and some Taiwanese customers, which are denominated in Japanese yen. Thus, increases in the value of the U.S. dollar could increase the price of our products in non-U.S. markets and make our products more expensive than competitors products in these markets.

Also, denominating some sales in Japanese yen subjects us to fluctuations in the exchange rates between the U.S. dollar and the Japanese yen. The functional currencies of our Chinese subsidiaries are the local currencies. We incur transaction gains or losses resulting from consolidation of expenses incurred in local currencies for these subsidiaries, as well as in translation of the assets and liabilities of these assets at each balance sheet date. If we do not effectively manage the risks associated with international sales, our revenue, cash flows and financial condition could be adversely affected.

Because of power shortages in China, we may have to temporarily close our China operations, which would adversely impact our ability to manufacture our products, meet customer orders, and result in reduced revenues.

The Chinese government faced a power crunch over the summer of 2004 and reported that power demand in 24 provinces outstripped supply in peak periods during the first four months of 2004. Instability in electrical supply caused sporadic outages among residential and commercial consumers. As a result, the Chinese government implemented tough measures in 2004 to ease the energy shortage. Provinces imposed power brownouts during 2004 to reduce electricity demand and some companies in Beijing were ordered to give their employees a week off to ease the pressure on power supply. The plants, most of which are state-owned, were closed and reopened on a staggered schedule to reduce power consumption during the capital s hottest months during 2004. As a result we closed most of our operations for a week in late July 2004 in conformance with this policy. Although shortages requiring closure of facilities did not occur during summer 2005, if we are required to make additional temporary closures of our Beijing and joint venture operations at any time during 2006, we may be unable to manufacture our products, and would then be unable to meet customer orders except from inventory on hand. As a result, we could lose sales, adversely impacting our revenues, and our relationships with our customers could suffer, impacting our ability to generate future sales. In addition, if power is shut off at our Beijing operations at any time, either voluntarily or as a result of unplanned brownouts, during certain phases of our manufacturing process including our crystal growth phase, the work in process may be ruined and rendered unusable, causing us to incur expense that will not be covered by revenue, and negatively impacting our cost of goods sold and gross margins. We are attempting to partially mitigate the potential effects of power outages by building inventory in anticipation of power outages during the summer. This inventory build is prepared to accommodate forecast demand rather specific customer orders. If the inventory we build is not ordered by customers, we may have to scrap these products and incur a cost which will reduce our gross margins.

Legislative actions, higher insurance costs and potential new accounting pronouncements are likely to cause our general and administrative expenses to increase and impact our future financial position and results of operations.

In order to comply with rules and regulations adopted pursuant to the Sarbanes-Oxley Act of 2002 by the SEC, as well as changes to listing standards adopted by NASDAQ, and accounting changes adopted affecting accounting for stock-based compensation we may be required to increase our internal controls, hire additional personnel and additional outside legal, accounting and advisory services, all of which will cause our general and administrative costs to increase. Insurers may increase premiums as a result of the high claims rates they incurred over the past year. Changes in the accounting rules, including legislative and other rules to account for employee stock options as a compensation expense among others, could materially increase the expense that we report under generally accepted accounting principles and adversely affect our operating results.

If we fail to manage periodic contractions, we may utilize our cash balances and our existing cash and cash equivalent balances could decline.

We anticipate that our existing cash resources will fund any anticipated operating losses, purchases of capital equipment and provide adequate working capital for the next twelve months. However, our liquidity is affected by many

factors including, among others, the extent to which we pursue additional capital expenditures, the level of our production, and other factors related to the uncertainties of the industry and global economies. If we fail to manage our contractions successfully we may draw down our cash reserves, which would adversely affect our operating results and financial condition, reduce our value and may impinge our ability to raise debt and equity funding in the future, at a time when we may be required to raise additional cash. Accordingly, there can be no assurance that events in the future will not require us to seek additional capital, or, if so required, that such capital will be available on terms acceptable to us, if at all. As part of our effort to reduce costs, we may lose key staff, production resources, and technology that we will need to grow when end markets recover. These events could reduce our ability to grow profitably as markets recover.

Changes in China s political, social and economic environment may affect our financial performance.

Our financial performance may be affected by changes in China s political, social and economic environment. The role of the Chinese central and local governments in the Chinese economy is significant. Chinese policies toward economic liberalization, and laws and policies affecting technology companies, foreign investment, currency exchange rates and other matters could change, resulting in greater restrictions on our ability to do business and operate our manufacturing facilities in China. Any imposition of surcharges or any increase in Chinese tax rates could hurt our operating results. The Chinese government could revoke, terminate or suspend our license for national security and similar reasons without compensation to us. If the government of China were to take any of these actions, we would be prevented from conducting all or part of our business. Any failure on our part to comply with governmental regulations could result in the loss of our ability to manufacture our products in China.

China has from time to time experienced instances of civil unrest and hostilities. Confrontations have occurred between the military and civilians. Events of this nature could influence the Chinese economy, result in nationalization of foreign-owned operations such as ours, and could negatively affect our ability to operate our facilities in China.

We may face additional risks as a result of the revaluation of the Chinese currency.

In July 2005, the People s Republic of China agreed to a shift in Chinese currency policy and established a 2% revaluation of the renminbi, and the renminbi will now be referenced to a basket of currencies, with a daily trading band of +/-0.3%. Depending on market conditions and the state of the Chinese economy, it is possible that China will make more adjustments in the future. Over the next five to ten years, China may move to a managed float system, with opportunistic interventions. This reserve diversification may negatively impact the United States dollar and U.S. interest rates, which could in turn negatively impact the Company s operating results and financial condition. A significant percentage of our sales are made to customers located outside of the United States, particularly Asia. Our sales are denominated in U.S. dollars, except for sales to our Japanese and some Taiwanese customers, which are denominated in Japanese yen. Thus, increases in the value of the U.S. dollar could increase the price of our products in non-U.S. markets and make our products more expensive than competitors products in these markets. The functional currencies of our Chinese subsidiaries, including our joint ventures, are the local currency; since most of our operations are conducted in China, many of our costs are incurred in Chinese currency, which subjects us to fluctuations in the exchange rates between the U.S. dollar and the Chinese renminbi. We incur transaction gains or losses resulting from consolidation of expenses incurred in local currencies for these subsidiaries, as well as in translation of the assets and liabilities of these assets at each balance sheet date. These risks may be increased by the fluctuation and revaluation of the Chinese renminbi. If we do not effectively manage the risks associated with this currency risk, our revenue, cash flows and financial condition could be adversely affected.

A reoccurrence of Severe Acute Respiratory Syndrome (SARS) or the outbreak of a different contagious diseasesuch as the Avian Flu may adversely impact our manufacturing operations and some of our key suppliers and customers.

The majority of our substrate manufacturing activities are conducted in China. In addition, we source key raw materials, including gallium, from our joint ventures and other suppliers in China. The 2003 SARS outbreak was most notable in China and a small number of cases were reported in 2004. One employee at our LED production facility in China contracted SARS in late April 2003 prompting us to close the facility for ten days. There was no significant impact to our ability to fill customer orders. If there were to be another outbreak of SARS or a different contagious disease, such as Avian Flu, and if our employees contracted the disease, we may be required to temporarily close our manufacturing operations. Similarly, if one of our key suppliers is required to close for an extended period, we may not have enough raw material inventory to continue manufacturing operations. In addition, while we possess management skills among our China staff that enable us to maintain our manufacturing operations with minimal on-site supervision from our US-based staff, our business could also be harmed if travel to or from Asia and the United States is restricted or inadvisable, as it was during parts of 2003. None of our substrate competitors is as dependent on manufacturing facilities

in China as we are. If our manufacturing operations were closed for a significant period, we could lose revenue and market share during that period which would depress our financial performance and could be difficult to recapture. Finally, if one of our key customers is required to close for an extended period, we may not be able to ship product to them, our revenue would decline and our financial performance would suffer.

The effect of terrorist threats and actions on the general economy could decrease our revenues.

The United States continues to be on alert for terrorist activity. The potential near- and long-term impact terrorist activities may have in regards to our suppliers, customers and markets for our products and the U.S. economy are uncertain. There may be embargos of ports or products, or destruction of shipments or our facilities, or attacks that affect our personnel. There may be other potential adverse effects on our operating results due to a significant event that we cannot foresee. Since we perform substantially all of our manufacturing operations in China, and a significant portion of our customers are located outside of the Untied States, terrorist activity or threats against US-owned enterprise are a particular concern to us.

If any of our facilities is damaged by actions such as fire, explosion, or natural disaster, we may not be able to manufacture our products.

The ongoing operation of our manufacturing and production facilities in China is critical to our ability to meet demand for our products. If we are not able to use all or a significant portion of our facilities for prolonged periods for any reason, we will not be able to manufacture products for our customers. For example, a natural disaster, fire or explosion caused by our use of combustible chemicals and high temperatures during our manufacturing processes would render some or all of our facilities inoperable for an indefinite period of time. Actions outside of our control, such as earthquakes, could also damage our facilities, rendering them inoperable. If we are unable to operate our facilities and manufacture our products, we will lose customers and revenue and our business will be harmed.

Unpredictable fluctuations in our operating results could disappoint analysts or our investors, which could cause our stock price to decline.

We have not over the past years been able to sustain growth, and may not be able to return to historic growth levels in the current economic environment. Our net loss in 2002 was the largest in our history and our losses continued during 2003, 2004, 2005 and for the three month period ended March 31, 2006.

We have and may continue to experience significant fluctuations in our revenue and earnings. Our quarterly and annual revenue and operating results have varied significantly in the past and may vary significantly in the future due to a number of factors, including:

our ability to develop, manufacture and deliver high quality products in a timely and cost-effective manner;

decline in general economic conditions or downturns in the industry in which we compete;

fluctuations in demand for our products;

expansion of our manufacturing capacity;

expansion of our operations in China;

limited availability and increased cost of raw materials;

the volume and timing of orders from our customers, and cancellations, push outs and delays of customer orders;

fluctuation of our manufacturing yields;

decreases in the prices of our competitors products;

costs incurred in connection with any future acquisitions of businesses or technologies; and

increases in our expenses, including expenses for research and development.

Due to these factors, we believe that period-to-period comparisons of our operating results may not be meaningful indicators of our future performance. Our operating results have over the past year at times been below the expectations of securities analysts or investors. If this occurs again in future periods, the price of our common stock could decline or fluctuate.

A substantial percentage of our operating expenses are fixed in the short term and we may be unable to adjust spending to compensate for an unexpected shortfall in revenues. As a result, any delay in generating revenue could cause our operating results to be below the expectations of market analysts or investors, which could also cause our stock price to fall.

Our stock price has been and may continue to be volatile.

Our stock price has fluctuated significantly since we began trading on the NASDAQ National Market. For the year ended December 31, 2005, the high and low closing sales prices of our common stock were $2.47 and $1.08, respectively, and for the three months ended March 31, 2006, the high and low closing sales prices of our common stock were $3.87 and $1.98, respectively. A number of factors could cause the price of our common stock to continue to fluctuate substantially, including:

actual or anticipated fluctuations in our quarterly or annual operating results;

changes in expectations about our future financial performance or changes in financial estimates of securities analysts;

announcements of technological innovations by us or our competitors;

new product introduction by us or our competitors;

large customer orders or order cancellations; and

the operating and stock price performance of comparable companies.

In addition, the stock market in general has experienced extreme volatility that often has been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the trading price of our common stock, regardless of our actual operating performance.

We have adopted certain anti-takeover measures that may make it more difficult for a third party to acquire us.

Our board of directors has the authority to issue up to 2,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of shares of preferred stock, while potentially providing desirable flexibility in connection with possible acquisitions and for other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. We have no present intention to issue shares of preferred stock.

We have adopted a preferred stock purchase rights plan intended to guard against certain takeover tactics. The adoption of this plan was not in response to any proposal to acquire us, and the board is not aware of any such effort. The existence of this plan could also have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. In addition, certain provisions of our certificate of incorporation may have the effect of delaying or preventing a change of control, which could adversely affect the market price of our common stock.

In addition, provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a merger, acquisition or change of control of us, or changes in our management, including:

the division of our board of directors into three separate classes, each with three year terms;

the right of our board to elect a director to fill a space created by a board vacancy or the expansion of the board;

the ability of our board to alter our bylaws;

the ability of our board to authorize the issuance of up to 2,000,000 shares of blank check preferred stock; and

the requirement that only our board or the holders of at least 10% of our outstanding shares may call a special meeting of our stockholders.

Furthermore, because we are incorporated in Delaware, we are subject to the provisions of Section 203 of the Delaware General Corporation Law. These provisions prohibit large stockholders, in particular those owning 15% or more of the outstanding voting stock, from consummating a merger or combination with a corporation unless:

$66^{2}/_{3}$% of the shares of voting stock not owned by these large stockholders approve the merger or combination, or

the board of directors approves the merger or combination or the transaction which resulted in the large stockholder owning 15% or more of our outstanding voting stock.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

a. Exhibits

Exhibit Number	Description
3.1(1)	Restated Certificate of Incorporation
3.2(2)	Certificate of Designation, Preferences and Rights of Series A Preferred Stock
3.3(3)	Second Amended and Restated Bylaws
3.4(4)	Certificate of Amendment to the Restated Certificate of Incorporation
4.2(5)	Rights Agreement dated April 24, 2001 by and between AXT, Inc. and ComputerShare Trust Company, Inc.
31.1	Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2	Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to the exhibit of the same number filed with the SEC with our Annual Report on Form 10-K for the year ended December 31, 1998.

(2) Incorporated by reference to Exhibit 2.1 to registrant s Form 8-K filed with the SEC on June 14, 1999.

(3) Incorporated by reference to Exhibit 3.4 to registrant s Form 8-K filed with the SEC on May 30, 2001.

(4) Incorporated by reference to Exhibit 3.4 to registrant s Form 10-Q filed with SEC on August 5, 2004.

(5) Incorporated by reference to the exhibit as of the same number as filed with the SEC in our Form 8-K on May 30, 2001.

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.

AXT, INC.

Dated: May 12, 2006

By: /s/ Philip C. S. Yin
Philip C. S. Yin
Chief Executive Officer
(Principal Executive Officer)

/s/ Wilson W. Cheung
Wilson W. Cheung
Chief Financial Officer
(Principal Financial and Accounting Officer)

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