

INFINERA CORP  
Form 10-Q  
May 03, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 26, 2011

OR

.. **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: 001-33486

**Infinera Corporation**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

169 Java Drive

77-0560433  
(IRS Employer  
Identification No.)

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Sunnyvale, CA 94089

(Address of principal executive offices, including zip code)

(408) 572-5200

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

As of April 28, 2011, 104,543,311 shares of the registrant's Common Stock, \$0.001 par value, were issued and outstanding.

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**INFINERA CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE FISCAL QUARTER ENDED MARCH 26, 2011**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****INFINERA CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except par values)****(Unaudited)**

|  | <b>March 26,<br/>2011</b> | <b>December 25,<br/>2010</b> |
|--|---------------------------|------------------------------|
| <b>ASSETS</b>                              |                           |                              |
| Current assets:                            |                           |                              |
| Cash and cash equivalents                  | \$ 111,352                | \$ 113,649                   |
| Short-term investments                     | 163,850                   | 168,013                      |
| Short-term restricted cash                 | 1,690                     | 1,856                        |
| Accounts receivable                        | 60,923                    | 75,931                       |
| Other receivables                          | 1,829                     | 4,420                        |
| Inventories, net                           | 78,331                    | 81,893                       |
| Deferred inventory costs                   | 5,737                     | 6,715                        |
| Prepaid expenses and other current assets  | 12,959                    | 9,118                        |
| <b>Total current assets</b>                | <b>436,671</b>            | <b>461,595</b>               |
| Property, plant and equipment, net         | 56,431                    | 51,740                       |
| Deferred inventory costs, non-current      | 3,686                     | 2,512                        |
| Long-term investments                      | 7,897                     | 9,953                        |
| Cost-method investment                     | 4,500                     | 4,500                        |
| Long-term restricted cash                  | 2,334                     | 2,235                        |
| Deferred tax asset                         | 8,982                     | 11,882                       |
| Other non-current assets                   | 5,831                     | 7,108                        |
| <b>Total assets</b>                        | <b>\$ 526,332</b>         | <b>\$ 551,525</b>            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |                           |                              |
| Current liabilities:                       |                           |                              |
| Accounts payable                           | \$ 28,015                 | \$ 35,658                    |
| Accrued expenses                           | 18,352                    | 19,790                       |
| Accrued compensation and related benefits  | 11,969                    | 25,098                       |
| Accrued warranty                           | 4,677                     | 5,696                        |
| Deferred revenue                           | 22,536                    | 21,958                       |
| Deferred tax liability                     | 8,982                     | 11,882                       |
| <b>Total current liabilities</b>           | <b>94,531</b>             | <b>120,082</b>               |
| Accrued warranty, non-current              | 5,483                     | 5,726                        |
| Deferred revenue, non-current              | 4,040                     | 4,633                        |
| Other long-term liabilities                | 10,138                    | 10,335                       |
| Commitments and contingencies (Note 13)    |                           |                              |

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|  |            |            |
|--|------------|------------|
| Stockholders' equity:  |            |            |
| Preferred stock, \$0.001 par value   |            |            |
| Authorized shares 25,000 and no shares issued and outstanding                                  |            |            |
| Common stock, \$0.001 par value  |            |            |
| Authorized shares 500,000 as of March 26, 2011 and December 25, 2010                           |            |            |
| Issued and outstanding shares 104,042 as of March 26, 2011 and 102,492 as of December 25, 2010 | 104        | 102        |
| Additional paid-in capital   | 834,684    | 817,200    |
| Accumulated other comprehensive loss   | (962)      | (1,261)    |
| Accumulated deficit  | (421,686)  | (405,292)  |
| <br>   |            |            |
| Total stockholders' equity   | 412,140    | 410,749    |
| <br>   |            |            |
| Total liabilities and stockholders' equity   | \$ 526,332 | \$ 551,525 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**INFINERA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

|  | Three Months Ended |                    |
|--|--------------------|--------------------|
|  | March 26,<br>2011  | March 27,<br>2010  |
| Revenue:   |                    |                    |
| Product  | \$ 82,528          | \$ 86,167          |
| Ratable product and related support and services   | 922                | 1,614              |
| Services   | 9,440              | 7,979              |
| <b>Total revenue</b>   | <b>92,890</b>      | <b>95,760</b>      |
| Cost of revenue:   |                    |                    |
| Cost of product  | 46,618             | 55,440             |
| Cost of ratable product and related support and services                                     | 385                | 755                |
| Cost of services   | 3,143              | 2,542              |
| Restructuring credit related to cost of revenue  |                    | (93)               |
| <b>Total cost of revenue</b>   | <b>50,146</b>      | <b>58,644</b>      |
| Gross profit   | 42,744             | 37,116             |
| Operating expenses:  |                    |                    |
| Research and development   | 31,309             | 28,483             |
| Sales and marketing  | 13,935             | 13,037             |
| General and administrative   | 13,509             | 15,737             |
| Restructuring and other costs  |                    | 161                |
| <b>Total operating expenses</b>  | <b>58,753</b>      | <b>57,418</b>      |
| <b>Loss from operations</b>  | <b>(16,009)</b>    | <b>(20,302)</b>    |
| Other income (expense), net:   |                    |                    |
| Interest income  | 312                | 485                |
| Other gain (loss), net   | (411)              | (316)              |
| <b>Total other income (expense), net</b>   | <b>(99)</b>        | <b>169</b>         |
| <b>Loss before income taxes</b>  | <b>(16,108)</b>    | <b>(20,133)</b>    |
| Provision for (benefit from) income taxes  | 286                | (142)              |
| <b>Net loss</b>  | <b>\$ (16,394)</b> | <b>\$ (19,991)</b> |
| <b>Net loss per common share, basic and diluted</b>  | <b>\$ (0.16)</b>   | <b>\$ (0.21)</b>   |
| <b>Weighted average shares used in computing basic and diluted net loss per common share</b> | <b>103,426</b>     | <b>97,276</b>      |

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The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****INFINERA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

|   | <b>Three Months Ended</b> |                           |
|---|---------------------------|---------------------------|
|   | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| <b>Cash Flows from Operating Activities:</b>  |                           |                           |
| Net loss  | \$ (16,394)               | \$ (19,991)               |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                           |                           |
| Depreciation and amortization   | 4,215                     | 3,983                     |
| Amortization of premium on investments  | 987                       | 540                       |
| Stock-based compensation expense  | 12,365                    | 12,910                    |
| Unrealized loss on Put Rights   |                           | 2,104                     |
| Unrealized holding gain for trading securities  |                           | (2,104)                   |
| Non-cash tax benefit  | (78)                      | (270)                     |
| Loss (gain) on disposal of assets   | (104)                     | 60                        |
| Other gain  | (19)                      | (25)                      |
| Changes in assets and liabilities:  |                           |                           |
| Accounts receivable   | 18,897                    | 11,028                    |
| Inventories, net  | 3,986                     | (3,209)                   |
| Prepaid expenses and other current assets   | (3,357)                   | (708)                     |
| Deferred inventory costs  | (278)                     | (1,555)                   |
| Other non-current assets  | 4,482                     | 1,627                     |
| Accounts payable  | (8,750)                   | 2,624                     |
| Accrued liabilities and other expenses  | (15,528)                  | (6,502)                   |
| Deferred revenue  | (16)                      | 2,254                     |
| Accrued warranty  | (1,262)                   | (489)                     |
| Net cash provided by (used in) operating activities                                       | (854)                     | 2,277                     |
| <b>Cash Flows from Investing Activities:</b>  |                           |                           |
| Purchase of available-for-sale investments  | (107,049)                 | (75,656)                  |
| Proceeds from sale of available-for-sale investments                                      | 3,035                     |                           |
| Proceeds from maturities and calls of investments   | 109,416                   | 68,598                    |
| Proceeds from disposal of assets  | 104                       | 85                        |
| Purchase of property and equipment  | (10,602)                  | (4,692)                   |
| Advance to secure manufacturing capacity  | (1,500)                   |                           |
| Reimbursement of manufacturing capacity advance   | 75                        |                           |
| Change in restricted cash   | 68                        | 99                        |
| Net cash used in investing activities   | (6,453)                   | (11,566)                  |
| <b>Cash Flows from Financing Activities:</b>  |                           |                           |
| Proceeds from issuance of common stock  | 4,909                     | 4,397                     |
| Repurchase of common stock  |                           | (2)                       |
| Payments for purchase of assets under financing arrangement                               | (87)                      | (87)                      |
| Net cash provided by financing activities   | 4,822                     | 4,308                     |
| Effect of exchange rate changes on cash   | 188                       | (61)                      |



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|  |            |            |
|--|------------|------------|
| Net change in cash and cash equivalents          | (2,297)    | (5,042)    |
| Cash and cash equivalents at beginning of period | 113,649    | 109,859    |
| Cash and cash equivalents at end of period       | \$ 111,352 | \$ 104,817 |

### Supplemental disclosures of cash flow information:

|                            |        |        |
|----------------------------|--------|--------|
| Cash paid for income taxes | \$ 442 | \$ 335 |
|----------------------------|--------|--------|

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****1. Basis of Presentation**

Infinera Corporation (Infinera or the Company) prepared its interim condensed consolidated financial statements that accompany these notes in conformity with U.S. generally accepted accounting principles (U.S. GAAP) and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC), consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the fiscal year ended December 25, 2010.

The Company has made estimates and judgments affecting the amounts reported in its condensed consolidated financial statements and the accompanying notes. The Company's actual results may differ materially from these estimates. The accounting estimates that require most significant, difficult, and subjective judgment include revenue recognition, stock-based compensation, inventory valuation, allowance for doubtful accounts, accrued warranty, cash equivalents, short-term and long-term investments, fair value measurement of investments, other-than-temporary impairments and accounting for income taxes.

The interim financial information is unaudited, but reflects all normal adjustments that are, in management's opinion, necessary to provide a fair statement of results for the interim periods presented. The Company reclassified certain amounts reported in previous periods to conform to the current presentation. This interim information should be read in conjunction with the consolidated financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended December 25, 2010.

**2. Significant Accounting Policies**

There have been no material changes in the Company's significant accounting policies for the three months ended March 26, 2011 as compared to those disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 25, 2010.

**3. Fair Value Measurements and Other-Than-Temporary Impairments ( OTTI )*****Fair Value Measurements***

Pursuant to the accounting guidance for fair value measurements and its subsequent updates, fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

Valuation techniques used by the Company are based upon observable and unobservable inputs. Observable or market inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions about market participant assumptions based on best information available. Observable inputs are the preferred source of values. These two types of inputs create the following fair value hierarchy:

|         |  |
|---------|--|
| Level 1 | Quoted prices in active markets for identical assets or liabilities.   |
| Level 2 | Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. |
| Level 3 | Prices or valuations that require management inputs that are both significant to the fair value measurement and unobservable.  |

The Company measures its cash equivalents, derivative instruments and debt securities at fair value and classifies its securities in accordance with the fair value hierarchy. The Company's money market funds are classified within Level 1 of the fair value hierarchy and are valued based

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on quoted prices in active markets for identical securities.

The Company classifies its certificates of deposit, commercial paper, corporate bonds and derivative instruments within Level 2 of the fair value hierarchy as follows:

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**INFINERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Certificates of Deposit*

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day. In the absence of any observable market transactions for a particular security, the fair market value at period end would be equal to the par value. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data, and result in the classification of these securities as Level 2 of the fair value hierarchy.

*Commercial Paper*

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level 2 of the fair value hierarchy.

*Corporate Bonds*

The Company reviews trading activity and pricing for each of the corporate bond securities in its portfolio as of the measurement date and determines if pricing data of sufficient frequency and volume in an active market exists in order to support Level 1 classification of these securities. Since sufficient quoted pricing for identical securities is not available, the Company obtains market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, the Company classifies its corporate bonds as Level 2 of the fair value hierarchy.

*Foreign Currency Exchange Forward Contracts*

As discussed in Note 5, *Derivative Instruments*, to the Notes to Condensed Consolidated Financial Statements, the Company mainly holds non-speculative foreign exchange forward contracts to hedge certain foreign currency exchange exposures. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, credit risk, foreign exchange rates, and forward and spot prices for currencies. As a result, the Company classifies its derivative instruments as Level 2 of the fair value hierarchy.

The Company classifies its auction rate securities (ARS) within Level 3 of the fair value hierarchy.

The Company's ARS are classified within Level 3 because they are valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. Uncertainties in the credit markets have affected all of the Company's ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for the Company's ARS, the Company used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, the Company performed its own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of March 26, 2011, and therefore incorporated both valuations in the Company's fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the Company's ARS, as of March 26, 2011, are as follows:

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### Contractual cash flow

The model assumed that the principal amount or par value for these securities will be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then-current U.S. Treasury Bill rate adjusted for a failed auction premium of 150 basis points ( bps ) for A3 rated securities and 150 bps to 350 bps for AAA rated securities.

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The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then adjusted by a factor that ranged from 230 bps to 370 bps, representing an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and credit risk associated with these securities. As of March 26, 2011, the Company held \$5.0 million (par value) of AAA rated securities and \$3.7 million (par value) of A3 rated securities. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer's credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. The Company's valuation analysis indicates that the estimated credit risk element included in the discount rate was 210 bps for A3 rated securities and 300 bps for AAA rated securities.

**Estimated maturity**

The Company estimated the workout period of its ARS as the weighted-average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, the Company used the weighted-average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date was 15.1 years and 17.4 years.

The following tables represent the Company's fair value hierarchy for its assets and liabilities measured at fair value on a recurring basis (in thousands):

|   | As of March 26, 2011 |                   |                 |                   | As of December 25, 2010 |                   |                 |                   |
|---|----------------------|-------------------|-----------------|-------------------|-------------------------|-------------------|-----------------|-------------------|
|   | Level 1              | Level 2           | Level 3         | Total             | Level 1                 | Level 2           | Level 3         | Total             |
| <b>Assets</b>                               |                      |                   |                 |                   |                         |                   |                 |                   |
| Money market funds                          | \$ 41,025            | \$                | \$              | \$ 41,025         | \$ 37,010               | \$                | \$              | \$ 37,010         |
| Certificates of deposit                     |                      | 240               |                 | 240               |                         | 240               |                 | 240               |
| Commercial paper                            |                      | 68,403            |                 | 68,403            |                         | 82,415            |                 | 82,415            |
| Corporate bonds                             |                      | 101,781           |                 | 101,781           |                         | 90,620            |                 | 90,620            |
| ARS   |                      |                   | 7,897           | 7,897             |                         |                   | 7,790           | 7,790             |
| Foreign currency exchange forward contracts |                      | 49                |                 | 49                |                         | 303               |                 | 303               |
| <b>Total assets</b>                         | <b>\$ 41,025</b>     | <b>\$ 170,473</b> | <b>\$ 7,897</b> | <b>\$ 219,395</b> | <b>\$ 37,010</b>        | <b>\$ 173,578</b> | <b>\$ 7,790</b> | <b>\$ 218,378</b> |
| <b>Liabilities</b>                          |                      |                   |                 |                   |                         |                   |                 |                   |
| Foreign currency exchange forward contracts | \$                   | \$ 86             | \$              | \$ 86             | \$                      | \$ 74             | \$              | \$ 74             |
| <b>Total liabilities</b>                    | <b>\$</b>            | <b>\$ 86</b>      | <b>\$</b>       | <b>\$ 86</b>      | <b>\$</b>               | <b>\$ 74</b>      | <b>\$</b>       | <b>\$ 74</b>      |

During the three months ended March 26, 2011, there were no transfers of assets or liabilities between Level 1 and Level 2 and there were no transfers into or out of Level 3 financial assets. The following tables present a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable (Level 3) inputs (in thousands):

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|     |                    | Three Months Ended   |   |                         |                   |
|-----|--------------------|----------------------|---|-------------------------|-------------------|
|     |                    | December 25,<br>2010 | Total Net Gains<br>Included in<br>Other<br>Comprehensive Loss | Calls                   | March 26,<br>2011 |
| ARS | available-for-sale | \$ 7,790             | \$ 235 <sup>(1)</sup>   | \$ (128) <sup>(2)</sup> | \$ 7,897          |

<sup>(1)</sup> Amount represents the change in the non-credit loss related OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

<sup>(2)</sup> Amount represents the fair market value of the securities called. Realized gains on these calls for the three months ended March 26, 2011 were immaterial.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

|                          | December<br>26, 2009 | Other Income<br>(Expense), Net | Three Months Ended<br>Total Net Gains (Losses) Included<br>In |                         | March 27,<br>2010 |
|--------------------------|----------------------|--------------------------------|---|-------------------------|-------------------|
|                          |                      |                                | Other Comprehensive<br>Loss                                   | Calls                   |                   |
| ARS - available-for-sale | \$ 7,671             | \$                             | \$ 504 <sup>(3)</sup>   | \$ (154) <sup>(4)</sup> | \$ 8,021          |
| ARS - trading securities | 49,911               | 2,104 <sup>(1)</sup>           |   | (4,443) <sup>(4)</sup>  | 47,572            |
| Put Rights               | 10,864               | (2,104) <sup>(2)</sup>         |   | (1,007) <sup>(4)</sup>  | 7,753             |
| Total                    | \$ 68,446            | \$                             | \$ 504  | \$ (5,604)              | \$ 63,346         |

(1) Unrealized holding gains for ARS trading securities were included in Other gain (loss), net in the accompanying condensed consolidated statements of operations.

(2) Amount represents the decrease in fair value of the Put Rights recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

(3) Amount represents the change in the non-credit loss related to OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

(4) Amount represents the fair market value of the securities called and the related Put Rights. Realized gains on these calls for the three months ended March 27, 2010 were immaterial.

Investments at fair value were as follows (in thousands):

|                                      | Adjusted<br>Amortized<br>Cost | Non-credit<br>OTTI | March 26, 2011               |                               | Fair Value           |
|--------------------------------------|-------------------------------|--------------------|------------------------------|-------------------------------|----------------------|
|                                      |                               |                    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                      |
| Money market funds                   | \$ 41,025                     | \$                 | \$                           | \$                            | \$ 41,025            |
| Certificates of deposit              | 240                           |                    |                              |                               | 240                  |
| Commercial paper                     | 68,404                        |                    | 7                            | (8)                           | 68,403               |
| Corporate bonds                      | 101,859                       |                    | 15                           | (93)                          | 101,781              |
| ARS                                  | 7,762 <sup>(1)</sup>          | (58)               | 193                          |                               | 7,897 <sup>(2)</sup> |
| Total available-for-sale investments | \$ 219,290                    | \$ (58)            | \$ 215                       | \$ (101)                      | \$ 219,346           |

|                                      | Adjusted<br>Amortized<br>Cost | Non-credit<br>OTTI | December 25, 2010            |                               | Fair Value           |
|--------------------------------------|-------------------------------|--------------------|------------------------------|-------------------------------|----------------------|
|                                      |                               |                    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                      |
| Money market funds                   | \$ 37,010                     | \$                 | \$                           | \$                            | \$ 37,010            |
| Certificates of deposit              | 240                           |                    |                              |                               | 240                  |
| Commercial paper                     | 82,428                        |                    | 4                            | (17)                          | 82,415               |
| Corporate bonds                      | 90,644                        |                    | 8                            | (32)                          | 90,620               |
| ARS                                  | 7,893 <sup>(1)</sup>          | (103)              |                              |                               | 7,790 <sup>(2)</sup> |
| Total available-for-sale investments | \$ 218,215                    | \$ (103)           | \$ 12                        | \$ (49)                       | \$ 218,075           |



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- (1) Amount represents the par value less \$1.0 million of credit-related OTTI recognized through earnings in prior years.
- (2) Amount reflects investments in a continuous loss position for twelve months or longer.

As of March 26, 2011, the Company's available-for-sale investments in certificates of deposit, commercial paper and corporate bonds have a contractual maturity term of up to approximately one year, and ARS have contractual maturity terms of up to 34.7 years. Proceeds from maturities and calls of available-for-sale investments were \$109.4 million and \$68.6 million in the three months ended March 26, 2011 and March 27, 2010, respectively. Gross realized gains (losses) on short-term and long-term investments were immaterial for these periods. The specific identification method is used to account for gains and losses on available-for-sale investments.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Other-Than-Temporary Impairments***

As of March 26, 2011, the Company held \$8.7 million (par value) of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. During the second quarter of 2009, the Company determined that it did not intend to sell these securities and did not believe that it was more likely than not that it would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis, had occurred. This OTTI write-down was separated into an amount representing credit loss, which is recognized as Other gain (loss), net in the Company's condensed consolidated statements of operations, and an amount related to all other factors, which is recorded in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheets. In determining if a credit loss had occurred, the Company isolated the credit loss related portion of the discount rate used to derive the fair market value of the securities and applied this to the expected cash flows in order to determine the portion of the OTTI that was credit loss related. This credit loss related portion of the discount rate is based on the financial condition of the issuer, rating agency credit ratings for the security and credit related yield spreads on similar securities offered by the same issuer.

These ARS had a net increase in fair value of \$0.2 million for the three months ended March 26, 2011. This change was recognized in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheets. The Company did not recognize any additional OTTI credit loss on any of its securities during the three months ended March 26, 2011. During the three months ended March 26, 2011, \$0.2 million of these ARS were called at par value.

A roll-forward of amortized cost, cumulative OTTI recognized in earnings and Accumulated other comprehensive loss is as follows (in thousands):

|                              | Amortized<br>Cost | Cumulative<br>OTTI in<br>Earnings | Unrealized<br>Gain | OTTI Loss<br>in<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) |
|------------------------------|-------------------|-----------------------------------|--------------------|--|---|
| Balance at December 25, 2010 | \$ 7,893          | \$ (958)                          | \$ 1,286           | \$ (1,389)   | \$ (103)  |
| Unrealized gain              |                   |                                   | 235                |  | 235   |
| Call on investments          | (131)             | 19                                | (16)               | 19   | 3   |
| Balance at March 26, 2011    | \$ 7,762          | \$ (939)                          | \$ 1,505           | \$ (1,370)   | \$ 135  |

The Company believes that the credit risk associated with its available-for-sale ARS could change significantly in the future based on market conditions and continued uncertainties in the financial markets. The ARS student loan credit spread may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in the ARS student loan credit spread would result in an increase of \$0.2 million in the credit loss related portion of the OTTI for the first quarter of 2011.

**4. Cost-method Investment**

In May 2010, the Company invested \$4.5 million in a privately-held company. This investment is accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant influence over operating and financial policies of the entity. The Company's investment is in an entity that is not publicly traded and, therefore, no established market for the securities exists. The Company's cost-method investment is carried at historical cost in its condensed consolidated financial statements and measured at fair value on a nonrecurring basis. If the Company believes that the carrying value of the cost basis investment is in excess of estimated fair value, the Company's policy is to record an impairment charge in Other income (expense), net in the accompanying condensed consolidated statements of operations to adjust the carrying value to estimated fair value, when the impairment is deemed

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other-than-temporary. The Company regularly evaluates the carrying value of this cost-method investment for impairment. As of March 26, 2011, no event had occurred that would adversely affect the carrying value of this investment. The Company did not record any impairment charges for this cost-method investment during the first quarter of 2011.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Derivative Instruments*****Foreign Currency Exchange Forward Contracts***

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivables, and therefore, do not subject the Company to material balance sheet risk. The forward contracts are with one high-quality institution and the Company consistently monitors the creditworthiness of the counterparty. The forward contracts entered into during the first quarter of 2011 were denominated in Euros and typically had maturities of no more than 30 days. The contracts were settled for U.S. dollars at maturity at rates agreed to at inception of the contracts. As of March 26, 2011, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes, and accordingly changes in the fair value of these instruments are included in Other gain (loss), net in the accompanying condensed consolidated statements of operations. For the three months ended March 26, 2011 and March 27, 2010, the before-tax effect of foreign currency exchange forward contracts for Euro denominated receivables not designated as hedging instruments was a loss of \$1.5 million and a gain of \$0.9 million, respectively, included in Other gain (loss), net in the condensed consolidated statement of operations.

The Company also enters into foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. Prior to December 25, 2010, these contracts were designated as cash flow hedges, however, the Company ceased hedge accounting prospectively at the end of fiscal 2010 because it was no longer probable that the original forecasted transactions would occur within two months of the originally specified transaction dates. In the first quarter of 2011, the Company recognized a loss of \$0.3 million in Other gain (loss), net, from the change of fair value on the related open contracts.

The fair value of derivative instruments in the Company's condensed consolidated balance sheets was as follows (in thousands):

|   | As of March 26, 2011             |  |                                 | As of December 25, 2010          |  |                                 |
|---|----------------------------------|--|---------------------------------|----------------------------------|--|---------------------------------|
|   | Gross<br>Notional <sup>(1)</sup> | Prepaid<br>Expenses and<br>Other Current<br>Assets | Other<br>Accrued<br>Liabilities | Gross<br>Notional <sup>(1)</sup> | Prepaid<br>Expenses and<br>Other Current<br>Assets | Other<br>Accrued<br>Liabilities |
| Derivatives not designated as<br>hedging instruments: |                                  |  |                                 |                                  |  |                                 |
| Foreign currency exchange<br>forward contracts        | \$ 16,696                        | \$ 49  | \$ 86                           | \$ 26,365                        | \$ 303   | \$ 74                           |

<sup>(1)</sup> Represents the face amounts of forward contracts that were outstanding as of the period noted.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. Balance Sheet Details**

The following table provides details of selected balance sheet items (in thousands):

|   | March 26,<br>2011 | December 25,<br>2010 |
|---|-------------------|----------------------|
| <b>Inventories, net:</b>  |                   |                      |
| Raw materials   | \$ 20,130         | \$ 23,104            |
| Work in process   | 17,152            | 14,798               |
| Finished goods <sup>(1)</sup>                                   | 41,049            | 43,991               |
| <b>Total inventories, net</b>                                   | <b>\$ 78,331</b>  | <b>\$ 81,893</b>     |
| <b>Property, plant and equipment, net:</b>                      |                   |                      |
| Computer hardware   | \$ 7,952          | \$ 7,599             |
| Computer software   | 7,082             | 6,523                |
| Laboratory and manufacturing equipment                          | 96,733            | 92,474               |
| Furniture and fixtures  | 1,072             | 711                  |
| Leasehold improvements  | 25,010            | 22,549               |
| <b>Subtotal</b>   | <b>\$ 137,849</b> | <b>\$ 129,856</b>    |
| Less accumulated depreciation and amortization                  | (81,418)          | (78,116)             |
| <b>Total property, plant and equipment, net</b>                 | <b>\$ 56,431</b>  | <b>\$ 51,740</b>     |
| <b>Accrued expenses:</b>  |                   |                      |
| Loss contingency related to non-cancelable purchase commitments | \$ 3,160          | \$ 1,421             |
| Taxes payable   | 2,348             | 2,043                |
| Royalties   | 1,089             | 1,548                |
| Accrued rebate and customer prepay liability                    | 4,140             | 3,877                |
| Leasehold improvements accrual                                  | 771               | 3,686                |
| Other accrued expenses  | 6,844             | 7,215                |
| <b>Total accrued expenses</b>                                   | <b>\$ 18,352</b>  | <b>\$ 19,790</b>     |

<sup>(1)</sup> Included in finished goods inventory at March 26, 2011 and December 25, 2010 were \$2.5 million and \$9.0 million, respectively, of inventory at customer locations for which product acceptance had not occurred.

**7. Comprehensive Loss**

Total comprehensive loss consists of other comprehensive loss and net loss. Other comprehensive loss includes certain changes in equity that are excluded from net loss. Specifically, cumulative foreign currency translation adjustments and unrealized holding gains and losses on available-for-sale investments are included in Accumulated other comprehensive loss in the condensed consolidated balance sheets.

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

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|  | <b>March 26,<br/>2011</b> | <b>December 25,<br/>2010</b> |
|--|---------------------------|------------------------------|
| Accumulated net unrealized loss on foreign currency translation adjustment   | \$ (308)                  | \$ (490)                     |
| Accumulated unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments | (58)                      | (103)                        |
| Accumulated unrealized holding loss on all other available-for-sale investments                                    | (79)                      | (37)                         |
| Accumulated unrealized gain on auction rate securities   | 193                       |                              |
| Accumulated tax effect on items related to available-for-sale investments  | (710)                     | (631)                        |
| Total accumulated other comprehensive loss   | \$ (962)                  | \$ (1,261)                   |

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The following table reconciles net loss to comprehensive loss (in thousands):

|  | <b>Three Months Ended</b> |                           |
|--|---------------------------|---------------------------|
|  | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| Net loss   | \$ (16,394)               | \$ (19,991)               |
| Change in foreign currency translation gain (loss)   | 182                       | 80                        |
| Accumulated unrealized gain on cash flow hedges  |                           | 242                       |
| Change in unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments | 45                        | 525                       |
| Change in unrealized gain (loss) on all other available-for-sale investments                                     | (42)                      | (90)                      |
| Change in unrealized gain on auction rate securities   | 193                       |                           |
| Change in tax effect related to available-for-sale investments   | (79)                      | (270)                     |
| Total comprehensive loss   | \$ (16,095)               | \$ (19,504)               |

**8. Basic and Diluted Net Loss Per Common Share**

Basic net loss per common share is computed by dividing net loss by the weighted average number of vested common shares outstanding during the period. Diluted net loss per common share is computed using net loss and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options, assumed vesting of outstanding restricted stock units ( RSUs ) and performance stock units ( PSUs ), assumed exercise of outstanding warrants, and assumed issuance of stock under the employee stock purchase plan ( ESPP ) using the treasury stock method.

The following table sets forth the computation of net loss per basic and diluted share (in thousands, except per share amounts):

|  | <b>Three Months Ended</b> |                           |
|--|---------------------------|---------------------------|
|  | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| <b>Numerator:</b>                                  |                           |                           |
| Net loss   | \$ (16,394)               | \$ (19,991)               |
| <b>Denominator:</b>                                |                           |                           |
| Basic weighted average common shares outstanding   | 103,426                   | 97,276                    |
| Effect of dilutive securities:                     |                           |                           |
| Employee equity plans                              |                           |                           |
| Warrants to purchase common stock                  |                           |                           |
| Diluted weighted average common shares outstanding | 103,426                   | 97,276                    |
| Net loss per common share basic and diluted        | \$ (0.16)                 | \$ (0.21)                 |

The Company had the following equity awards outstanding that could potentially dilute basic net loss per common share in the future, but were excluded from the computation of diluted loss per common share in the periods presented as their effect would have been anti-dilutive (in thousands):

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|                                   | As of             |                   |
|-----------------------------------|-------------------|-------------------|
|                                   | March 26,<br>2011 | March 27,<br>2010 |
| Stock options                     | 9,777             | 10,992            |
| RSUs                              | 7,999             | 5,944             |
| PSUs                              | 2,682             | 3,304             |
| ESPP                              | 632               | 591               |
| Warrants to purchase common stock | 124               | 124               |
| Total                             | 21,214            | 20,955            |



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## INFINERA CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. Stockholders' Equity

*Equity Incentive Plans*

As of March 26, 2011, there were a total of 5.6 million shares available for grant under the Company's 2007 Equity Incentive Plan. The following tables summarize the Company's equity award activity and related information (in thousands, except per share data):

|   | Number of<br>Options | Weighted-<br>Average<br>Exercise<br>Price<br>Per Share | Aggregate<br>Intrinsic<br>Value |
|---|----------------------|--|---------------------------------|
| <b>Outstanding at December 25, 2010</b> | 7,815                | \$ 6.52  | \$ 30,923                       |
| Options granted                         | 2,170                | \$ 8.38  |                                 |
| Options exercised                       | (183)                | \$ 5.56  | \$ 705                          |
| Options canceled                        | (25)                 | \$ 11.70   |                                 |
| <b>Outstanding at March 26, 2011</b>    | 9,777                | \$ 6.94  | \$ 16,941                       |
| Vested and expected to vest             | 9,660                |  | \$ 16,902                       |

  

|   | Number of<br>Restricted<br>Stock Units | Weighted-<br>Average<br>Grant Date<br>Fair Value<br>Per Share | Aggregate<br>Intrinsic<br>Value |
|---|--|---|---------------------------------|
| <b>Outstanding at December 25, 2010</b> | 6,783                                  | \$ 9.03   | \$ 69,927                       |
| RSUs granted                            | 2,031                                  | \$ 8.38   |                                 |
| RSUs released                           | (763)                                  | \$ 8.36   | \$ 6,378                        |
| RSUs canceled                           | (52)                                   | \$ 9.37   |                                 |
| <b>Outstanding at March 26, 2011</b>    | 7,999                                  | \$ 8.93   | \$ 66,863                       |
| Expected to release                     | 7,484                                  |   | \$ 62,563                       |

  

|   | Number of<br>Performance<br>Stock Units | Weighted-<br>Average<br>Grant Date<br>Fair Value<br>Per Share | Aggregate<br>Intrinsic<br>Value |
|---|---|---|---------------------------------|
| <b>Outstanding at December 25, 2010</b> | 2,682                                   | \$ 10.51  | \$ 27,660                       |
| PSUs granted                            |   | \$  |                                 |
| PSUs released                           |   | \$  | \$                              |
| PSUs canceled                           |   | \$  |                                 |
| <b>Outstanding at March 26, 2011</b>    | 2,682                                   | \$ 10.51  | \$ 22,429                       |

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|                  |       |           |
|------------------|-------|-----------|
| Expected to vest | 2,593 | \$ 21,681 |
|------------------|-------|-----------|

The aggregate intrinsic value of unexercised options, unreleased RSUs and unreleased PSUs is calculated as the difference between the closing price of the Company's common stock of \$8.36 at March 25, 2011 and the exercise prices of the underlying equity awards. The aggregate intrinsic value of the options which have been exercised and RSUs released is calculated as the difference between the fair market value of the common stock at the date of exercise or release and the exercise price of the underlying equity awards.

### *Employee Stock Options*

During the first quarter of 2011, the Company granted options to employees to purchase an aggregate of 2.2 million shares of common stock at a weighted-average exercise price of \$8.38 per share. Options granted during this period have exercise prices equal to the closing market prices of the Company's common stock on the dates these options were granted. The weighted-average remaining contractual term of options exercisable was 6.3 years as of March 26, 2011. Amortization of stock-based compensation for

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the three months ended March 26, 2011 and March 27, 2010 was approximately \$3.2 million and \$3.9 million, respectively, net of estimated forfeitures.

As of March 26, 2011, the total stock-based compensation cost related to options granted but not yet amortized was \$20.4 million, net of estimated forfeitures of \$0.7 million. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 2.1 years. Total fair value of stock options granted to employees and members of the board of directors that vested during the three months ended March 26, 2011 was approximately \$2.7 million based on the grant date fair value.

In accordance with the Company's 2007 Equity Incentive Plan, the Company may grant performance-based stock options whose vesting is contingent upon meeting various individual and company-wide performance goals. Performance-based stock options are generally granted at-the-money and vest upon achievement of performance objectives. These options generally have contractual lives of 10 years.

During the first quarter of 2011, the Company granted 0.9 million shares of performance-based stock options to executive officers. The options have an exercise price of \$8.58 per share, equal to the closing price of the Company's common stock on the date of grant. The options will vest upon the achievement of the pre-determined performance goals within the established timeframes. If the performance goals are not met within the established timeframes, the total number of shares subject to vesting upon achievement of such performance goals will be canceled immediately and any recognized compensation cost will be reversed. The grant date fair value per share of the options has been calculated using the Black-Scholes option pricing model.

Excluding options granted in connection with the Company's one-time stock option exchange program, which occurred in fiscal 2010, the ranges of estimated values of stock options and performance-based stock options granted, as well as ranges of assumptions used in calculating these values were based on estimates as follows:

|  | <b>Three Months Ended</b> |                           |
|--|---------------------------|---------------------------|
|  | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| <b>Employee and Director Stock Options</b> |                           |                           |
| Volatility                                 | 58% - 60%                 | 60% - 61%                 |
| Risk-free interest rate                    | 2.1% - 2.6%               | 2.6% - 2.7%               |
| Expected life                              | 4.9 - 5.5 years           | 4.9 - 5.4 years           |
| Estimated fair value                       | \$4.17 - \$4.63           | \$3.62 - \$5.05           |
| <b>Employee Stock Purchase Plan</b>        |                           |                           |

Stock-based compensation costs related to the Company's ESPP were approximately \$0.9 million and \$0.7 million for the three months ended March 26, 2011 and March 27, 2010, respectively. The fair value of the ESPP shares was estimated at the date of grant using the following assumptions:

|                                     | <b>Three Months Ended</b> |                           |
|-------------------------------------|---------------------------|---------------------------|
|                                     | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| <b>Employee Stock Purchase Plan</b> |                           |                           |
| Volatility                          | 66%                       | 45%                       |
| Risk-free interest rate             | 0.2%                      | 0.2%                      |
| Expected life                       | 0.5 years                 | 0.5 years                 |
| Estimated fair value                | \$2.70                    | \$2.13                    |
| <b>Restricted Stock Units</b>       |                           |                           |

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During the first quarter of 2011, the Company granted RSUs to employees to receive an aggregate of 2.0 million shares of the Company's common stock, at no cost. The Company accounted for the fair value of the RSUs using the closing market price of the Company's common stock on the date of grant. Amortization of stock-based compensation related to RSUs in the three months ended March 26, 2011 and March 27, 2010 was approximately \$6.1 million and \$5.4 million, respectively. As of March 26, 2011, total stock-based compensation cost related to RSUs granted but not yet amortized was approximately \$50.6 million, net of estimated forfeitures of \$5.7 million. These costs will be amortized on a straight-line basis over a weighted-average period of 2.4 years.

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The number of shares to be issued upon vesting of PSUs range from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to the NASDAQ Composite Index over a three-year or four-year period. Amortization of stock-based compensation related to PSUs in the three months ended March 26, 2011 and March 27, 2010 was approximately \$2.4 million and \$2.8 million, respectively. As of March 26, 2011, total stock-based compensation cost related to PSUs granted to but not yet amortized was approximately \$10.7 million, net of estimated forfeitures of \$0.4 million. These costs will be amortized on a straight-line basis over a weighted-average period of 1.4 years.

**Common Stock Warrants**

As of March 26, 2011, there were warrants to purchase 0.1 million shares of common stock outstanding with exercise prices ranging from \$5.40 to \$8.96 per share and a weighted-average exercise price of \$6.30 per share. These warrants expire between June 2011 and July 2013.

**Stock-Based Compensation**

The following table summarizes the effects of stock-based compensation on the Company's condensed consolidated balance sheets and statements of operations for the periods presented (in thousands):

|   | <b>March 26,<br/>2011</b> | <b>December 25,<br/>2010</b> |
|---|---------------------------|------------------------------|
| Stock-based compensation effects in inventory                           | \$ 2,831                  | \$ 2,497                     |
| Stock-based compensation effects in deferred inventory cost             | \$ 294                    | \$ 287                       |
|   | <b>Three Months Ended</b> |                              |
|   | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b>    |
| <b>Stock-based compensation effects in net loss before income taxes</b> |                           |                              |
| Cost of revenue   | \$ 731                    | \$ 569                       |
| Research and development  | 3,826                     | 3,423                        |
| Sales and marketing   | 2,060                     | 1,847                        |
| General and administration  | 4,783                     | 5,709                        |
|   | 11,400                    | 11,548                       |
| Cost of revenue amortization from balance sheet <sup>(1)</sup>          | 965                       | 1,362                        |
| Total stock-based compensation expense                                  | \$ 12,365                 | \$ 12,910                    |

<sup>(1)</sup> Stock-based compensation expense deferred to inventory and deferred inventory costs in prior periods and recognized in the current period.

**10. Income Taxes**

Provision for income taxes for the three months ended March 26, 2011 was \$0.3 million, or negative 1.8%, on a pre-tax loss of \$16.1 million, compared to a tax benefit of \$0.1 million, or 0.1%, on a pre-tax loss of \$20.1 million for the three months ended March 27, 2010. The difference between our effective tax rates and the federal statutory rate of 35% is primarily attributable to unbenefited U.S. losses, foreign taxes provided

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on the income of our foreign subsidiaries, non-deductible stock-based compensation expense, and various discrete items. The higher effective tax rate in 2011 primarily relates to a greater proportion of foreign earnings taxed at a higher overall effective foreign tax rate due to the expiration of the Indian holiday benefits.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, the Company has

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provided a full valuation allowance against its domestic deferred tax assets, net of deferred tax liabilities, as of March 26, 2011 and December 25, 2010. In determining future taxable income, the Company makes assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the Company's forecasts used to manage its business. The Company intends to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

**11. Segment Information**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Company's chief executive officer. The Company's chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

Revenue by geographic region is based on the shipping address of the customer. The following tables set forth revenue and long-lived assets by geographic region (in thousands):

**Revenue**

|                                | <b>Three Months Ended</b> |                           |
|--------------------------------|---------------------------|---------------------------|
|                                | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| Americas:                      |                           |                           |
| United States                  | \$ 68,826                 | \$ 75,965                 |
| Other Americas                 | 663                       | 294                       |
|                                | \$ 69,489                 | \$ 76,259                 |
| Europe, Middle East and Africa | 20,272                    | 17,742                    |
| Asia Pacific                   | 3,129                     | 1,759                     |
| Total revenue                  | \$ 92,890                 | \$ 95,760                 |

**Property, plant and equipment, net**

|  | <b>March 26,<br/>2011</b> | <b>December 25,<br/>2010</b> |
|--|---------------------------|------------------------------|
| United States                            | \$ 54,020                 | \$ 49,186                    |
| Other Americas                           | 83                        | 49                           |
| Asia Pacific                             | 2,328                     | 2,505                        |
| Total property, plant and equipment, net | \$ 56,431                 | \$ 51,740                    |





**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. Guarantees***Product Warranties*

Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under hardware warranty. In general, hardware warranty periods range from one to five years. Hardware warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the warranty period, the purchaser's sole and exclusive remedy in the event of such defect or failure to perform is limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company's sole option and expense. The Company estimates its hardware warranty obligations based on the Company's historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company's recorded warranty liabilities and adjusts the amounts as necessary.

Activity related to product warranty was as follows (in thousands):

|   | <b>Three Months Ended</b> |                           |
|---|---------------------------|---------------------------|
|   | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
| Beginning balance                       | \$ 11,422                 | \$ 11,140                 |
| Charges to operations                   | 1,470                     | 3,164                     |
| Utilization                             | (1,763)                   | (2,228)                   |
| Change in estimate <sup>(1)</sup>       | (969)                     | (1,426)                   |
| <b>Balance at the end of the period</b> | <b>\$ 10,160</b>          | <b>\$ 10,650</b>          |

<sup>(1)</sup> The Company records hardware warranty liabilities based on the latest quality and cost information available as of that date. The favorable changes in estimate shown here are due to continued improvements in overall actual failure rates and the impact of these improvements on the Company's estimate of expected future returns and changes in the estimated cost of replacing failed units using either repaired or new units.

**13. Litigation and Contingencies***Legal Matters*

From time to time, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material effect on its consolidated financial position, results of operations, or cash flows. A complete description of the Company's legal proceedings can be found in Item 3. Legal Proceedings of Part I of the Company's Annual Report on Form 10-K for the fiscal year ended December 25, 2010 filed with the Securities and Exchange Commission on March 1, 2011, which is incorporated herein by reference. Any updates to the information contained in the Company's Annual Report on Form 10-K are set forth below.

*Cheetah Patent Infringement*

On March 30, 2011, Cheetah Omni LLC filed a motion re-urging the U.S. District Court for the Eastern District of Texas Texarkana Division to lift the stay, which the Company opposed on April 18, 2011.



**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues, gross margins, expenses or other financial items; any statements of the plans, strategies and objectives of management for future operations and personnel; factors that may affect our operating results; statements concerning new products or services, including future PIC capacity and new product delivery dates; statements related to capital expenditures; statements related to future economic conditions, performance, market growth or our sales cycle; statements related to the liquidity of our auction rate securities; statements related to the effects of litigation on our financial position, results of operations, or cash flows; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Form 10-Q and in our other SEC filings, including our annual report on Form 10-K for the fiscal year ended December 25, 2010 filed on March 1, 2011. Such forward-looking statements speak only as of the date of this report. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q.*

**Executive Overview**

Infinera was founded in December 2000 with a unique vision for optical networking. Prior to Infinera, service provider optical networks were built from fairly commoditized products, broadly known as dense wavelength division multiplexing ( DWDM ) systems. Recent rapid and unpredictable growth in bandwidth demand has increased the need for the delivery of high-capacity low-cost bandwidth throughout the network. We believe that traditional point-to-point network architectures do not provide the required flexibility. It takes large amounts of low-cost bandwidth, pervasive Optical Transport Network ( OTN ) switching, and the intelligence of bandwidth management to manage these larger networks and deliver high-capacity services quickly and cost-effectively. Infinera believes this can only be achieved with photonic integrated circuits ( PICs ) and that only through photonic integration can network operators scale their network bandwidth without significant increases in space, power or operational workload.

We first introduced our Digital Optical Network architecture to the market in 2005. This architecture is based on our unique PICs and enables high-capacity low-cost bandwidth in the cloud and distributed switching throughout the network. Since 2005, our strategy has been to extend the benefits of our Digital Optical Network throughout the optical networking market. We have made significant enhancements to our Digital Transport Node System ( DTN System ) during this time by increasing reach and fiber capacity for the long-haul market, adding the Infinera MTC, a 19-inch chassis option tailored for the metro core market, and adding a submarine version of the DTN System for the Submarine Line Terminating Equipment market. In addition, we launched our ATN metro access platform, extending Infinera's digital bandwidth management and intelligent network benefits to the network edge. Both the DTN and ATN Systems are designed to operate as a tightly-integrated network with a single management system providing an end-to-end Digital Optical Network experience.

**Future Business and Industry Trends**

Traffic patterns in the optical network continue to grow to accommodate increased bandwidth demand from video, mobility and cloud computing. The market is seeing growing demand for increased fiber capacity with networks migrating from the current 10 Gigabits per second ( Gbps ) wavelength solutions to 40Gbps solutions in the short-term and 100Gbps solutions in the longer-term. Infinera plans to launch a 100Gbps PIC-based platform in the fourth quarter of 2011 and begin shipments in the first half of 2012. This system will incorporate our 500Gbps PICs and our 5 Terabit OTN switch and will combine competitive fiber capacity with the unique features of the Digital Optical Network. To address the needs of customers who require higher fiber capacity in advance of the release of our 100Gbps system, we plan to introduce a non-PIC based 40Gbps solution that will increase the fiber capacity of the DTN System from 1.6 Terabits per second ( Tb/s ) to up to 6.4 Tb/s. We currently expect to introduce this system in the third quarter of 2011. We believe that it will be more cost-effective for customers to move to 100Gbps systems when these become broadly available as they will offer more favorable network economics.

We continue to extend our Digital Optical Network into the metro market with new releases of our ATN System and into the submarine market with a product extension of our DTN System. Our ATN System is a metro access platform that extends Infinera's



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digital bandwidth management and intelligent software operating system benefits to the network edge. Both the DTN System and ATN System are designed to operate as a tightly-integrated network with a single management system providing an end-to-end Digital Optical Network experience.

Our goal is to be a leading provider of optical networking systems to operators of optical networks, including telecom carriers, cable operators, internet or content service providers, and others. Our revenue growth will depend on the continued acceptance of our products, growth of communications traffic and the proliferation of next-generation bandwidth-intensive services, which are expected to drive the need for increased levels of bandwidth. Our ability to increase revenue and achieve profitability will be directly affected by the level of acceptance of our products in the long-haul and metro DWDM markets and by our ability to cost-effectively develop and sell innovative products that leverage our technology advantages on a time-to-market basis.

As of March 26, 2011, we have sold our network systems for deployment in the optical networks of 86 customers worldwide, including Cox Communications, Deutsche Telekom, Global Crossing, Interoute and Level 3. We currently have 26 ATN customers enjoying the benefits of an ATN network and 22 of those have deployed an integrated ATN-DTN solution. We do not have long-term sales commitments from our customers. To date, a few of our customers have accounted for a significant portion of our revenue. In particular, Level 3 accounted for approximately 14% and 22% of our revenue in the three months ended March 26, 2011 and March 27, 2010, respectively. As a result, our business will be harmed if any of our key customers, including Level 3, do not generate as much revenue as we forecast, stop purchasing from us, or substantially reduce their orders to us.

We are headquartered in Sunnyvale, California, with employees located throughout the Americas, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States and internationally to develop our products and provide additional geographic sales and technical support coverage. We primarily sell our products through our direct sales force, with a small portion sold indirectly through resellers. We derived 96% and 97% of our revenue from direct sales to customers for the three months ended March 26, 2011 and March 27, 2010, respectively. We expect to continue generating a substantial majority of our revenue from direct sales in the future.

Our near-term year-over-year and quarter-over-quarter growth in revenue will likely be volatile and may be impacted by several factors including general economic and market conditions, time-to-market development of new products, acquisitions of new customers and the timing of large product deployments.

We will continue to make significant investments in the business, and management currently believes that operating expenses for 2011 will range from \$249 million to \$256 million, including stock-based compensation expense in the range of \$45 million to \$48 million.

## **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our condensed consolidated financial statements, which we have prepared in accordance with U.S. GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Management believes that there have been no significant changes during the three months ended March 26, 2011 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 25, 2010.

**Table of Contents****Results of Operations**

The following sets forth, for the periods presented, certain unaudited condensed consolidated statements of operations information (in thousands, except %):

|  | March 26,<br>2011 | Three Months Ended<br>% of total<br>revenue | March 27,<br>2010 | % of total<br>revenue |
|--|-------------------|---|-------------------|-----------------------|
| <b>Revenue:</b>                                  |                   |   |                   |                       |
| Product  | \$ 82,528         | 89%   | \$ 86,167         | 90%                   |
| Ratable product and related support and services | 922               | 1%  | 1,614             | 2%                    |
| Services   | 9,440             | 10%   | 7,979             | 8%                    |
| <b>Total revenue</b>                             | <b>\$ 92,890</b>  | <b>100%</b>                                 | <b>\$ 95,760</b>  | <b>100%</b>           |
| <b>Cost of revenue:</b>                          |                   |   |                   |                       |
| Product  | \$ 46,618         | 50%   | \$ 55,440         | 58%                   |
| Ratable product and related support and services | 385               | 1%  | 755               | 1%                    |
| Services   | 3,143             | 3%  | 2,542             | 2%                    |
| Restructuring credit related to cost of revenue  |                   | %   | (93)              | %                     |
| <b>Total cost of revenue</b>                     | <b>\$ 50,146</b>  | <b>54%</b>                                  | <b>\$ 58,644</b>  | <b>61%</b>            |
| <b>Gross profit</b>                              | <b>\$ 42,744</b>  | <b>46%</b>                                  | <b>\$ 37,116</b>  | <b>39%</b>            |

The following table summarizes our revenue by geography and sales channel for the periods presented (in thousands, except %):

|                                       | March 26,<br>2011 | Three Months Ended<br>March 27,<br>2010 |
|---------------------------------------|-------------------|---|
| <b>Total revenue by geography</b>     |                   |   |
| Domestic                              | \$ 68,826         | \$ 75,965                               |
| International                         | 24,064            | 19,795                                  |
|                                       | \$ 92,890         | \$ 95,760                               |
| <b>% Revenue by geography</b>         |                   |   |
| Domestic                              | 74%               | 79%                                     |
| International                         | 26%               | 21%                                     |
|                                       | 100%              | 100%                                    |
| <b>Total revenue by sales channel</b> |                   |   |
| Direct                                | \$ 88,814         | \$ 93,292                               |
| Indirect                              | 4,076             | 2,468                                   |
|                                       | \$ 92,890         | \$ 95,760                               |
| <b>% Revenue by sales channel</b>     |                   |   |
| Direct                                | 96%               | 97%                                     |
| Indirect                              | 4%                | 3%                                      |

**Revenue**

Total revenue decreased to \$92.9 million for the first quarter of 2011 from \$95.8 million for the corresponding period in 2010 primarily due to a reduction in new footprint deployments with new and existing customers.

International revenue increased to 26% of total revenue in the first quarter of 2011 from 21% of total revenue in the corresponding period in 2010. While we expect international revenues to continue to grow in absolute dollars on a long-term basis as we increase our sales activities in Europe, Asia Pacific and other regions, this metric may fluctuate as a percentage of total revenue depending on the size and timing of deployments both internationally and in the United States.

Total product revenue decreased to \$82.5 million for first quarter of 2011 from \$86.2 million for the corresponding period in 2010. Product and related support services revenue that is recognized ratably includes sales of products and services that were deferred under previous accounting standards, prior to our adoption of ASU 2009-13 and ASU 2009-14 as further discussed in Note 3, Summary of Significant Accounting Policies, to the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K filed on March 1, 2011, because vendor specific objective evidence of fair value had not been established for the undelivered elements. Total ratable revenue levels decreased to \$0.9 million for the three months ended March 26, 2011 from \$1.6 million for the corresponding period in 2010 primarily due to the recognition of the previously deferred ratable product revenue.

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Total services revenue increased to \$9.4 million for the first quarter of 2011 from \$8.0 million for the corresponding period in 2010 primarily reflecting the incremental recognition of \$1.0 million of extended hardware warranty revenue, \$0.6 million of software subscription revenue and \$0.3 million of spares management services revenue. These increases were partially offset by a \$0.6 million decrease in deployment services revenue. We expect to continue to grow our extended hardware warranty and spares management services revenues in future periods.

We do not have visibility necessary to accurately predict future revenues beyond a one-quarter time horizon. However, we believe that we will continue to be competitively disadvantaged in regard to fiber capacity until our 40Gbps solution is released in the third quarter of 2011. We expect that this will negatively impact revenues in 2011.

**Cost of Revenue and Gross Margin**

Gross margin increased to 46% in the first quarter of 2011 from 39% in the corresponding period in 2010 primarily reflecting a higher proportion of revenue coming from our higher gross margin Tributary Adaptor Modules ( TAM ) and line modules in the first quarter of 2011. We expect this increased level of TAM shipments to continue in the second quarter of 2011, however, this positive impact will be offset by the effects of increased sales of lower margin common equipment and increased pricing pressure as we compete for new footprint deployments.

**Operating Expenses**

The following table summarizes our operating expenses for the periods presented (in thousands):

|                               | March 26,<br>2011 | Three Months Ended<br>% of total<br>revenue | March 27,<br>2010 | % of total<br>revenue |
|-------------------------------|-------------------|---|-------------------|-----------------------|
| Operating expenses:           |                   |   |                   |                       |
| Research and development      | \$ 31,309         | 34%   | \$ 28,483         | 30%                   |
| Sales and marketing           | 13,935            | 15%   | 13,037            | 14%                   |
| General and administrative    | 13,509            | 14%   | 15,737            | 16%                   |
| Restructuring and other costs |                   | %   | 161               | %                     |
| Total operating expenses      | \$ 58,753         | 63%   | \$ 57,418         | 60%                   |

The following table summarizes the stock-based compensation expense included in our operating expenses (in thousands):

|                            | Three Months Ended<br>March 26,<br>2011 | March 27,<br>2010 |
|----------------------------|---|-------------------|
| Research and development   | \$ 3,826                                | \$ 3,423          |
| Sales and marketing        | 2,060                                   | 1,847             |
| General and administration | 4,783                                   | 5,709             |
| Total                      | \$ 10,669                               | \$ 10,979         |

**Research and Development Expenses**

Research and development expenses increased by \$2.8 million in the first quarter of 2011 compared to the corresponding period in 2010 primarily due to increased headcount and personnel-related costs of \$1.6 million comprised of \$1.2 million of cash compensation and \$0.4 million of stock-based compensation expense. In addition, during the first quarter of 2011, we incurred \$0.8 million of increased depreciation, \$0.2 million increase in spending on equipment and software and \$0.2 million increase in professional and outside services as compared to the same period in 2010.

**Sales and Marketing Expenses**



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Sales and marketing expenses increased by \$0.9 million in the first quarter of 2011 compared to the corresponding period in

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2010 primarily due to an increase of \$0.5 million in travel and related expenses, \$0.4 million in marketing program expenses and trade show costs, \$0.3 million in outside professional services and fees and \$0.2 million of increased stock-based compensation expense. These increases were offset by \$0.3 million in decreased cash compensation, sales commissions and personnel-related expenses and \$0.2 million related to lower expenses for customer lab trials.

*General and Administrative Expenses*

General and administrative expenses decreased by \$2.2 million in the first quarter of 2011 compared to the corresponding period in 2010 primarily due to \$0.9 million of decreased stock-based compensation expense, \$0.9 million related to lower outside professional services and fees and a \$0.4 million decrease in cash compensation.

*Restructuring and Other Costs*

In first quarter of 2010, we incurred \$0.2 million of restructuring and other costs associated with the closure of our Maryland-based semiconductor fabrication plant. These expenses related to operating lease and contract termination costs and severance and related expenses. We completed the restructuring actions in 2010.

*Other Income (Expense), Net*

|                                    | <b>Three Months Ended</b> |                           |
|------------------------------------|---------------------------|---------------------------|
|                                    | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b> |
|                                    | <b>(In thousands)</b>     |                           |
| Interest income                    | \$ 312                    | \$ 485                    |
| Other gain (loss), net             | (411)                     | (316)                     |
| <b>Total income (expense), net</b> | <b>\$ (99)</b>            | <b>\$ 169</b>             |

Interest income decreased in the first quarter of 2011 compared to the corresponding period in 2010 mainly due to lower interest rates on investments.

Other gain (loss), net for the first quarter of 2011 included a loss of \$0.5 million of realized and unrealized foreign currency transactions and a gain of \$0.1 million related to sale of assets.

Other gain (loss), net for the first quarter of 2010 also included a loss of \$0.4 million realized and unrealized foreign currency transactions and a gain of \$0.1 million related to sale of assets.

*Income Tax Provision (Benefit)*

Provision for income taxes for the three months ended March 26, 2011 was \$0.3 million, or negative 1.8%, on a pre-tax loss of \$16.1 million, compared to a tax benefit of \$0.1 million, or 0.1%, on a pre-tax loss of \$20.1 million for the three months ended March 27, 2010. The difference between our effective tax rates and the federal statutory rate of 35% is primarily attributable to unbenefited U.S. losses, foreign taxes provided on the income of our foreign subsidiaries, non-deductible stock-based compensation expense, and various discrete items. The higher effective tax rate in 2011 primarily relates to a greater proportion of foreign earnings taxed at a higher overall effective foreign tax rate due to the expiration of the Indian holiday benefits.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, the Company has provided a full valuation allowance against its domestic deferred tax assets, net of deferred tax liabilities, as of March 26, 2011 and December 25, 2010. In determining future taxable income, the Company makes assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the Company's forecasts used to manage its business. The Company intends to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease, in the valuation allowance.



**Table of Contents****Liquidity and Capital Resources**

|   | <b>Three Months Ended</b> |                              |
|---|---------------------------|------------------------------|
|   | <b>March 26,<br/>2011</b> | <b>March 27,<br/>2010</b>    |
|   | <b>(In thousands)</b>     |                              |
| <b>Net cash flow provided by (used in):</b> |                           |                              |
| Operating activities                        | \$ (854)                  | \$ 2,277                     |
| Investing activities                        | \$ (6,453)                | \$ (11,566)                  |
| Financing activities                        | \$ 4,822                  | \$ 4,308                     |
|   | <b>March 26,<br/>2011</b> | <b>December 25,<br/>2010</b> |
|   | <b>(In thousands)</b>     |                              |
| Cash and cash equivalents                   | \$ 111,352                | \$ 113,649                   |
| Short-term and long-term investments        | \$ 171,747                | 177,966                      |
| Short-term and long-term restricted cash    | \$ 4,024                  | 4,091                        |
|   | \$ 287,123                | \$ 295,706                   |

Cash, cash equivalents, short-term and long-term investments and short-term and long-term restricted cash consist generally of highly liquid investments in certificates of deposits, money market funds, commercial paper and corporate bonds. Long-term investments include \$8.7 million (par value) of available-for-sale auction rate securities ( ARS ) which have contractual maturity terms of up to 34.7 years. No agreement has been reached to sell these ARS back to the original broker or on the open market and it is therefore unclear when these securities will become liquid and whether we can recover their full par value. The restricted cash balance amounts are pledged as collateral for certain stand-by and commercial letters of credit.

*Operating Activities*

Net cash used in operating activities for the first quarter of 2011 was \$0.9 million as compared to cash provided by operating activities of \$2.3 million for the corresponding period in 2010. Cash flow from operating activities consists of net income (loss), adjusted for non-cash charges, plus or minus working capital changes. Our working capital requirements can fluctuate significantly depending on the timing of deployments and the acceptance, billing and payment terms on those deployments. Additionally, our ability to manage inventory turns and our ability to negotiate favorable payment terms with our vendors may also impact our working capital requirements.

Net loss for the first quarter of 2011 was \$16.4 million, which included non-cash charges of \$17.4 million, compared to a net loss of \$20.0 million in the corresponding period in 2010, including non-cash charges of \$17.2 million.

Net cash used to fund working capital was \$1.8 million for the first quarter of 2011. Accrued liabilities decreased by \$15.5 million primarily due to reduced levels of compensation and commission related accruals. Accounts payable decreased \$8.8 million due to lower inventory receipts during the period. This was partially offset by a decrease in accounts receivables of \$18.9 million primarily driven by lower level of sales in the quarter and the collection of prior quarter receivables. Inventory decreased by \$4.0 million primarily due to lower levels of inventory at customer sites awaiting customer acceptance.

Net cash provided by working capital changes was \$5.1 million for the first quarter of 2010. Accounts receivable decreased by \$11.0 million primarily reflecting improved invoicing and collections activities in the quarter. This was partially offset by a reduction in accrued liabilities and other expenses of \$6.5 million primarily due to decreases in compensation accruals related to the payment of payroll and other incentive related compensation amounts during the quarter. Inventory increased by \$3.2 million due to increased inventory requirements associated with our spares management service offerings and increased levels of inventory awaiting customer acceptance.

**Table of Contents***Investing Activities*

Net cash used in investing activities in the first quarter of 2011 was \$6.5 million compared to \$11.6 million in the corresponding period of 2010. Investing activities for the first quarter of 2011 included a net usage of cash of \$5.4 million from purchases, maturities, calls and sales of investments in the period and \$10.6 million of capital expenditures. Investing activities for the first quarter of 2010 included a net usage of cash of \$7.1 million from purchases, maturities and sales of investments in the period and \$4.7 million of capital expenditures.

*Financing Activities*

Net proceeds from financing activities in the first quarter of 2011 and 2010 were \$4.8 million and \$4.3 million, respectively, primarily related to proceeds from the issuance of common stock under our ESPP and other equity plans.

*Liquidity*

As of March 26, 2011, we held \$8.7 million (par value) with a fair value of \$7.9 million of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. These ARS have contractual maturity terms of up to 34.7 years and it is not clear when we will be able to liquidate these investments. During the second quarter of 2009, we determined that we did not intend to sell these securities and did not believe that it was more likely than not that we would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial other-than-temporary impairment ( OTTI ) of \$2.7 million, equal to the difference between the fair value and the par value had occurred. During the first quarter of 2011, \$0.2 million of these ARS were called at par value.

Failed auctions resulted in a lack of liquidity in the ARS but do not affect the underlying collateral of the securities. We do not anticipate that any potential lack of liquidity in our ARS, even for an extended period of time, will affect our ability to finance our operations, including our continued investments in research and development and planned capital expenditures. We continue to monitor efforts by the financial markets to find alternative means for restoring the liquidity of these investments. Our ARS investments are classified as non-current assets until we have better visibility as to when their liquidity will be restored.

For 2011, capital expenditures are expected to be approximately \$40 million, primarily for product development and manufacturing expansion related to new products. In addition, we may experience an increase in working capital requirements as we complete future product transitions. We believe that our current cash and cash equivalents and investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least 12 months. If these sources of cash are insufficient to satisfy our liquidity requirements beyond 12 months, we may require additional capital from equity or debt financings to fund our operations, to respond to competitive pressures or strategic opportunities, or otherwise. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of us, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock.

**Contractual Obligations**

The following is a summary of our contractual obligations as of March 26, 2011 (in thousands):

|  | Total     | Payments Due by Period |             |             |                   |
|--|-----------|------------------------|-------------|-------------|-------------------|
|  |           | Less than 1 year       | 1 - 3 years | 3 - 5 years | More than 5 years |
| Purchase obligations <sup>(1)</sup>          | \$ 32,179 | \$ 32,179              | \$          | \$          | \$                |
| Operating leases                             | 33,095    | 5,101                  | 7,743       | 6,677       | 13,574            |
| Other contracts <sup>(2)</sup>               | 3,910     | 3,010                  | 900         |             |                   |
| Total contractual obligations <sup>(3)</sup> | \$ 69,184 | \$ 40,290              | \$ 8,643    | \$ 6,677    | \$ 13,574         |

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- (1) We have service agreements with our major production suppliers under which we are committed to purchase certain parts.
- (2) Other contracts are related to contractual obligations for non-recurring engineering costs.
- (3) Tax liabilities of \$0.9 million are not included in the table because we are unable to determine the timing of settlement, if any, of these future payments with a reasonably reliable estimate.

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We had \$4.0 million of standby letters of credit outstanding as of March 26, 2011. These consisted of \$1.7 million related to a customer proposal guarantee, \$1.5 million related to a value added tax license and \$0.8 million related to property leases. We had \$4.0 million of standby letters of credit outstanding as of December 25, 2010. These consisted of \$1.7 million related to a customer proposal guarantee, \$1.3 million related to a value added tax license and \$1.0 million related to property leases.

### **Off-Balance Sheet Arrangements**

As of March 26, 2011, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

### **Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

For quantitative and qualitative disclosures about market risk affecting us, see *Quantitative and Qualitative Disclosures About Market Risk* in Item 7A. of Part II of our Annual Report on Form 10-K for the fiscal year ended December 25, 2010, which is incorporated herein by reference. Our exposure to market risk has not changed materially since December 25, 2010.

### **Item 4. *Controls and Procedures***

#### **Evaluation of Disclosure Controls and Procedures**

As of March 26, 2011, an evaluation was performed by management, with the participation of our chief executive officer ( CEO ) and our chief financial officer ( CFO ), of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d - 15(e) under the Securities Exchange Act of 1934, as amended). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Based on this evaluation, our CEO and CFO have concluded that, as of the end of the fiscal period covered by this quarterly report on Form 10-Q, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the U.S. Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures.

#### **Changes in Internal Control over Financial Reporting**

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **Inherent Limitations of Internal Controls**

Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within us have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving our stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.





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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we are subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material effect on our consolidated financial position, results of operations, or cash flows. A complete description of our legal proceedings can be found in Item 3. Legal Proceedings of Part I of our Annual Report on Form 10-K for the fiscal year ended December 25, 2010 filed with the Securities and Exchange Commission on March 1, 2011. Any updates to the information contained in the Company's Annual Report on Form 10-K are set forth below.

*Cheetah Patent Infringement*

On March 30, 2011, Cheetah Omni LLC filed a motion re-urging the U.S. District Court for the Eastern District of Texas Texarkana Division to lift the stay, which we opposed on April 18, 2011.

**Item 1A. Risk Factors**

*A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 25, 2010. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended December 25, 2010 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.*

**We have a history of significant operating losses and may not achieve profitability on an annual basis in the future.**

For the fiscal year ended December 25, 2010, we recorded a net loss of \$27.9 million. As of December 25, 2010, our accumulated deficit was \$405.3 million. On March 26, 2011, our accumulated deficit was \$421.7 million. We expect to continue to make significant expenditures related to the continued development of our business. These expenditures may include the addition of personnel related to the sales, marketing and research and development of our products and other costs related to the maintenance and expansion of our manufacturing facilities and research and development operations. We may therefore sustain significant operating losses and negative cash flows in the future. We will have to maintain significant increased revenue and product gross margins to achieve profitability on an annual basis.

**Our revenue and operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.**

Our revenue and operating results may fluctuate due to a variety of factors, many of which are outside of our control. Over the past four fiscal quarters, our revenue has ranged from \$92.9 million to \$130.1 million and our operating income (loss) has ranged from an operating loss of \$16.0 million to operating income of \$4.1 million. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Our budgeted expense levels are based, in large part, on our expectations of long-term future revenue and the development efforts associated with these future revenues. As a result, fluctuations in our revenue and gross margins will have a significant impact on our operating results. Given the relatively fixed nature of our operating costs including our personnel and facilities, particularly for our engineering personnel, any substantial adjustment to our expenses to account for lower levels of revenue will be difficult and may take time. Consequently, if our revenue does not meet projected levels in the short-term, our inventory levels and operating expenses would be high relative to revenue, resulting in additional operating losses.

In addition to other risks discussed in this section, factors that may contribute to fluctuations in our revenue and our operating results include:

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fluctuations in demand, sales cycles and prices for products and services, including discounts given in response to competitive pricing pressures;

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fluctuations in our product mix, including the mix of higher and lower margin products and significant mix changes resulting from new customer deployments;

reductions in customers' budgets for optical communications network equipment purchases and delays in their purchasing cycles;

order cancellations or reductions or delays in delivery schedules by our customers;

timeliness of our customers' payments for their purchases;

our ability to control costs, including our operating expenses and the costs of components we purchase for our products;

readiness of customer sites for installation of our products;

the timing of product releases or upgrades by us or by our competitors. In particular, if we fail to achieve targeted release dates for our higher capacity products, our revenue and operating results may be negatively impacted;

any significant changes in the competitive dynamics of our market, including any new entrants, technological advances or substantial discounting of products;

availability of third party suppliers to provide contract engineering and installation services for us;

the timing of recognizing revenue in any given quarter, including the impact of recently announced revenue recognition standards and any future changes in U.S. GAAP or new interpretations of existing accounting rules; and

general economic conditions in domestic and international markets.

Many factors affecting our results of operations are beyond our control and make it difficult to predict our results for a particular quarter or to accurately predict future revenues beyond a one-quarter time horizon. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may in the future provide to the market, the price of our common stock may decline substantially.

**Our gross margin may fluctuate from quarter-to-quarter and may be adversely affected by a number of factors, some of which are beyond our control.**

Our gross margin fluctuates from period-to-period and varies by customer and by product specification. Over the past four fiscal quarters, our gross margins have ranged from 42% to 50%. Our gross margins are likely to continue to fluctuate and will be affected by a number of factors, including:

the mix in any period of the customer's purchasing our products and the product mix, including the relative mix of higher and lower margin products and services;

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significant new customer deployments, often with a higher portion of lower or negative margin common equipment;

price discounts negotiated by our customers;

sales volume from each customer during the period;

the amount of equipment we sell or expect to sell for a loss in any given quarter;

increased price competition, including competition from low-cost producers from China;

charges for excess or obsolete inventory;

changes in the price or availability of components for our products;

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changes in our manufacturing costs, including fluctuations in yields and production volumes;

introduction of new products, with initial sales at relatively small volumes and higher product costs; and

increased warranty or repair costs.

It is likely that the average unit prices of our products will decrease over time in response to competitive pricing pressures, increased negotiated sales discounts, new product introductions by us or our competitors or other factors. In addition, some of our customer contracts contain annual technology discounts that require us to decrease the sales price of our products to these customers. In response, we will need to reduce the cost of our products through manufacturing efficiencies, design improvements and cost reductions. If these efforts are not successful or if we are unable to reduce our costs to a greater extent than the reduction in the price of our products, our revenue and gross margin will decline, causing our operating results to decline. Fluctuations in gross margin may make it difficult to manage our business and achieve or maintain profitability.

### **Aggressive business tactics by our competitors may harm our business.**

The markets in which we compete are extremely competitive and have resulted in aggressive business tactics by our competitors, including:

aggressively pricing their products, including offering significant one-time discounts and guaranteed future price decreases;

providing financing, marketing and advertising assistance to customers;

announcing competing products prior to market availability combined with extensive marketing efforts;

influencing customer requirements to emphasize different product capabilities, such as greater minimum bandwidth requirements or higher transport speeds;

offering to repurchase our equipment from existing customers;

selling at a discount used equipment or inventory that had previously been written-down or written-off; and

asserting intellectual property rights.

The level of competition and pricing pressure tend to increase during periods of economic weakness or during periods when there are fewer network build-out projects. If we fail to compete successfully against our current and future competitors, or if our current or future competitors continue or expand aggressive business tactics, including those described above, demand for our products could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our prices or increase our expenses.

### **We must respond to rapid technological change and comply with evolving industry standards and requirements for our products to be successful.**

The optical networking equipment market is characterized by rapid technological change, changes in customer requirements and evolving industry standards. We continually invest in research and development to sustain or enhance our existing products, but the introduction of new communications technologies and the emergence of new industry standards or requirements could render our products obsolete. Further, in developing our products, we have made, and will continue to make, assumptions with respect to which standards or requirements will be adopted by our customers and competitors. If the standards or requirements adopted by our prospective customers are different from those on which we

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have focused our efforts, market acceptance of our products would be reduced or delayed and our business would be harmed.

We are continuing to invest in a significant portion of our research and development efforts in the development of our next-generation products. We expect our competitors to continue to improve the performance of their existing products and to introduce new products and technologies and to influence customers' buying criteria so as to emphasize product capabilities that we do not, or may not, possess. To be competitive, we must properly anticipate future customer requirements and we must continue to

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invest significant resources in research and development, sales and marketing and customer support. If we do not anticipate these future customer requirements and invest in the technologies necessary to enable us to have and to sell the appropriate solutions, it may limit our competitive position and future sales, which would have an adverse effect on our business and financial condition. We may not have sufficient resources to make these investments and we may not be able to make the technological advances necessary to be competitive.

### **Our ability to increase our revenue will depend upon continued growth of demand by consumers and businesses for additional network capacity.**

Our future success depends on factors such as the continued growth of the Internet and IP traffic and the continuing adoption of high-capacity, revenue-generating services to increase the amount of data transmitted over communications networks and the growth of optical communications networks to meet the increased demand for bandwidth. If demand for such bandwidth does not continue, or slows down, the need for increased bandwidth across networks and the market for optical communications network products may not continue to grow. If this growth does not continue or slows down, our product sales would be negatively impacted. In addition, if general economic conditions weaken, our customers and potential customers may slow or delay their purchase decisions, which would have an adverse effect on our business and financial condition.

### **Any delays in the development and introduction of our products, and any future delays in releasing new products or in releasing enhancements to our existing products may harm our business.**

Because our products are based on complex technology, including, in some cases, the development of next-generation PICs and specialized application-specific integrated circuits (ASICs), we may experience unanticipated delays in developing, improving, manufacturing or deploying these products. The development process for our PICs is lengthy, and any modifications to our PICs, including the development of our next-generation PICs, entail significant development cost and risks.

At any given time, various new product introductions and enhancements to our existing products, such as future products based on our next-generation PICs, are in the development phase and are not yet ready for commercial manufacturing or deployment. Recently, we have increased our reliance on third parties, some of which are relatively early stage companies, to develop and manufacture components for our next-generation (40Gbps and 100Gbps) products, some of which require custom development. The maturing process from laboratory prototype to customer trials, and subsequently to general availability, involves a significant number of simultaneous development efforts. These efforts often must be completed in a timely manner so that they may be introduced into the product development cycle for our systems, and include:

completion of product development, including the completion of any associated PIC development, such as our next-generation PICs, and the completion of associated module development, including modules developed by third parties;

the qualification and multiple sourcing of critical components;

validation of manufacturing methods and processes;

extensive quality assurance and reliability testing and staffing of testing infrastructure;

validation of software; and

establishment of systems integration and systems test validation requirements.

Each of these steps, in turn, presents risks of failure, rework or delay, any one of which could decrease the speed and scope of product introduction and marketplace acceptance of our products. New generations of our PICs, specialized ASICs and intensive software testing and validation are important to the timely introduction of new products, enhancements to our existing products and our entrance into new markets. In addition, unexpected intellectual property disputes, failure of critical design elements, and a host of other execution risks may delay, or even

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prevent, the introduction of new products or enhancements to our existing products. If we do not develop and successfully introduce or enhance products in a timely manner, our competitive position will suffer. In addition, if we do not develop and successfully introduce or enhance products in sufficient time so as to satisfy our customer's expectations, we may lose future business from such customers and harm our reputation and our customer relationships, either of which would harm our business and operating results.

**We have a limited operating history and limited history of selling our DTN Systems and ATN Systems, both of which make it**



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### **difficult to predict our future operating results.**

We were incorporated in December 2000, shipped our first DTN System in November 2004 and shipped our first ATN System in August 2009. Our limited operating history gives very little basis upon which to evaluate our ability to accomplish our business objectives. In making an investment decision, you should evaluate our business in light of the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in the rapidly changing optical networking market. We may not be successful in addressing these risks. It is difficult to accurately forecast our future revenue and plan expenses accordingly and, therefore, predict our future operating results.

### **The markets in which we compete are highly competitive and dominated by large corporations, and we may not be able to compete effectively.**

Competition in the optical networking equipment market is intense, and we expect such competition to increase. A number of very large companies have historically dominated the optical communications network equipment industry. Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena Corporation, Cisco Systems, Ericsson, Fujitsu Limited, Huawei Technologies Co., NEC Corporation, Nokia-Siemens Networks, Tellabs and ZTE Corporation. Competition in these markets is based on price, commercial terms, functionality, manufacturing capability, pre-existing installation, services, existing business and customer relationships, scalability and the ability of products and breadth and quality of services to meet our customers' immediate and future network requirements. Other companies have, or may in the future develop, products that are or could be competitive with our products. In particular, if a competitor develops a photonic integrated circuit with similar functionality to our PICs, our business could be harmed. Recent mergers from our competitors and any future acquisitions or combinations between or among our competitors may adversely affect our competitive position by strengthening our competitors.

Many of our competitors have substantially greater name recognition and technical, financial and marketing resources, greater manufacturing capacity and better established relationships with incumbent carriers and other potential customers than we have. Many of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for those products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at aggressive pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers.

We also compete with low-cost producers from China that can increase pricing pressure on us and a number of smaller companies that provide competition for a specific product, customer segment or geographic market. These competitors often base their products on the latest available technologies. Due to the narrower focus of their efforts, these competitors may achieve commercial availability of their products more quickly than we can and may provide attractive alternatives to our customers.

### **We are dependent on a small number of key customers for a significant portion of our revenue and the loss of, or a significant reduction in, orders from one or more of our key customers would reduce our revenue and harm our operating results.**

A relatively small number of customers account for a large percentage of our net revenue. As a result, our business will be harmed if any of our key customers, including Level 3, do not generate as much revenue as we forecast, stop purchasing from us, or substantially reduce their orders to us. In addition, our business would be harmed if we fail to maintain our competitive advantage with our key customers.

Our ability to continue to generate revenue from our key customers will depend on our ability to maintain strong relationships with these customers and introduce new products that are desirable to these customers at competitive prices, and we may not be successful at doing so. Because, in most cases, our sales are made to these customers pursuant to standard purchase agreements rather than long-term purchase commitments, orders may be cancelled or reduced readily. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business. Our operating results will continue to depend on our ability to sell our products to our key customers.

### **Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that result in increased cost of sales, decreased revenue and lower average selling prices and gross margins, all of which would harm our operating results.**

Substantial changes in the optical networking industry have occurred over the last few years. Many potential customers have confronted static or declining revenue. Many of our customers have substantial debt burdens, many have experienced financial distress, and some have gone out of business have been acquired by other service providers or announced their withdrawal from segments of the business. Consolidation in the

markets in which we compete has resulted in changes in the structure of the

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communications networking industry, with greater concentration of purchasing power in a small number of large service providers, cable operators, internet content providers and government agencies. This increased concentration among our customer base may also lead to increased competition for new network deployments and increased negotiating power for our customers. This may require us to decrease our average selling prices and have an adverse impact on our operating results.

Further, many of our customers are large communications service providers that have substantial purchasing power and leverage in negotiating contractual arrangements with us. Our customers have and may continue to seek advantageous pricing, payment and other commercial terms and may require us to develop additional features in the products we sell to them. If we are required to develop additional features for our product for a customer, we may be required to defer some of our revenue for such a customer until we have developed and delivered such additional features. We have and may continue to be required to agree to unfavorable commercial terms with these customers, including reducing the average selling price of our products or agreeing to extended payment terms in response to these commercial requirements or competitive pricing pressures. To maintain acceptable operating results, we will need to comply with these commercial terms, develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs.

We expect the factors described above to continue to affect our business and operating results for an indeterminate period, in several ways, including:

overall capital expenditures by many of our customers or potential customers may be flat or reduced;

we will continue to have only limited ability to forecast the volume and product mix of our sales;

managing expenditures and inventory will be difficult in light of the uncertainties surrounding our business; and

increased competition will enable customers to insist on more favorable terms and conditions for sales, including product discounts, extended payment terms or financing assistance, as a condition of procuring their business.

If we are unable to offset any reductions in our average selling prices with increased sales volumes and reduced production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, or if we disagree on our interpretation and compliance with the commercial terms of our customer agreements, our relationships with our customers and our operating results would be harmed.

**We are dependent on sole source and limited source suppliers for several key components, and if we fail to obtain these components on a timely basis, we will not meet our customers' product delivery requirements.**

We currently purchase several key components for our products from single or limited sources. In particular, we rely on our own production of certain components of our products, such as PICs, and on third parties as sole source suppliers for certain of the components of our products, including: ASICs, field-programmable gate arrays, processors, and other semiconductor and optical components. We purchase these items on a purchase order basis and have no long-term contracts with many of these sole source suppliers. Recently, we have increased our reliance on third parties to develop and manufacture components for our next-generation (40Gbps and 100Gbps) products, some of which require custom development. For example, for the 40Gbps application of our DTN System, we will be purchasing a customized discrete component. If any of our sole or limited source suppliers suffer from capacity constraints, lower than expected yields, deployment delays, work stoppages or any other reduction or disruption in output, they may be unable to meet our delivery schedule which could result in lost revenue, additional product costs and deployment delays that could harm our business and customer relationships. Further, our suppliers could enter into exclusive arrangements with our competitors, refuse to sell their products or components to us at commercially reasonable prices or at all, go out of business or discontinue their relationships with us. We may be unable to develop alternative sources for these components.

The loss of a source of supply, or lack of sufficient availability of key components, could require us to redesign products that use such components, which could result in lost revenue, additional product costs and deployment delays that could harm our business and customer relationships. If we do not receive critical components for our products in a timely manner, we will be unable to deliver those components to our contract manufacturer in a timely manner and would, therefore, be unable to meet our prospective customers' product delivery requirements. In addition, the sourcing from new suppliers may require us to re-design our products, which could cause delays in the manufacturing and delivery of our products. In the past, we have experienced delivery delays because of lack of availability of components or reliability issues with

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components that we were purchasing. In addition, some of our suppliers have gone out of business, limited their supply of components to us, or indicated that they may be going out of business. Historically, we have seen a tightening of supply with a number of our suppliers and we have experienced longer than normal lead times and supply delays. We may in the future experience a shortage of certain components as a result of our own manufacturing issues, manufacturing issues at our suppliers or contract manufacturers, capacity problem experiences by our suppliers or contract manufacturers, or strong demand in the industry for such components. A return to growth in the economy is likely to continue to create pressure on us and our suppliers

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to accurately project overall component demand and manufacturing capacity. These supplier disruptions may continue to occur in the future, which could limit our ability to produce our products and cause us to fail to meet a customer's delivery requirements. Such events could harm our reputation and our customer relationships, either of which would harm our business and operating results.

### **If our contract manufacturers do not perform as we expect, our business may be harmed.**

We rely on third-party contract manufacturers to perform a significant portion of the manufacturing of our products, and our future success will depend on our ability to have sufficient volumes of our products manufactured in a cost-effective and quality-controlled manner. We have engaged third parties to manufacture certain elements of our products at multiple contract manufacturing sites located around the world but do not have long-term agreements in place with some of our manufacturers and suppliers. There are a number of risks associated with our dependence on contract manufacturers, including:

reduced control over delivery schedules, particularly for international contract manufacturing sites;

reliance on the quality assurance procedures of third parties;

potential uncertainty regarding manufacturing yields and costs;

potential lack of adequate capacity during periods of excess demand;

potential uncertainty related to the use of international contract manufacturing sites;

limited warranties on components supplied to us;

potential misappropriation of our intellectual property; and

potential manufacturing disruptions (including disruptions caused by geopolitical events, military actions or natural disasters).

Any of these risks could impair our ability to fulfill orders. Our contract manufacturers may not be able to meet the delivery requirements of our customers, which could decrease customer satisfaction and harm our product sales. We do not have long-term contracts or arrangements with our contract manufacturers that will guarantee product availability, or the continuation of particular pricing or payment terms. If our contract manufacturers are unable or unwilling to continue manufacturing our products or components of our products in required volumes or our relationship with any of our contract manufacturers is discontinued for any reason, we would be required to identify and qualify alternative manufacturers, which could cause us to be unable to meet our supply requirements to our customers and result in the breach of our customer agreements. Qualifying a new contract manufacturer and commencing volume production is expensive and time-consuming and if we are required to change or qualify a new contract manufacturer, we would likely lose sales revenue and damage our existing customer relationships.

### **We are dependent on a single product, and the lack of continued market acceptance of our DTN System would harm our business.**

Although we added the ATN System as part of our product offering in 2009, our DTN System accounts for substantially all of our revenue and will continue to do so for the foreseeable future. As a result, our business could be harmed by:

any decline in demand for our DTN System;

the failure of our existing DTN System to achieve continued market acceptance;

the introduction of products and technologies that serve as a replacement or substitute for, or represent an improvement over, our DTN System;

technological innovations or new communications standards that our DTN System does not address; and

our inability to release enhanced versions of our DTN System on a timely basis.

**If we fail to expand sales of our products into international markets or to sell our products to new types of customers, such as**

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### **U.S. regional Bell operating companies and international postal, telephone and telegraph companies, our revenue will be harmed.**

We believe that, in order to grow our revenue and business and to build a large and diverse customer base, we must successfully sell our products in international markets and to new types of customers, such as U.S. regional Bell operating companies and international postal, telephone and telegraph companies. We have limited experience selling our products internationally and to U.S. regional Bell operating companies and international postal, telephone and telegraph companies. Sales cycles for these customers are often very lengthy and competition for these customers is intense. To succeed in these sales efforts, we believe we must hire additional sales personnel to develop our relationships with these potential customers and develop and manage new sales channels through resellers, distributors and systems integrators. If we do not succeed in our efforts to sell to these customers, the size of our total addressable market will be limited. This, in turn, would harm our ability to grow our customer base and revenue.

### **If we fail to protect our intellectual property rights, our competitive position could be harmed or we could incur significant expense to enforce our rights.**

We depend on our ability to protect our proprietary technology. We rely on a combination of methods to protect our intellectual property, including limiting access to certain information, and utilizing trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. The steps we have taken to protect our proprietary rights may be inadequate to preclude misappropriation or unauthorized disclosure of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation, unauthorized disclosure or infringement is uncertain, particularly in countries outside of the United States. This is likely to become an increasingly important issue as we expand our operations and product development into countries that provide a lower level of intellectual property protection. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, the rights granted under any issued patents may not provide us with a competitive advantage, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future.

Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult, time consuming and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity or scope of the proprietary rights of others. Such litigation could result in substantial cost and diversion of management resources, either of which could harm our business, financial condition and operating results. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

### **Claims by others that we infringe their intellectual property could harm our business.**

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, many leading companies in the optical networking industry, including our competitors, have extensive patent portfolios with respect to optical networking technology. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. From time to time, third parties may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are important to our business or seek to invalidate the proprietary rights that we hold. Competitors or other third parties have, and may continue to assert claims or initiate litigation or other proceedings against us or our manufacturers, suppliers or customers alleging infringement of their proprietary rights, or seeking to invalidate our proprietary rights, with respect to our products and technology. In the event that we are unsuccessful in defending against any such claims, or any resulting lawsuit or proceedings, we could incur liability for damages and/or have valuable proprietary rights invalidated.

Any claim of infringement from a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful. Any of these events could harm our business, financial condition and operating results. Competitors and other third parties have and may continue to assert infringement claims against our customers and sales partners. Any of these claims would require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our

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customers and sales partners from claims of infringement of proprietary rights of third parties. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or sales partners, which could have an adverse effect on our business, financial condition and operating results.

We incorporate open source software into our products. Although we monitor our use of open source software closely, the terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, to re-engineer our products or to discontinue the sale of our products in the event re-engineering cannot be accomplished on a timely basis, any of which could adversely affect our business, operating results and financial condition.

We are currently involved in litigation with Cheetah and Level 3 in the United States District Court for the Eastern District of Texas Texarkana Division whereby Cheetah alleges that Infinera and Level 3 infringe on two Cheetah patents. Information regarding the Company's lawsuit with Cheetah is set forth below under Part II, Item 1. Legal Proceedings and is incorporated herein by reference. We believe this lawsuit is without merit and intend to defend ourselves vigorously, but are unable to predict the likelihood of an unfavorable outcome. In the event that Cheetah is successful in obtaining a judgment requiring us to pay damages or obtains an injunction preventing the sale of our products, our business and operating results could be harmed.

**Our manufacturing process is very complex and the partial or complete loss of our manufacturing facility, or a reduction in yields or an inability to scale capacity to meet customer demands could harm our business.**

The manufacturing process for certain components of our products, including our PICs, is technically challenging. In the event that any of these manufacturing facilities were fully or partially destroyed, as a result of fire, water damage, or otherwise, it would limit our ability to produce our products. Because of the complex nature of our manufacturing facilities, such loss would take a considerable amount of time to repair or rebuild. The partial or complete loss of any of our manufacturing facilities, or an event causing the interruption in our use of such facility for any extended period of time would cause our business, financial condition and operating results to be harmed.

Minor deviations in the PIC manufacturing process can cause substantial decreases in yields and, in some cases, cause production to be suspended. In the past, we have had significant variances in our PIC yields, including production interruptions and suspensions and may have continued yield variances, including additional interruptions or suspensions in the future. We expect our manufacturing yield for our next-generation PICs to be lower initially and increase as we achieve full production. Poor yields from our PIC manufacturing process or defects, integration issues or other performance problems in our products could limit our ability to satisfy customer demand requirements, and could cause us customer relations and business reputation problems, harming our business and operating results.

Although we are currently in the process of expanding our manufacturing facilities, our manufacturing facilities may not have adequate capacity to meet the demand for our products or we may not be able to increase our capacity to meet potential increases in demand for our products. Our inability to obtain sufficient manufacturing capacity to meet demand, either in our own facilities or through foundry or similar arrangements with third parties, could harm our relationships with customers, our business and our operating results.