

AXT INC  
Form 10-Q  
November 10, 2008  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

(Mark One)

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

**for the quarterly period ended September 30, 2008**

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 000-24085**

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**AXT, INC.**

(Exact name of registrant as specified in its charter)

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**DELAWARE**  
(State or other jurisdiction of  
Incorporation or organization)

**94-3031310**  
(I.R.S. Employer  
Identification No.)

**4281 Technology Drive, Fremont, California 94538**

(Address of principal executive offices) (Zip code)

**(510) 683-5900**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  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 definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

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

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

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

| Class                           | Outstanding at October 30, 2008 |
|---------------------------------|---------------------------------|
| Common Stock, \$0.001 par value | 30,450,007                      |

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AXT, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share data)

|   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| <b>Assets:</b>  |                       |                      |
| <b>Current assets:</b>  |                       |                      |
| Cash and cash equivalents   | \$ 11,577             | \$ 18,380            |
| Short-term investments  | 17,895                | 20,825               |
| Accounts receivable, net of allowances of \$681 and \$379 as of September 30, 2008 and December 31, 2007, respectively  | 13,292                | 12,149               |
| Inventories, net  | 39,150                | 24,781               |
| Prepaid expenses and other current assets   | 2,964                 | 3,569                |
| Assets held for sale  |                       | 5,140                |
| <b>Total current assets</b>   | <b>84,878</b>         | <b>84,844</b>        |
| Property, plant and equipment, net  | 21,462                | 15,986               |
| Restricted deposits   | 3,000                 | 6,700                |
| Other assets  | 5,246                 | 5,242                |
| <b>Total assets</b>   | <b>\$ 114,586</b>     | <b>\$ 112,772</b>    |
| <b>Liabilities and stockholders' equity:</b>  |                       |                      |
| <b>Current liabilities:</b>   |                       |                      |
| Accounts payable  | \$ 8,674              | \$ 4,328             |
| Accrued liabilities   | 3,415                 | 4,326                |
| Line of credit  | 3,000                 |                      |
| Current portion of long-term debt   |                       | 450                  |
| Income taxes payable  | 298                   | 390                  |
| <b>Total current liabilities</b>  | <b>15,387</b>         | <b>9,494</b>         |
| Long-term debt, net of current portion  | 18                    | 6,250                |
| Other long-term liabilities   | 3,233                 | 3,778                |
| <b>Total liabilities</b>  | <b>18,638</b>         | <b>19,522</b>        |
| Commitments and contingencies (Note 10)   |                       |                      |
| <b>Stockholders' equity:</b>  |                       |                      |
| Preferred stock, \$0.001 par value per share; 2,000 shares authorized; 883 shares issued and outstanding as of September 30, 2008 and December 31, 2007                           | 3,532                 | 3,532                |
| Common stock, \$0.001 par value per share; 70,000 shares authorized; 30,450 and 30,358 shares issued and outstanding as of September 30, 2008 and December 31, 2007, respectively | 30                    | 30                   |
| Additional paid-in capital  | 186,588               | 185,949              |
| Accumulated deficit   | (96,861)              | (98,543)             |
| Accumulated other comprehensive income  | 2,659                 | 2,282                |
| <b>Total stockholders' equity</b>   | <b>95,948</b>         | <b>93,250</b>        |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 114,586</b>     | <b>\$ 112,772</b>    |

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See accompanying notes to condensed consolidated financial statements.

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AXT, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, in thousands, except per share data)

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2008                                | 2007      | 2008                               | 2007      |
| Revenue   | \$ 17,863                           | \$ 14,474 | \$ 57,429                          | \$ 40,639 |
| Cost of revenue                                       | 13,326                              | 9,944     | 40,227                             | 25,672    |
| Gross profit  | 4,537                               | 4,530     | 17,202                             | 14,967    |
| Operating expenses:                                   |                                     |           |                                    |           |
| Selling, general and administrative                   | 4,901                               | 3,083     | 12,146                             | 10,529    |
| Research and development                              | 562                                 | 382       | 1,635                              | 1,190     |
| Impairment (recovery) on assets held for sale         |                                     |           | 83                                 | (481)     |
| Total operating expenses                              | 5,463                               | 3,465     | 13,864                             | 11,238    |
| Income (loss) from operations                         | (926)                               | 1,065     | 3,338                              | 3,729     |
| Interest income, net                                  | 68                                  | 102       | 433                                | 551       |
| Minority interests                                    | (277)                               | (537)     | (1,424)                            | (1,290)   |
| Other income, net                                     | 298                                 | 381       | 707                                | 851       |
| Income (loss) before provision for income taxes       | (837)                               | 1,011     | 3,054                              | 3,841     |
| Provision for income taxes                            | 177                                 | 153       | 1,372                              | 426       |
| Net income (loss)                                     | \$ (1,014)                          | \$ 858    | \$ 1,682                           | \$ 3,415  |
| Net income (loss) per share:                          |                                     |           |                                    |           |
| Basic   | \$ (0.03)                           | \$ 0.03   | \$ 0.05                            | \$ 0.11   |
| Diluted   | \$ (0.03)                           | \$ 0.03   | \$ 0.05                            | \$ 0.10   |
| Shares used in computing net income (loss) per share: |                                     |           |                                    |           |
| Basic   | 30,455                              | 30,150    | 30,410                             | 29,940    |
| Diluted   | 30,455                              | 31,464    | 31,502                             | 31,287    |

See accompanying notes to condensed consolidated financial statements.

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AXT, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2008                               | 2007      |
| <b>Cash flows from operating activities:</b>                               |                                    |           |
| Net income   | \$ 1,682                           | \$ 3,415  |
| <b>Adjustments to reconcile net income to net cash used in operations:</b> |                                    |           |
| Depreciation   | 1,494                              | 1,064     |
| Accretion of marketable securities premium/discount                        | (5)                                | (51)      |
| Gain on disposal of property, plant and equipment                          | (2)                                |           |
| Impairment (recovery) on assets held for sale                              | 83                                 | (481)     |
| Stock-based compensation   | 468                                | 341       |
| Realized loss (gain) on sale of investments                                | (326)                              | 83        |
| <b>Changes in assets and liabilities:</b>                                  |                                    |           |
| Accounts receivable  | (1,060)                            | (2,193)   |
| Inventories  | (13,904)                           | (4,712)   |
| Prepaid expenses   | 709                                | 512       |
| Other assets   | 50                                 | (696)     |
| Accounts payable   | 4,106                              | (1,050)   |
| Accrued liabilities  | (934)                              | 475       |
| Income taxes   | (103)                              | 251       |
| Other long-term liabilities  | (693)                              | 467       |
| Net cash used in operating activities                                      | (8,435)                            | (2,575)   |
| <b>Cash flows from investing activities:</b>                               |                                    |           |
| Purchases of property, plant and equipment                                 | (5,995)                            | (2,786)   |
| Proceeds from sale of property, plant and equipment                        | 4                                  | 6         |
| Proceeds from sale of assets held for sale                                 | 5,057                              |           |
| Purchases of marketable securities   | (22,638)                           | (22,704)  |
| Proceeds from sale of marketable securities                                | 24,495                             | 24,508    |
| Decrease in restricted deposits  | 3,700                              | 450       |
| Net cash provided by (used in) investing activities                        | 4,623                              | (526)     |
| <b>Cash flows from financing activities:</b>                               |                                    |           |
| Proceeds from issuance of common stock, net                                | 171                                | 4,390     |
| Proceeds from line of credit   | 3,000                              |           |
| Long-term debt payments  | (6,682)                            | (546)     |
| Net cash provided by (used in) financing activities                        | (3,511)                            | 3,844     |
| Effect of exchange rate changes on cash and cash equivalents               | 520                                | 208       |
| Net increase (decrease) in cash and cash equivalents                       | (6,803)                            | 951       |
| Cash and cash equivalents at the beginning of the period                   | 18,380                             | 16,116    |
| Cash and cash equivalents at the end of the period                         | \$ 11,577                          | \$ 17,067 |

See accompanying notes to condensed consolidated financial statements.





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AXT, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**Note 1. Basis of Presentation**

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

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

The results of operations are not necessarily indicative of the results to be expected in the future or for the full fiscal year. It is recommended that these condensed consolidated financial statements be read in conjunction with our consolidated financial statements and the notes thereto included in our 2007 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the SEC ) on March 14, 2008 and our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2008 and June 30, 2008 filed with the SEC on May 12, 2008 and August 11, 2008, respectively.

**Note 2. Accounting for Stock-Based Compensation**

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

We elected the modified prospective transition method for adopting SFAS 123(R). Under this method, the provisions of SFAS 123(R) apply to all awards granted or modified after the date of adoption. The unrecognized expense of awards not yet vested at the date of adoption will be

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recognized in net income in the periods after the date of adoption using the same Black-Scholes valuation method and assumptions determined under the original provisions of SFAS 123, as disclosed in our previous quarterly and annual reports.

The effect of recording stock compensation for the three and nine months ended September 30, 2008 and 2007 was as follows (in thousands, except per share data):

|   | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|---|-------------------------------------|---------------|------------------------------------|---------------|
|   | 2008                                | 2007          | 2008                               | 2007          |
| Stock-based compensation in the form of<br>employee stock options, included in: |                                     |               |                                    |               |
| Cost of revenue   | \$ 13                               | \$ 12         | \$ 44                              | \$ 38         |
| Selling, general and administrative   | 109                                 | 96            | 324                                | 245           |
| Research and development  | 25                                  | 22            | 100                                | 58            |
| <b>Total stock-based compensation</b>   | <b>147</b>                          | <b>130</b>    | <b>468</b>                         | <b>341</b>    |
| Tax effect on stock-based compensation  |                                     |               |                                    |               |
| <b>Net effect on net income</b>   | <b>\$ 147</b>                       | <b>\$ 130</b> | <b>\$ 468</b>                      | <b>\$ 341</b> |
| Effect on basic net income (loss) per share                                     | \$ 0.00                             | \$ 0.00       | \$ 0.02                            | \$ 0.01       |
| Effect on diluted net income (loss) per share                                   | \$ 0.00                             | \$ 0.00       | \$ 0.01                            | \$ 0.01       |

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As of September 30, 2008 the total compensation costs related to unvested stock-based awards granted to employees under our stock option plan but not yet recognized was approximately \$1,037,000, net of estimated forfeitures of \$49,000. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 2.2 years and will be adjusted for subsequent changes in estimated forfeitures. We elected not to capitalize any stock-based compensation to inventory as of September 30, 2008 due to the immateriality of the amount.

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

We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), and the SEC Staff Accounting Bulletin No. 107. There were no stock option grants made in the three and nine months ended September 30, 2007 and no options were granted in the three months ended September 30, 2008. The fair value of our stock options granted to employees for the nine months ended September 30, 2008 was estimated using the following weighted-average assumptions:

|                             | <b>Nine Months Ended<br/>September 30, 2008</b> |
|-----------------------------|---|
| Expected term (in years)    | 4.0   |
| Volatility                  | 60.79%  |
| Expected dividend           | 0%  |
| Risk-free interest rate     | 2.69%   |
| Estimated forfeitures       | 4.3%  |
| Weighted-average fair value | \$ 2.47   |

The following table summarizes the stock option transactions during nine months ended September 30, 2008 (in thousands, except per share data):

|   | Shares | Weighted-<br>average<br>Exercise<br>Price | Weighted-<br>average<br>Remaining<br>Contractual<br>Life<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|---|--------|---|--|---------------------------------|
| Options outstanding as of December 31, 2007 | 2,477  | \$ 2.95                                   |  |                                 |
| Granted                                     | 2      | 5.09                                      |  |                                 |
| Exercised                                   | (92)   | 1.85                                      |  |                                 |
| Canceled                                    | (34)   | 7   |  |                                 |

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|  |       |    |      |      |    |     |
|--|-------|----|------|------|----|-----|
| Options outstanding as of September 30, 2008                 | 2,353 | \$ | 2.94 | 6.29 | \$ | 721 |
| Options vested and expected to vest as of September 30, 2008 | 2,343 | \$ | 2.93 | 6.28 | \$ | 720 |
| Options exercisable as of September 30, 2008                 | 1,758 | \$ | 2.42 | 5.61 | \$ | 626 |

As of December 31, 2007, options to purchase 1,638,139 shares at a weighted average exercise price of \$2.56 per share were vested and exercisable.

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing price of \$1.88 on September 30, 2008, which would have been received by the option holder had all option holders exercised their options on of that date. The total number of in-the-money options exercisable as of September 30, 2008 was 1,079,000.

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The options outstanding and exercisable as of September 30, 2008 were in the following exercise price ranges:

| Range of Exercise Price | Options Outstanding as of September 30, 2008 |                                 |   | Options Exercisable as of September 30, 2008 |                                 |  |
|-------------------------|--|---------------------------------|---|--|---------------------------------|--|
|                         | Shares                                       | Weighted-average Exercise Price | Weighted-average Remaining Contractual Life | Shares                                       | Weighted-Average Exercise Price |  |
| \$ 1.17 - \$1.38        | 1,198,583                                    | \$ 1.28                         | 6.15  | 1,043,205                                    | \$ 1.28                         |  |
| \$ 1.39 - \$1.44        | 5,094  | \$ 1.43                         | 6.89  | 3,074  | \$ 1.44                         |  |
| \$ 1.45 - \$2.24        | 412,363                                      | \$ 2.16                         | 4.49  | 406,176                                      | \$ 2.17                         |  |
| \$ 2.25 - \$6.31        | 677,995                                      | \$ 4.95                         | 7.93  | 247,310                                      | \$ 3.69                         |  |
| \$ 6.32 - \$41.50       | 58,500                                       | \$ 19.17                        | 2.85  | 58,500                                       | \$ 19.17                        |  |
|                         | 2,352,535                                    | \$ 2.94                         | 6.29  | 1,758,265                                    | \$ 2.42                         |  |

The total intrinsic value of options exercised for the three and nine months ended September 30, 2008, was \$30,000 and \$275,000, respectively. The total intrinsic value of options exercised for the three and nine months ended September 30, 2007, was \$929,000 and \$1,089,000, respectively. Cash received from option exercises for the three and nine months ended September 30, 2008 was \$22,000 and \$171,000, respectively. Cash received from option exercises for the three and nine months ended September 30, 2007 was \$548,000 and \$776,000, respectively.

A summary of activity related to restricted stock awards for the nine months ended September 30, 2008 is presented below:

|   | Shares  | Weighted-Average Grant Date Fair Value |
|---|---------|--|
| Non-vested restricted stock shares outstanding as of December 31, 2007  | 23,480  | \$ 4.26                                |
| Restricted stock shares granted   |         | \$                                     |
| Restricted stock shares vested  | (7,827) | \$ 4.26                                |
| Non-vested restricted stock shares outstanding as of September 30, 2008 | 15,653  | \$ 4.26                                |

As of September 30, 2008, we had \$59,000 of unrecognized compensation expense, net of forfeitures, related to restricted stock awards, which will be recognized over the weighted average period of 1.76 years. During the nine months ended September 30, 2008, 7,827 shares of restricted stock vested.

**Note 3. Investments and Fair Value Measurements**

Our cash, cash equivalents and investments, and strategic investments in privately-held companies are classified as follows (in thousands):

| Amortized | September 30, 2008 |                  |  | Fair | Amortized | December 31, 2007 |                  |      |
|-----------|--------------------|------------------|--|------|-----------|-------------------|------------------|------|
|           | Gross Unrealized   | Gross Unrealized |  |      |           | Gross Unrealized  | Gross Unrealized | Fair |

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|   | Cost      | Gain | (Loss)     | Value     | Cost      | Gain   | (Loss)   | Value     |
|---|-----------|------|------------|-----------|-----------|--------|----------|-----------|
| <b>Classified as:</b>                         |           |      |            |           |           |        |          |           |
| Cash  | \$ 11,577 | \$   | \$         | \$ 11,577 | \$ 10,818 | \$     | \$       | \$ 10,818 |
| <b>Cash equivalents:</b>                      |           |      |            |           |           |        |          |           |
| Money market fund                             |           |      |            |           | 7,562     |        |          | 7,562     |
| Total cash equivalents                        |           |      |            |           | 7,562     |        |          | 7,562     |
| Total cash and cash equivalents               | 11,577    |      |            | 11,577    | 18,380    |        |          | 18,380    |
| <b>Investments:</b>                           |           |      |            |           |           |        |          |           |
| U.S. Treasury, agency securities              |           |      |            |           | 1,400     |        |          | 1,400     |
| Asset-backed securities                       |           |      |            |           | 3,820     |        | (77)     | 3,743     |
| Commercial paper                              |           |      |            |           | 3,300     |        | (115)    | 3,185     |
| Corporate bonds                               | 22,345    |      | (1,450)    | 20,895    | 19,051    | 260    | (114)    | 19,197    |
| Total investments                             | 22,345    |      | (1,450)    | 20,895    | 27,571    | 260    | (306)    | 27,525    |
| Total cash, cash equivalents and investments  | \$ 33,922 |      | \$ (1,450) | \$ 32,472 | \$ 45,951 | \$ 260 | \$ (306) | \$ 45,905 |
| <b>Contractual maturities on investments:</b> |           |      |            |           |           |        |          |           |
| Due within 1 year                             | \$ 448    |      |            | \$ 430    | \$ 2,050  |        |          | \$ 2,050  |
| Due after 1 through 5 years                   | 21,897    |      |            | 20,465    | 25,521    |        |          | 25,475    |
|   | \$ 22,345 |      |            | \$ 20,895 | \$ 27,571 |        |          | \$ 27,525 |

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The investments include \$3.0 million and \$6.7 million recorded as restricted deposits on the condensed consolidated balance sheets as of September 30, 2008 and December 31, 2007, respectively. On July 1, 2008, we paid down the entire principal amount of \$6.4 million plus accrued interest and accordingly the related restricted deposits were released. In September 2008, we obtained an express line of credit of \$5.0 million from Citigroup Smith Barney and drew down \$3.0 million for operating purposes and classified the same amount as restricted deposits as of September 30, 2008. The \$3.0 million express line of credit carries an annual interest rate of 4.0%.

We manage our investments as a single portfolio of highly marketable securities that is intended to be available to meet our current cash requirements. For the three months ended September 30, 2008, we had no gross realized gains or losses and for the nine months ended September 30, 2008, we had \$326,000 in gross realized gains on sales of our available-for-sale securities, respectively. For the three and nine months ended September 30, 2007 we had \$54,000 and \$83,000 in gross realized losses on sales of our available-for-sale securities, respectively.

The gross unrealized losses related to our portfolio of available-for-sale securities were primarily due to a decrease in the fair value of debt securities. We have determined that the gross unrealized losses on our available-for-sale securities as of September 30, 2008 are temporary in nature. We reviewed our investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value. The following table provides a breakdown of our available-for-sale securities with unrealized losses as of September 30, 2008 (in thousands):

|                        | In Loss Position<br>< 12 months |                               | In Loss Position<br>> 12 months |                               | Total In<br>Loss Position |                               |
|------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------|-------------------------------|
|                        | Fair<br>Value                   | Gross<br>Unrealized<br>(Loss) | Fair<br>Value                   | Gross<br>Unrealized<br>(Loss) | Fair<br>Value             | Gross<br>Unrealized<br>(Loss) |
| Investments:           |                                 |                               |                                 |                               |                           |                               |
| Corporate bonds        | \$ 20,895                       | \$ (1,450)                    | \$                              | \$                            | \$ 20,895                 | \$ (1,450)                    |
| Total in loss position | \$ 20,895                       | \$ (1,450)                    | \$                              | \$                            | \$ 20,895                 | \$ (1,450)                    |

***Investments in Privately-held Companies***

We have made strategic investments in private companies located in China in order to gain access at a competitive cost to raw materials that are critical to our substrate business (see Note 9). As of September 30, 2008 and December 31, 2007, our investments in unconsolidated privately-held companies had a carrying value of \$4.1 million and \$3.3 million, respectively, and are included in other assets in the condensed consolidated balance sheets.

***Fair Value Measurements***

On January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ) which defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. SFAS No. 157 applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, except for non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a

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nonrecurring basis, for which application has been deferred for one year.

The following table summarizes our financial assets and liabilities measured at fair value on a recurring basis in accordance with SFAS No. 157 as of September 30, 2008 (in thousands):

|                         | Balance as of<br>September 30, 2008 | Quoted Prices in<br>Active Markets of<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) |
|-------------------------|-------------------------------------|--|---|
| <b>Assets:</b>          |                                     |  |   |
| Short-term investments: |                                     |  |   |
| Corporate bonds         | \$ 20,895                           | \$   | \$ 20,895   |
| Total                   | \$ 20,895                           | \$   | \$ 20,895   |
| <b>Liabilities</b>      |                                     |  |   |
|                         | \$                                  | \$   | \$  |



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Our financial assets and liabilities are valued using market prices on both active markets (Level 1) and less active markets (Level 2). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets. Level 2 instrument valuations are obtained from readily-available pricing sources for comparable instruments. As of September 30, 2008, we did not have any assets or liabilities without observable market values that would require a high level of judgment to determine fair value (Level 3 assets).

**Items Measured at Fair Value on a Nonrecurring Basis**

Certain assets that are subject to nonrecurring fair value measurements are not included in the table above. These assets include equity and cost method investments in private companies. We did not record other-than-temporary impairment charges for either of these investments during the first nine months of 2008.

**Note 4. Inventories, Net**

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

|                   | September 30,<br>2008 | December 31,<br>2007 |
|-------------------|-----------------------|----------------------|
| Inventories, net: |                       |                      |
| Raw materials     | \$ 20,541             | \$ 11,154            |
| Work in process   | 14,158                | 12,254               |
| Finished goods    | 4,451                 | 1,373                |
|                   | \$ 39,150             | \$ 24,781            |

**Note 5. Recovery (Impairment) on Assets Held For Sale**

During the first nine months of 2008, we completed the sale of our property in Fremont, California for \$5.3 million in gross proceeds and \$5.1 million in net proceeds after deducting commissions and selling expenses. We recorded an impairment charge upon the sale of the property of \$83,000.

During the first nine months of 2007, we benefited from a recovery of impairment on assets held for sale in connection with our adjustment of the fair value of the same property in Fremont, California, which had been decontaminated and was being prepared for sale. We recorded a \$481,000 market value adjustment after we entered into an agreement with an independent third party purchaser in June 2007. However, the sale was not consummated with this purchaser under this agreement, and the property was not sold until March 2008 to a different independent third-party purchaser.

**Note 6. Net Income (Loss) Per Share**

Basic net income (loss) per common share is calculated by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common and common equivalent shares include the dilutive effect of common stock equivalents outstanding during the period calculated using the treasury stock method. Common stock equivalents consist of the shares issuable upon the exercise of stock options.

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

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|---------|------------------------------------|----------|
|   | 2008                                | 2007    | 2008                               | 2007     |
| <b>Numerator:</b>   |                                     |         |                                    |          |
| Net income (loss)   | \$ (1,014)                          | \$ 858  | \$ 1,682                           | \$ 3,415 |
| Less: Preferred stock dividends   | (44)                                | (44)    | (132)                              | (132)    |
| Net income (loss) available to common stockholders  | \$ (1,058)                          | \$ 814  | \$ 1,550                           | \$ 3,283 |
| <b>Denominator:</b>   |                                     |         |                                    |          |
| Denominator for basic net income (loss) per share -<br>weighted average common shares       | 30,455                              | 30,150  | 30,410                             | 29,940   |
| <b>Effect of dilutive securities:</b>   |                                     |         |                                    |          |
| Common stock options  |                                     | 1,314   | 1,092                              | 1,347    |
| Denominator for dilutive net income (loss) per<br>common share                              | 30,455                              | 31,464  | 31,502                             | 31,287   |
| Basic net income (loss) per share   | \$ (0.03)                           | \$ 0.03 | \$ 0.05                            | \$ 0.11  |
| Diluted net income (loss) per share   | \$ (0.03)                           | \$ 0.03 | \$ 0.05                            | \$ 0.10  |
| Options excluded from diluted net income (loss) per<br>share as the impact is anti-dilutive | 2,353                               | 98      | 679                                | 822      |

Table of Contents**Note 7. Comprehensive Income**

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

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2008</b>                                 | <b>2007</b> | <b>2008</b>                                | <b>2007</b> |
| Net income (loss)   | \$ (1,014)                                  | \$ 858      | \$ 1,682                                   | \$ 3,415    |
| Change in foreign currency translation gain                           | 28  | 357         | 1,781                                      | 956         |
| Change in unrealized gain (loss) on<br>available-for-sale investments | (707)                                       | 110         | (1,404)                                    | 582         |
| Comprehensive income (loss)   | \$ (1,693)                                  | \$ 1,325    | \$ 2,059                                   | \$ 4,953    |

**Note 8. Segment Information and Foreign Operations***Segment Information*



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We operate in one segment for the design, development, manufacture and distribution of high-performance compound semiconductor substrates and sale of related materials. In accordance with SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information* ( SFAS No. 131 ), our chief operating decision-maker has been identified as the Chief Executive Officer, who reviews operating results to make decisions about allocating our resources and assessing our performance. We manage the Company on a consolidated basis with a review of revenue by product. We discuss revenue and capacity for both AXT and our China joint ventures collectively, when determining capacity constraints and need for raw materials in our business, and consider their capacity when determining our strategic and product marketing and advertising strategies. While we consolidate three of the joint ventures, we do not allocate resources to any of them, nor allocate any portion of overhead, interest and other income, interest expense or taxes to them. Accordingly, we have determined that our joint venture operations do not constitute an operating segment in accordance with SFAS No. 131. Since we operate in one segment, all financial segment and product line information required by SFAS No. 131 can be found in the condensed consolidated financial statements.

### *Product Information*

|                          | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                          | 2008                                | 2007      | 2008                               | 2007      |
| Revenue by product type: |                                     |           |                                    |           |
| GaAs substrates          | \$ 13,617                           | \$ 9,909  | \$ 40,479                          | \$ 27,997 |
| InP substrates           | 484                                 | 408       | 1,462                              | 1,586     |
| Ge substrates            | 795                                 | 536       | 3,564                              | 1,479     |
| Raw materials and other  | 2,967                               | 3,621     | 11,924                             | 9,577     |
| Consolidated             | \$ 17,863                           | \$ 14,474 | \$ 57,429                          | \$ 40,639 |

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*Geographical Information*

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

|                | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|----------------|-------------------------------------|-----------|------------------------------------|-----------|
|                | 2008                                | 2007      | 2008                               | 2007      |
| Net revenues:  |                                     |           |                                    |           |
| North America* | \$ 5,030                            | \$ 2,820  | \$ 15,466                          | \$ 8,918  |
| Europe         | 2,913                               | 2,521     | 9,696                              | 7,163     |
| Japan          | 3,557                               | 3,301     | 12,292                             | 8,699     |
| Taiwan         | 1,978                               | 2,444     | 6,846                              | 6,512     |
| Asia Pacific   | 4,385                               | 3,388     | 13,129                             | 9,347     |
| Consolidated   | \$ 17,863                           | \$ 14,474 | \$ 57,429                          | \$ 40,639 |

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\*Primarily the United States

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

|                    | As of                 |                      |
|--------------------|-----------------------|----------------------|
|                    | September 30,<br>2008 | December 31,<br>2007 |
| Long-lived assets: |                       |                      |
| North America      | \$ 383                | \$ 149               |
| China              | 21,079                | 15,837               |
|                    | \$ 21,462             | \$ 15,986            |

### *Significant Customers*

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Beginning 2008, we have grouped sales to all IQE companies as sales to one customer. Two customers represented 28.7% and 10.2% of revenue for the three month period ended September 30, 2008 while no customers represented more than 10% of revenue for the three month period ended September 30, 2007. One customer represented 20.2% of revenue for the nine month period ended September 30, 2008 while no customer represented more than 10% of revenue for the nine month period ended September 30, 2007. Our top five customers represented 62.0% and 35.9% of revenue for the three month periods ended September 30, 2008 and 2007, respectively. Our top five customers represented 47.5% and 38.5% of revenue for the nine month periods ended September 30, 2008 and 2007, respectively.



Table of Contents**Note 9. Investments in Privately-held Companies**

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

| Company   | Investment Balance as of |                   | Accounting Method | Ownership Percentage |
|---|--------------------------|-------------------|-------------------|----------------------|
|   | September 30, 2008       | December 31, 2007 |                   |                      |
| Beijing Ji Ya Semiconductor Material Co., Ltd                   | \$ 996                   | \$ 996            | Consolidated      | 46%                  |
| Nanjing Jin Mei Gallium Co., Ltd                                | 592                      | 592               | Consolidated      | 83%                  |
| Beijing BoYu Semiconductor Vessel Craftwork Technology Co., Ltd | 410                      | 410               | Consolidated      | 70%                  |
| Xilingol Tongli Germanium Co., Ltd                              | 2,861                    | 2,138             | Equity            | 25%                  |
| Emeishan Jia Mei High Purity Metals Co., Ltd                    | 816                      | 761               | Equity            | 25%                  |

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

- both companies have sustainable businesses of their own;
- our voting power is proportionate to our ownership interests;
- we only recognize our respective share of the losses and/or residual returns generated by the companies if they occur; and
- we do not have a controlling financial interest in, do not maintain operational or management control of, do not control the board of directors of, and are not required to provide additional investment or financial support to, either company.

Undistributed retained earnings relating to our investments were \$10.9 million and \$7.8 million as of September 30, 2008 and December 31, 2007, respectively. Net income recorded from our investments was \$879,000 and \$729,000 for the three months ended September 30, 2008 and 2007, respectively. Net income recorded from our investments was \$3.1 million and \$2.3 million for the nine months ended September 30, 2008 and 2007, respectively.

The minority interest for the three majority-owned joint ventures that are consolidated is included within Other long-term liabilities in the condensed consolidated balance sheets and separately disclosed under Minority interests on the condensed consolidated statements of operations. The equity earnings from the two minority-owned joint ventures that are not consolidated are recorded as Other income (expense), net on the condensed consolidated statements of operations.

We also have investments in two privately-held companies which are accounted for under the cost method as we do not have the ability to exercise significant influence over their operations. As of September 30, 2008 and December 31, 2007, these investments totaled approximately \$0.4 million and are included in Other assets on the condensed consolidated balance sheets.

**Note 10. Commitments and Contingencies**

*Indemnification Agreements*

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

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

***Product Warranty***



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We warrant our products for a specific period of time, generally twelve months, against material defects. We provide for the estimated future costs of warranty obligations in cost of sales when the related revenue is recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that we expect to incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. On a quarterly basis, we review the accrued balances and update these based on the historical warranty cost trends. The following table reflects the change in our warranty accrual which is included in accrued liabilities on the condensed consolidated balance sheets, during the three and nine months ended September 30, 2008 and 2007 (in thousands):

|  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2008                                | 2007   | 2008                               | 2007   |
| Beginning accrued warranty and related costs | \$ 1,309                            | \$ 949 | \$ 1,030                           | \$ 459 |
| Charged (credited) to cost of revenue        | (95)                                | (116)  | 313                                | 580    |
| Actual warranty expenditures                 | (118)                               | (14)   | (247)                              | (220)  |
| Ending accrued warranty and related costs    | \$ 1,096                            | \$ 819 | \$ 1,096                           | \$ 819 |

### **Purchase Commitment**

On February 27, 2007, we entered into an agreement with Recapture Metals Limited of Ontario, Canada ( Recapture ), pursuant to which Recapture will supply our subsidiary in the People's Republic of China with one thousand kilograms per month of 99.99999% pure gallium, during the eighteen month period beginning July 1, 2007. Under the terms of the agreement, we are required to purchase a minimum of eighteen thousand kilograms of gallium, unless the agreement is terminated prior to the expiration of the eighteen month period on December 31, 2008. As of September 30, 2008, our total remaining commitment under this agreement is approximately \$1.2 million.

### **Note 11. Foreign Exchange Transaction Gains/Losses**

We incurred foreign currency transaction exchange losses of \$69,000 and \$162,000 for the three month periods ended September 30, 2008, and 2007, respectively. We incurred foreign currency transaction exchange losses of \$473,000 and \$128,000 for the nine month periods ended September 30, 2008, and 2007, respectively. These amounts are included in Other income (expense), net on the condensed consolidated statements of operations.

### **Note 12. Income Taxes**

In July 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48 ( FIN48 ), *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* ( SFAS 109 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN 48 effective January 1, 2007. We recognize interest and penalties related to uncertain tax positions in income tax expense. As of September 30, 2008, we do not have any gross unrecognized tax benefits, nor any accrued interest and penalties related to uncertain tax positions. As a result of the implementation of FIN 48, we identified \$16.4 million in unrecognized tax benefits. This amount decreased the tax loss carryforwards in the U.S. which are fully offset by a valuation allowance. We file income tax returns in the U.S. federal, various states and foreign jurisdictions. We have substantially concluded all U.S. federal and state income tax matters through December 31, 2007.



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**Note 13. Recent Accounting Pronouncements**

In May 2008, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard ( SFAS ) No. 162 The Hierarchy of Generally Accepted Accounting Principles ( SFAS No. 162 ). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS No. 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The FASB has stated that it does not expect that SFAS No. 162 will result in a change in current practice.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS 161 ). SFAS 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Based on our current operations, we do not expect that the adoption of SFAS 161 will have a material impact on our consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*, ( SFAS 141R ). SFAS 141R establishes the principles and requirements for how an acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) will be applicable beginning with our fiscal 2009. The impact of the adoption of SFAS 141(R) on our results of operations and financial position will depend on the nature and extent of business combinations that we complete, if any, in or after fiscal 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* ( SFAS 160 ). SFAS 160 requires that minority interest be separately reported in the consolidated entity's equity section and that no gain or loss shall be reported when transactions occur between the controlling interest and the non-controlling interests. Furthermore, the acquisition of non-controlling interest by the controlling interest is not treated as a business combination. SFAS 160 is effective for fiscal years beginning after December 15, 2008. We have not yet evaluated the impact that the adoption of SFAS 160 will have on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We do not have any instruments eligible for election of the fair value option. Therefore, the adoption of SFAS 159 in the first quarter of fiscal 2008 did not impact our consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods of those fiscal

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years. In February 2008, the FASB released a FASB Staff Position (FSP FAS 157-2 *Effective Date of FASB Statement No. 157*) which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. These non-financial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and non-financial assets acquired and liabilities assumed in a business combination. The partial adoption of SFAS 157 as of January 1, 2008 for financial assets and liabilities did not have a material impact on our condensed consolidated financial position, results of operations or cash flows. See Note 3 of the Notes to Condensed Consolidated Financial Statements.

On October 10, 2008, the FASB issued FASB Staff Position ( FSP ) No. 157-3 ( FSP 157-3 ), *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* ( FSP 157-3 ), to clarify the application of SFAS 157 in a market that is not active, providing an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP applies to financial assets within the scope of



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accounting pronouncements that require or permit fair value measurement in accordance with SFAS 157 and is effective upon issuance. We have determined there is no impact from adopting the provisions of FSP 157-3 on our consolidated financial position, results of operations or cash flows.

In various areas, including revenue recognition, stock option accounting, accounting standards and practices continue to evolve. Additionally, the SEC and the FASB's Emerging Issues Task Force continue to address revenues, stock option accounting related accounting issues. We believe that we are in compliance with all of the rules and related guidance as they currently exist. However, any changes to accounting principles generally accepted in the United States of America in these areas could impact the future accounting of our operations.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This quarterly report on Form 10-Q, including the following sections, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, particularly statements relating to our expectations regarding results of operations, customer demand, improvements in our product quality, our ability to expand our markets and increase sales, customer qualifications of our products, gross margins, favorable pricing, reliable supply and enhanced sourcing lead-times of raw materials, and our reserve balances. These forward-looking statements are based upon management's current views with respect to future events and financial performance, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated in such forward-looking statements. Such risks and uncertainties include those set forth under the section entitled "Risk Factors" below, which identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in this Form 10-Q and other filings we have made with the Securities and Exchange Commission. Forward-looking statements may be identified by the use of terms such as "anticipates," "believes," "estimates," "expects," "intends," and similar expressions. Statements concerning our future or expected financial results and condition, business strategy and plans or objectives for future operations are forward-looking statements.

These forward-looking statements are not guarantees of future performance. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. This discussion should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2007 and the condensed consolidated financial statements included elsewhere in this report.

**Overview**

We are a leading worldwide developer and producer of high-performance compound and single element semiconductor substrates comprising gallium arsenide (GaAs), indium phosphide (InP) and germanium (Ge). We currently sell the following substrate products in the sizes and for the applications indicated:

| Substrates             | Product | Diameter | Applications  |
|------------------------|---------|----------|---|
| GaAs (semi-insulating) |         | 2 to 6   | <ul style="list-style-type: none"> <li>• Power amplifiers and integrated circuits for wireless handsets</li> <li>• Direct broadcast television</li> <li>• High-performance transistors</li> <li>• Satellite communications</li> </ul> |
| GaAs (semi-conducting) |         | 2, 3, 4  | <ul style="list-style-type: none"> <li>• High brightness LEDs</li> <li>• Lasers</li> <li>• Optical couplers</li> </ul>  |
| InP                    |         | 2, 3, 4  | <ul style="list-style-type: none"> <li>• Broadband and fiber optic communications</li> </ul>  |
| Ge                     |         | 2, 4     | <ul style="list-style-type: none"> <li>• Satellite and terrestrial solar cells</li> <li>• Optical applications</li> </ul>   |

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We manufacture compound semiconductor substrates using our proprietary vertical gradient freeze, or VGF, technology. Our in-house VGF technology and manufacturing capabilities enables us to add capacity quickly and cost efficiently. We manufacture all of our products in China, which generally has lower costs for facilities, labor and materials than in the U.S. or Europe.

We also have three majority-owned and two minority-owned joint ventures in China which provide us favorable pricing, reliable supply and enhanced sourcing lead-times for key raw materials which are central to our final manufactured products. These joint ventures produce products including 99.99% pure gallium (4N Ga), high purity gallium, arsenic, germanium, germanium dioxide, paralytic boron nitride (pBN) crucibles and boron oxide. AXT's ownership interest in these entities ranges from 25% to 83%. We consolidate the three ventures in which we own a majority or controlling financial interest and employ equity accounting for the two joint ventures in which we have a 25% interest. We purchase portions of the materials produced by these ventures for our own use and the joint ventures sell the remainder of their production to third parties.

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Revenue increased \$16.8 million, or 41.3%, to \$57.4 million for the nine months ended September 30, 2008 from \$40.6 million for the same period of 2007 primarily due to higher customer demand for six-inch diameter wafers, and an increase in germanium substrates and raw material sales. While this is a large increase over the prior year, the demand for our GaAs products which are used in a number of consumer, industrial and automotive applications was softer than we expected. While the volatile business and financial markets are prompting us to continue to take a conservative approach to our business, we remain optimistic about our business in the quarters to come. Despite the continuing margin pressure, our gallium arsenide and raw materials businesses have been solid. Positive industry trends, coupled with our competitive manufacturing and cost advantages give us confidence in our ability to continue to drive future businesses in 2009. On March 28, 2008, we completed the sale of our Fremont, California facility and received net proceeds of approximately \$5.1 million after deducting commissions and selling expenses. As of September 30, 2008, we had available cash, cash equivalents and short-term investments of \$29.5 million, excluding restricted deposits. On July 1, 2008, we exercised our right to redeem the taxable variable rate revenue bond and repaid all outstanding indebtedness and accrued interest under the terms of the revenue bond of approximately \$6.4 million. Accordingly, all of our remaining obligations under the revenue bond have terminated and the related restricted deposits have been released. In September 2008, we obtained an express line of credit from Citigroup Smith Barney and drew down \$3.0 million and classified the same amount as restricted deposits as of September 30, 2008. The proceeds from the express line of credit was used in operations. The \$3.0 million restricted cash carries an annual interest rate of 4.0%.

**Critical Accounting Policies and Estimates**

We have prepared our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. As such, we have had to make estimates, assumptions and judgments that affect the amounts reported on our financial statements. These estimates, assumptions and judgments about future events and their effects on our results cannot be determined with certainty, and are made based upon our historical experience and on other assumptions that are believed to be reasonable under the circumstances. These estimates may change as new events occur or additional information is obtained, and we may periodically be faced with uncertainties, the outcomes of which are not within our control and may not be known for a prolonged period of time. The discussion and analysis of our results of operations and financial condition are based upon these condensed consolidated financial statements.

We have identified the policies below as critical to our business operations and understanding of our financial condition and results of operations.

A critical accounting policy is one that is both material to the presentation of our financial statements and requires us to make difficult, subjective or complex judgments that could have a material effect on our financial condition and results of operations. They may require us to make assumptions about matters that are highly uncertain at the time of the estimate, and different estimates that we could have used, or changes in the estimate that are reasonably likely to occur, may have a material impact on our financial condition or results of operations. We believe that the following are our critical accounting policies:

***Revenue Recognition***

We manufacture and sell high-performance compound semiconductor substrates and sell certain raw materials including gallium, germanium dioxide, and pBN crucibles. After we ship our products, there are no remaining obligations or customer acceptance requirements that would preclude revenue recognition. Our products are typically sold pursuant to a purchase order placed by our customers, and our terms and conditions of sale do not require customer acceptance. We recognize revenue upon shipment and transfer of title of products to our customers, which is either upon shipment from our dock, receipt at the customer's dock, or removal from consignment inventory at the customer's location,

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provided that we have received a signed purchase order, the price is fixed or determinable, title and risk of ownership have transferred, collection of resulting receivables is probable, and product returns are reasonably estimable. We do not provide training, installation or commissioning services. Additionally, we may provide discounts or other incentives to customers in order to secure business.

We provide for future returns based on historical experience, current economic trends and changes in customer demand at the time revenue is recognized.

### *Allowance for Doubtful Accounts*

We periodically review the likelihood of collection on our accounts receivable balances and provide an allowance for doubtful accounts receivable primarily based upon the age of these accounts. We provide a 100% allowance for receivables

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from U.S. customers in excess of 90 days and for receivables from customers located outside the U.S. in excess of 120 days. We assess the probability of collection based on a number of factors, including the length of time a receivable balance has been outstanding, our past history with the customer and their creditworthiness.

As of September 30, 2008 and December 31, 2007, our accounts receivable, net, balance was \$13.3 million and \$12.1 million, respectively, which was net of an allowance for doubtful accounts of \$681,000 and \$379,000, respectively. If actual uncollectible accounts differ substantially from our estimates, revisions to the estimated allowance for doubtful accounts would be required, which could have a material impact on our financial results for the period.

***Warranty Reserve***

We maintain a warranty reserve based upon our claims experience during the prior twelve months. Warranty costs are accrued at the time revenue is recognized. As of September 30, 2008 and December 31, 2007, accrued product warranties totaled \$1.1 million and \$1.0 million, respectively. If actual warranty costs differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material impact on our financial condition and results of operations.

***Inventory Valuation***

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average cost method. Our inventory consists of raw materials as well as finished goods and work-in-process that include material, labor and manufacturing overhead costs. Given the nature of our substrate products, and the materials used in the manufacturing process, the wafers and ingots comprising work-in-process may be held in inventory for up to two years and three years, respectively, as the risk of obsolescence for these materials is low. We routinely evaluate the levels of our inventory in light of current market conditions in order to identify excess and obsolete inventory, and we provide a valuation allowance for certain inventories based upon the age and quality of the product and the projections for sale of the completed products. As of September 30, 2008 and December 31, 2007, we had an inventory reserve of \$12.3 million and \$13.6 million for excess and obsolete inventory, respectively. The majority of this inventory has not been scrapped, and accordingly, may be sold in future periods. If actual demand for our products were to be substantially lower than estimated, additional inventory adjustments for excess or obsolete inventory might be required, which could have a material impact on our business, financial condition and results of operations.

***Impairment of Investments***

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

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

### ***Impairment of Long-Lived Assets***

We evaluate the recoverability of property, equipment and intangible assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. When events and circumstances indicate that long-lived assets may be impaired, we compare the carrying value of the long-lived assets to the projection of future undiscounted cash flows attributable to these assets. In the event that the carrying value exceeds the future undiscounted cash flows, we record an impairment charge against income equal to the excess of the carrying value over the assets' fair value. Fair values are determined based on quoted market values, discounted cash flows or internal and external appraisals, as applicable. Assets held for sale are carried at the lower of carrying value or estimated net realizable value.

Table of Contents**Employee Stock Options**

We grant options to substantially all management employees and believe that this program helps us to attract, motivate and retain high quality employees, to the ultimate benefit of our stockholders. Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123(R) ), using the modified prospective application transition method. Under this transition method, stock-based compensation cost was recognized in the condensed consolidated financial statements for all share-based payments after January 1, 2006. Compensation cost recognized includes the estimated expense for the portion of the vesting period after January 1, 2006 for share-based payments prior to, but not vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, *Accounting for Stock-Based Compensation*. We recognize these compensation costs net of an estimated forfeiture rate over the requisite service period of the award, which is generally the vesting term of four years for stock options. Results for prior periods have not been restated, as provided for under the modified prospective application transition method.

**Income Taxes**

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

We provide for income taxes based upon the geographic composition of worldwide earnings and tax regulations governing each region, particularly China. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws, particularly in foreign countries such as China. Effective January 1, 2007, we adopted FASB Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. See Note 12 Income Taxes in the condensed consolidated financial statements for additional information.

**Results of Operations****Revenue**

|               | Three Months Ended<br>September 30, |           | Increase<br>(Decrease) | % Change |
|---------------|-------------------------------------|-----------|------------------------|----------|
|               | 2008                                | 2007      |                        |          |
|               | (\$ in thousands)                   |           |                        |          |
| GaAs          | \$ 13,617                           | \$ 9,909  | \$ 3,708               | 37.4%    |
| InP           | 484                                 | 408       | 76                     | 18.6%    |
| Ge            | 795                                 | 536       | 259                    | 48.3%    |
| Raw materials | 2,967                               | 3,621     | (654)                  | (18.1)%  |
| Total revenue | \$ 17,863                           | \$ 14,474 | \$ 3,389               | 23.4%    |



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Revenue increased \$3.4 million, or 23.4%, to \$17.9 million for the three months ended September 30, 2008 from \$14.5 million for the three months ended September 30, 2007. Total GaAs substrate revenue increased \$3.7 million, or 37.4%, to \$13.6 million for the three months ended September 30, 2008 from \$9.9 million for the three months ended September 30, 2007. While this is a large increase over the prior year, the demand for our GaAs products which are used in a number of consumer, industrial and automotive applications was softer than we expected due to an overall market slowdown and lower than expected demand from customer orders. We are also continuing our efforts to resolve specific product specification issues with a few select customers from the prior quarter.

Sales of 5 inch and 6 inch diameter GaAs substrates were \$6.1 million for the three months ended September 30, 2008 compared to \$3.1 million for the three months ended September 30, 2007. The increase in larger diameter semi-insulating substrates came from the growth in demand for both cellular and WLAN (Wide Local Area Network) markets. Our growth came particularly from production orders pursuant to a supply agreement we signed in the fourth quarter of 2007 with IQE plc.

Sales of 2 inch, 3 inch and 4 inch diameter GaAs substrates were \$7.5 million for the three months ended September 30, 2008 compared with \$6.8 million for the three months ended September 30, 2007. The increase in revenue from smaller diameter substrates was due to the continued market growth generally of LED laser diodes and commercial epitaxy primarily from 4 inch large semi-conducting customers offset by lesser demand from 2 inch customers.

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InP substrate revenue increased \$76,000, or 18.6%, to \$484,000 for the three months ended September 30, 2008 from \$408,000 for the three months ended September 30, 2007 primarily due to a slight increase in demand from customers in the optical networking industry.

Ge substrate revenue increased \$259,000, or 48.3%, to \$795,000 for the three months ended September 30, 2008 from \$536,000 for the three months ended September 30, 2007. The increase in Ge substrate revenue was due to an overall increased demand for space applications.

Raw materials revenue decreased \$654,000, or 18.1%, to \$3.0 million for the three months ended September 30, 2008 from \$3.6 million for the three months ended September 30, 2007. The decrease in raw materials revenue was primarily due to transportation restrictions imposed in the Beijing area during the Olympics and Paralympics which ended on September 30, 2008.

|               | Nine Months Ended<br>September 30, |           | Increase<br>(Decrease) | % Change |
|---------------|------------------------------------|-----------|------------------------|----------|
|               | 2008                               | 2007      |                        |          |
|               | (\$ in thousands)                  |           |                        |          |
| GaAs          | \$ 40,479                          | \$ 27,997 | \$ 12,482              | 44.6%    |
| InP           | 1,462                              | 1,586     | (124)                  | (7.8)%   |
| Ge            | 3,564                              | 1,479     | 2,085                  | 141.0%   |
| Raw materials | 11,912                             | 9,532     | 2,380                  | 25.0%    |
| Other         | 12                                 | 45        | (33)                   | (73.3)%  |
| Total revenue | \$ 57,429                          | \$ 40,639 | \$ 16,790              | 41.3%    |

Revenue increased \$16.8 million, or 41.3%, to \$57.4 million for the nine months ended September 30, 2008 from \$40.6 million for the nine months ended September 30, 2007. Total GaAs substrate revenue increased \$12.5 million, or 44.6%, to \$40.5 million for the nine months ended September 30, 2008 from \$28.0 million for the nine months ended September 30, 2007. While this is a large increase over the prior year, the demand for our GaAs products which are used in a number of consumer, industrial and automotive applications was softer than we expected due to an overall market slowdown and lower than expected demand from customer orders. We are also continuing our efforts to resolve specific product specification issues with a few select customers from the prior quarter.

Sales of 5 inch and 6 inch diameter GaAs substrates were \$19.0 million for the nine months ended September 30, 2008 compared to \$11.1 million for the nine months ended September 30, 2007. The increase in larger diameter semi-insulating substrates came from the growth in demand for both cellular and WLAN (Wide Local Area Network) markets. Our growth came particularly from production orders pursuant to a supply agreement we signed in the fourth quarter of 2007 with IQE plc.

Sales of 2 inch, 3 inch and 4 inch diameter GaAs substrates were \$21.5 million for the nine months ended September 30, 2008 compared with \$16.9 million for the nine months ended September 30, 2007. The increase in revenue from smaller diameter substrates was due to the continued market growth generally of LED laser diodes and commercial epitaxy primarily from 4 inch large semi-conducting customers offset by lesser demand from 2 inch customers.

InP substrate revenue decreased \$124,000, or 7.8%, to \$1.5 million for the nine months ended September 30, 2008 from \$1.6 million for the nine months ended September 30, 2007. In the nine months ended June 30, 2007 we had a one-time sale of \$251,000 indium scrap metal that was fully reserved. Excluding the impact of the one-time sale, InP substrate revenue actually increased \$127,000 for the nine months ended

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September 30, 2008 compared to the nine months ended September 30, 2007 due to a slight increase in demand from customers in the optical networking industry.

Ge substrate revenue increased \$2.1 million, or 141.0%, to \$3.6 million for the nine months ended September 30, 2008 from \$1.5 million for the nine months ended September 30, 2007. The increase in Ge substrate revenue was due to an overall increased demand for space applications.

Raw materials revenue increased \$2.4 million, or 25.0%, to \$11.9 million for the nine months ended September 30, 2008 from \$9.5 million for the nine months ended September 30, 2007. Despite the transportation restrictions imposed in the Beijing area during the Olympics and Paralympics which ended on September 30, 2008, the increase in raw materials revenue was primarily due to a combination of increased sales to customers as demand increased and higher raw materials prices.

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*Revenue by Geographic Region*

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|   | Three Months Ended<br>September 30, |           | Increase<br>(Decrease) | % Change |
|---|-------------------------------------|-----------|------------------------|----------|
|   | 2008                                | 2007      |                        |          |
|   | (\$ in thousands)                   |           |                        |          |
| North America *                           | \$ 5,030                            | \$ 2,820  | \$ 2,210               | 78.4%    |
| <i>% of total revenue</i>                 | 28%                                 | 20%       |                        |          |
| Europe                                    | 2,913                               | 2,521     | 392                    | 15.5%    |
| <i>% of total revenue</i>                 | 16%                                 | 17%       |                        |          |
| Japan                                     | 3,557                               | 3,301     | 256                    | 7.8%     |
| <i>% of total revenue</i>                 | 20%                                 | 23%       |                        |          |
| Taiwan                                    | 1,978                               | 2,444     | (466)                  | (19.1)%  |
| <i>% of total revenue</i>                 | 11%                                 | 17%       |                        |          |
| Asia Pacific (excluding Japan and Taiwan) | 4,385                               | 3,388     | 997                    | 29.4%    |
| <i>% of total revenue</i>                 | 25%                                 | 23%       |                        |          |
| Total revenue                             | \$ 17,863                           | \$ 14,474 | \$ 3,389               | 23.4%    |

\*Primarily the United States

Revenue from customers in North America increased by \$2.2 million, or 78.4%, to \$5.0 million for the three months ended September 30, 2008 from \$2.8 million for the three months ended September 30, 2007. We expected our North America revenue to increase substantially in 2008 based upon a supply agreement we signed in the fourth quarter of 2007 with IQE plc. Under the terms of the agreement, IQE plc shall purchase from us a minimum of approximately \$15.1 million of 4-inch and 6-inch semi-insulating gallium arsenide (GaAs) substrates. IQE plc has an option to purchase an additional \$3.5 million of 6-inch substrates from us under the agreement. All substrates ordered pursuant to the agreement are to be shipped by the end of 2008.

Revenue from customers in Europe increased by \$0.4 million, or 15.5%, to \$2.9 million for the three months ended September 30, 2008 from \$2.5 million for the three months ended September 30, 2007. This increase came primarily from increased substrate sales to customers in Germany and France, and to a lesser extent from increased sales to a customer in the United Kingdom that is part of the IQE plc group with whom we signed a supply agreement in the fourth quarter of 2007.

Revenue from customers in Japan increased by \$0.3 million, or 7.8%, to \$3.6 million for the three months ended September 30, 2008 from \$3.3 million for the three months ended September 30, 2007. The increase came from increased substrate sales to two major existing customers, particularly in large diameter wafers, and from increased raw material sales of 4N gallium.

Revenue from customers in Taiwan decreased by \$0.5 million, or 19.1%, to \$2.0 million for the three months ended September 30, 2008 from \$2.4 million for the three months ended September 30, 2007. The decrease came mainly from one major existing customer for large diameter wafers as we continue our effort to resolving issues with product specifications.

Revenue from customers in Asia Pacific (excluding Japan and Taiwan) increased by \$1.0 million, or 29.4%, to \$4.4 million for the three months ended September 30, 2008 from \$3.4 million for the three months ended September 30, 2007. The increase came mainly from one major customer in Singapore that is part of the IQE plc group that signed the supply agreement with us in the fourth quarter of 2007.

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|   | Nine Months Ended<br>September 30, |           | Increase<br>(Decrease) | % Change |
|---|------------------------------------|-----------|------------------------|----------|
|   | 2008                               | 2007      |                        |          |
|   | (\$ in thousands)                  |           |                        |          |
| North America *                           | \$ 15,466                          | \$ 8,918  | \$ 6,548               | 73.4%    |
| <i>% of total revenue</i>                 | 27%                                | 22%       |                        |          |
| Europe                                    | 9,696                              | 7,163     | 2,533                  | 35.4%    |
| <i>% of total revenue</i>                 | 17%                                | 18%       |                        |          |
| Japan                                     | 12,292                             | 8,699     | 3,593                  | 41.3%    |
| <i>% of total revenue</i>                 | 21%                                | 21%       |                        |          |
| Taiwan                                    | 6,846                              | 6,512     | 334                    | 5.1%     |
| <i>% of total revenue</i>                 | 12%                                | 16%       |                        |          |
| Asia Pacific (excluding Japan and Taiwan) | 13,129                             | 9,347     | 3,782                  | 40.5%    |
| <i>% of total revenue</i>                 | 23%                                | 23%       |                        |          |
| Total revenue                             | \$ 57,429                          | \$ 40,639 | \$ 16,790              | 41.3%    |

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\*Primarily the United States



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Revenue from customers in North America increased by \$6.5 million, or 73.4%, to \$15.5 million for the nine months ended September 30, 2008 from \$8.9 million for the nine months ended September 30, 2007. We expected our North America revenue to increase substantially in 2008 based upon a supply agreement we signed in the fourth quarter of 2007 with IQE plc. Under the terms of the agreement, IQE plc shall purchase from us a minimum of approximately \$15.1 million of 4-inch and 6-inch semi-insulating gallium arsenide (GaAs) substrates. IQE plc has an option to purchase an additional \$3.5 million of 6-inch substrates from us under the agreement. All substrates ordered pursuant to the agreement are to be shipped by the end of 2008.

Revenue from customers in Europe increased by \$2.5 million, or 35.4%, to \$9.7 million for the nine months ended September 30, 2008 from \$7.2 million for the nine months ended September 30, 2007. This increase came primarily from increased substrate sales to customers in Germany and France, and to a lesser extent from increased sales to a customer in the United Kingdom that is part of the IQE plc group with whom we signed a supply agreement in the fourth quarter of 2007.

Revenue from customers in Japan increased by \$3.6 million, or 41.3%, to \$12.3 million for the nine months ended September 30, 2008 from \$8.7 million for the nine months ended September 30, 2007. The increase came from increased substrate sales to two major existing customers, particularly in large diameter wafers, and from increased raw material sales of 4N gallium.

Revenue from customers in Taiwan increased by \$0.3 million, or 5.1%, to \$6.8 million for the nine months ended September 30, 2008 from \$6.5 million for the nine months ended September 30, 2007. The increase came mainly from one major existing customer for large diameter wafers as we continue our effort to resolving issues with product specifications.

Revenue from customers in Asia Pacific (excluding Japan and Taiwan) increased by \$3.8 million, or 40.5%, to \$13.1 million for the nine months ended September 30, 2008 from \$9.3 million for the nine months ended September 30, 2007. Sales to customers in the People's Republic of China increased by \$2.7 million, of which raw materials was \$1.4 million, while \$0.7 million was from increased sales of substrates to existing customers, and \$0.6 million was from sales of substrates to new customers. Sales to a major customer in Singapore that is part of the IQE plc group that signed the supply agreement with us in the fourth quarter of 2007 increased by \$0.7 million. Sales to customers in Korea increased by \$0.4 million as demand increased in smaller diameter wafers.

**Gross Margin**

|                | <b>Three Months Ended<br/>September 30,</b> |             |                                |                 |
|----------------|---|-------------|--------------------------------|-----------------|
|                | <b>2008</b>                                 | <b>2007</b> | <b>Increase<br/>(Decrease)</b> | <b>% Change</b> |
|                | (\$ in thousands)                           |             |                                |                 |
| Gross profit   | \$ 4,537                                    | \$ 4,530    | \$ 7                           | 0.2%            |
| Gross Margin % | 25.4%                                       | 31.3%       |                                |                 |

Gross margin decreased to 25.4% of total revenue for the three months ended September 30, 2008 from 31.3% of total revenue for the three months ended September 30, 2007. Gross margins in the three months ended September 30, 2008 and 2007 were positively impacted by sales of approximately \$769,000 and \$556,000, respectively, of GaAs wafers that were previously fully reserved. In the three months ended September 30, 2007 we had manufacturing equipment that had become fully depreciated. Since the beginning of 2008, gross margins were

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negatively impacted by declining average selling prices and rising raw material costs, as well as an increase in depreciation as a result of our purchase of equipment acquired for our capacity expansion. The decline in sales in the third quarter of 2008 from the prior quarter also resulted in lower throughput of production with less recovery of overheads.

|                       | <b>Nine Months Ended<br/>September 30,</b> |             | <b>Increase<br/>(Decrease)</b> | <b>% Change</b> |
|-----------------------|--|-------------|--------------------------------|-----------------|
|                       | <b>2008</b>                                | <b>2007</b> |                                |                 |
|                       | <b>(\$ in thousands)</b>                   |             |                                |                 |
| <b>Gross profit</b>   | \$ 17,202                                  | \$ 14,967   | \$ 2,235                       | 14.9%           |
| <i>Gross Margin %</i> | 30.0%                                      | 36.8%       |                                |                 |

Gross margin decreased to 30.0% of total revenue for the nine months ended September 30, 2008 from 36.8% of total revenue for the nine months ended September 30, 2007. Gross margins in the nine months ended September 30, 2008 and 2007 were positively impacted by sales of approximately \$2.1 million and \$1.7 million, respectively, of GaAs wafers that were previously fully reserved. In the nine months ended September 30, 2007 we had manufacturing equipment that had become fully depreciated. In addition, during the nine months ended September 30, 2007, we had a one-time sale of \$251,000 of indium scrap metal that was fully reserved. Since the beginning of 2008, gross margins were negatively impacted by declining average selling prices and rising raw material costs, as well as an increase in depreciation as a result of our purchase of equipment acquired for our capacity expansion.

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*Selling, General and Administrative Expenses*



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|  | Three Months Ended<br>September 30, |          | Increase<br>(Decrease) | % Change |
|--|-------------------------------------|----------|------------------------|----------|
|  | 2008                                | 2007     |                        |          |
|  | (\$ in thousands)                   |          |                        |          |
| Selling, general and administrative expenses | \$ 4,901                            | \$ 3,083 | \$ 1,818               | 59.0%    |
| <i>% of total revenue</i>                    | 27.4%                               | 21.3%    |                        |          |

Selling, general and administrative expenses increased \$1.8 million to \$4.9 million for the three months ended September 30, 2008 from \$3.1 million for the three months ended September 30, 2007. The increase was primarily due to \$700,000 rent deposit forfeited, \$394,000 higher bad debt expenses for our slow-paying customers in Asia, \$225,000 increased selling, general and administrative expenses in our China joint ventures, mainly labor related, \$219,000 increased compensation related expenses from general annual adjustments and increased headcount, \$141,000 higher bank fees in connection with our paydown of the revenue bond in July 2008, \$127,000 higher insurance costs, and \$12,000 higher miscellaneous costs. The \$700,000 rent deposit forfeited was a result of a termination of our existing lease. We entered into a new lease with the same landlord for smaller headquarters facilities at a saving of approximately \$2.5 million over the next seven years.

|  | Nine Months Ended<br>September 30, |           | Increase<br>(Decrease) | % Change |
|--|------------------------------------|-----------|------------------------|----------|
|  | 2008                               | 2007      |                        |          |
|  | (\$ in thousands)                  |           |                        |          |
| Selling, general and administrative expenses | \$ 12,146                          | \$ 10,529 | \$ 1,617               | 15.4%    |
| <i>% of total revenue</i>                    | 21.1%                              | 25.9%     |                        |          |

Selling, general and administrative expenses increased \$1.6 million, or 15.4% to \$12.1 million for the nine months ended September 30, 2008 from \$10.5 million for the nine months ended September 30, 2007. The increase was primarily due to \$702,000 higher compensation related expenses from general annual adjustments and increased headcount, \$700,000 rent deposit forfeited, \$585,000 increased selling, general and administrative expenses in our China joint ventures, mainly labor related, \$205,000 higher insurance costs, \$126,000 higher bank fees in connection with our paydown of the revenue bond in July 2008, and \$41,000 higher miscellaneous costs, partially offset by \$420,000 lower bad debt expense and \$322,000 lower legal and professional fees. Legal fees in the nine months ended September 30, 2007 included \$350,000 which was our portion of the settlement of the securities class action lawsuit reached on April 24, 2007. The \$700,000 rent deposit forfeited was a result of a termination of our existing lease. We entered into a new lease with the same landlord for smaller headquarters facilities at a saving of approximately \$2.5 million over the next seven years.

**Research and Development**

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|                           | Three Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|---------------------------|-------------------------------------|--------|------------------------|----------|
|                           | 2008                                | 2007   |                        |          |
|                           | (\$ in thousands)                   |        |                        |          |
| Research and development  | \$ 562                              | \$ 382 | \$ 180                 | 47.1%    |
| <i>% of total revenue</i> | 3.1%                                | 2.6%   |                        |          |

Research and development expenses increased \$180,000, or 47.1% to \$562,000 for the three months ended September 30, 2008 from \$382,000 for the three months ended September 30, 2007. The increase was due to salary and related costs associated with the appointment of a new chief technology officer effective December 31, 2007, higher consulting fees and general annual salary and related cost increases.

|                           | Nine Months Ended<br>September 30, |          | Increase<br>(Decrease) | % Change |
|---------------------------|------------------------------------|----------|------------------------|----------|
|                           | 2008                               | 2007     |                        |          |
|                           | (\$ in thousands)                  |          |                        |          |
| Research and development  | \$ 1,635                           | \$ 1,190 | \$ 445                 | 37.4%    |
| <i>% of total revenue</i> | 2.8%                               | 2.9%     |                        |          |

Research and development expenses increased \$445,000, or 37.4% to \$1.6 million for the nine months ended September 30, 2008 from \$1.2 million for the nine months ended September 30, 2007. The increase was due to salary and related costs associated with the appointment of a new chief technology officer effective December 31, 2007, higher consulting fees and general annual salary and related cost increases.

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*Impairment (Recovery) on Assets Held For Sale*





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|   | Nine Months Ended<br>September 30, |          | Increase<br>(Decrease) | % Change |
|---|------------------------------------|----------|------------------------|----------|
|   | 2008                               | 2007     |                        |          |
|   | (\$ in thousands)                  |          |                        |          |
| Impairment (Recovery) on assets held for sale | \$ 83                              | \$ (481) | \$ (564)               | 117.3%   |
| <i>% of total revenue</i>                     | 0.1%                               | -1.2%    |                        |          |

During the nine months ended September 30, 2008, we completed the sale of our property in Fremont, California. The final purchase price for the property was \$5.3 million. We received net proceeds of \$5.1 million after deducting commissions and selling expenses. We recorded an impairment charge upon the sale of the property of \$83,000. During the nine months ended September 30, 2007, we benefited from a recovery of impairment on assets held for sale in connection with our adjustment of the fair value of the same property in Fremont, California, which had been decontaminated and was being prepared for sale. We recorded a \$481,000 market value adjustment after we entered into an agreement with an independent third party purchaser in June 2007. However, the sale was not consummated with this purchaser under this agreement, and the property was not sold until March 2008 to a different independent third-party purchaser.

***Interest Income, net***

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|                           | Three Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|---------------------------|-------------------------------------|--------|------------------------|----------|
|                           | 2008                                | 2007   |                        |          |
|                           | (\$ in thousands)                   |        |                        |          |
| Interest income, net      | \$ 68                               | \$ 102 | \$ (34)                | (33.3)%  |
| <i>% of total revenue</i> | 0.4%                                | 0.7%   |                        |          |

Interest income, net decreased \$34,000 to \$68,000 for the three months ended September 30, 2008 from \$102,000 for the three months ended September 30, 2007. Interest income, net for the three months ended September 30, 2008 was due to the overall lower balances of our cash and investments after we paid down on our taxable revenue bond and use of cash in operations, offset by lower interest expense related to the revenue bond, while interest income, net for the three months ended September 30, 2007 was primarily generated from the net proceeds of our public offering of common stock, completed in December 2006 and January 2007.

|                           | Nine Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|---------------------------|------------------------------------|--------|------------------------|----------|
|                           | 2008                               | 2007   |                        |          |
|                           | (\$ in thousands)                  |        |                        |          |
| Interest income, net      | \$ 433                             | \$ 551 | \$ (118)               | (21.4)%  |
| <i>% of total revenue</i> | 0.8%                               | 1.4%   |                        |          |

Interest income, net decreased \$118,000 to \$433,000 for the nine months ended September 30, 2008 from \$551,000 for the nine months ended September 30, 2007 as a result of higher balances of our cash and investments in the nine months ended September 30, 2007, which came from the net proceeds of our public offering of common stock, completed in December 2006 and January 2007. The lower balances of our cash and investments as of September 30, 2008 also resulted from our paydown of the taxable revenue bond.

**Minority interests**

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|                           | Three Months Ended<br>September 30, |          |                        |          |
|---------------------------|-------------------------------------|----------|------------------------|----------|
|                           | 2008                                | 2007     | Increase<br>(Decrease) | % Change |
|                           | (\$ in thousands)                   |          |                        |          |
| Minority interests        | \$ (277)                            | \$ (537) | \$ (260)               | (48.4)%  |
| <i>% of total revenue</i> | (1.6)%                              | (3.7)%   |                        |          |

Minority interests decreased \$260,000 or 48.4% to \$277,000 for the three months ended September 30, 2008 from \$537,000 for the three months ended September 30, 2007 due to the transportation restrictions imposed in the Beijing area during the Olympics and Paralympics which impacted the sales of raw materials from our three majority-owned joint ventures, and accordingly the minority interests decreased.

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|                           | Nine Months Ended<br>September 30, |            |                        |          |
|---------------------------|------------------------------------|------------|------------------------|----------|
|                           | 2008                               | 2007       | Increase<br>(Decrease) | % Change |
|                           | (\$ in thousands)                  |            |                        |          |
| Minority interests        | \$ (1,424)                         | \$ (1,290) | \$ 134                 | 10.4%    |
| <i>% of total revenue</i> | (2.5)%                             | (3.2)%     |                        |          |

Minority interests increased \$134,000 or 10.4% to \$1.4 million for the nine months ended September 30, 2008 from \$1.3 million for the nine months ended September 30, 2007 as each of our three majority-owned joint ventures increased sales due to capacity expansion, and were more profitable, and consequently the minority interests increased, offset by the temporary impact of decreased sales in the quarter ended September 30, 2008 due to the transportation restrictions imposed in the Beijing area during the Olympics and Paralympics.

***Other Income, net***

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|                           | Three Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|---------------------------|-------------------------------------|--------|------------------------|----------|
|                           | 2008                                | 2007   |                        |          |
|                           | (\$ in thousands)                   |        |                        |          |
| Other income, net         | \$ 298                              | \$ 381 | \$ (83)                | (21.8)%  |
| <i>% of total revenue</i> | 1.7%                                | 2.6%   |                        |          |

Other income, net was \$298,000 for the three months ended September 30, 2008 primarily due to \$367,000 from our equity earnings of the two minority-owned joint ventures that are not consolidated, partially offset by \$69,000 in foreign exchange losses. Other income, net was \$381,000 for the three months ended September 30, 2007 primarily due to \$199,000 from our equity earnings from the two minority-owned joint ventures that are not consolidated, \$162,000 in foreign exchange gains and \$20,000 of miscellaneous items.

|                           | Nine Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|---------------------------|------------------------------------|--------|------------------------|----------|
|                           | 2008                               | 2007   |                        |          |
|                           | (\$ in thousands)                  |        |                        |          |
| Other income, net         | \$ 707                             | \$ 851 | \$ (144)               | (16.9)%  |
| <i>% of total revenue</i> | 1.2%                               | 2.1%   |                        |          |

Other income, net was \$707,000 for the nine months ended September 30, 2008 primarily due to \$812,000 from our equity earnings from the two minority-owned joint ventures that are not consolidated, \$326,000 from our realized gain on sale of investments, and \$42,000 other income, partially offset by \$473,000 in foreign exchange losses. Other income, net was \$851,000 for the nine months ended September 30, 2007 primarily \$767,000 from our equity earnings from the two minority-owned joint ventures that are not consolidated and \$212,000 other income, mainly insurance proceeds from a fire loss in China, partially offset by foreign exchange losses of \$128,000.

***Provision for Income Taxes***

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|                            | Three Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|----------------------------|-------------------------------------|--------|------------------------|----------|
|                            | 2008                                | 2007   |                        |          |
|                            | (\$ in thousands)                   |        |                        |          |
| Provision for income taxes | \$ 177                              | \$ 153 | \$ 24                  | 15.7%    |
| <i>% of total revenue</i>  | 1.0%                                | 1.1%   |                        |          |

We provided for income taxes of \$177,000 for our China operations for the three months ended September 30, 2008 compared to \$153,000 for the three months ended September 30, 2007. Beginning in 2008, the tax provision was calculated based on the assumption that we will no longer receive refunds for profit reinvestments in China.

|                            | Nine Months Ended<br>September 30, |        | Increase<br>(Decrease) | % Change |
|----------------------------|------------------------------------|--------|------------------------|----------|
|                            | 2008                               | 2007   |                        |          |
|                            | (\$ in thousands)                  |        |                        |          |
| Provision for income taxes | \$ 1,372                           | \$ 426 | \$ 946                 | 222.1%   |
| <i>% of total revenue</i>  | 2.4%                               | 1.0%   |                        |          |

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We provided for income taxes of \$1.4 million for our China operations for the nine months ended September 30, 2008 compared to \$426,000 for the nine months ended September 30, 2007. Beginning in 2008, the tax provision was calculated based on the assumption that we will no longer receive refunds for profit reinvestments in China.

**Liquidity and Capital Resources**

As of September 30, 2008, our principal sources of liquidity were \$29.5 million in cash and cash equivalents and short-term investments, excluding restricted deposits. We consider cash and cash equivalents and short-term investments as liquid and available for use. Short-term investments are comprised of government bonds and high-grade commercial debt instruments.

Cash and cash equivalents and short-term investments of \$29.5 million decreased by \$7.5 million in the third quarter of 2008 compared to the second quarter of 2008. On July 1, 2008, we spent approximately \$6.4 million plus accrued interest to pay down our taxable revenue bond and approximately \$4.0 million was spent in operations. In September 2008, we obtained an express line of credit of \$5.0 million from Citigroup Smith Barney and drew down \$3.0 million for operating purposes and classified the same amount as restricted deposits as of September 30, 2008. The \$3.0 million restricted cash carries an annual interest rate of 4.0%.

Net cash used in operating activities of \$8.4 million for the nine months ended September 30, 2008 was primarily comprised of our net income of \$1.7 million, adjusted for non-cash items of depreciation of \$1.5 million, stock-based compensation of \$0.5 million, partially offset by a realized gain on sale of investments of \$0.3 million, and offset by a net increase of \$11.8 million in assets and liabilities. The \$11.8 million net increase in assets and liabilities primarily resulted from a \$13.9 million increase in inventories, \$1.1 million increase in accounts receivable, \$0.9 million decrease in accrued liabilities, \$0.7 million decrease in other long-term liabilities, primarily minority interests, a \$0.1 million decrease in income taxes payable, partially offset by a \$4.1 million increase in accounts payable, and a \$0.8 million decrease in prepaid and other assets.

Inventories, net, increased by \$13.9 million, as we increased inventory in raw materials and work-in-process to increase production in anticipation of increased forecast sales, and finished goods for consignment orders. Inventory in raw materials in our joint ventures increased due to transportation restrictions during the Beijing Olympics and Paralympics.

Accounts receivable, net increased by \$1.1 million, as a result of increased sales partially offset by an increase in our allowance for doubtful accounts. Our days sales outstanding (DSO) is 68 days as of September 30, 2008, compared to 64 days as of December 31, 2007.

Net cash provided by investing activities of \$4.6 million for the nine months ended September 30, 2008 was primarily from the proceeds from the sale of investments of \$24.4 million, proceeds from sale of assets held for sale of \$5.1 million and the decrease of restricted cash of \$3.7 million, partially offset by the purchase of investments totaling \$22.6 million, and the purchase of property, plant and equipment of \$6.0 million.

We expect to invest approximately \$0.8 million in capital projects for the remainder of 2008. We believe that our existing and planned facilities and equipment are sufficient to fulfill current and expected future orders.

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Net cash used in financing activities of \$3.5 million for the nine months ended September 30, 2008 consisted of payments of \$6.7 million related to long-term borrowings, partially offset by \$3.0 million proceeds from our express line of credit, and \$0.2 million from the proceeds from the exercise of employee stock options.

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



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Outstanding contractual obligations as of September 30, 2008 are summarized as follows (in thousands):

| Contractual Obligations | Total    | Payments due by period |                |                |                      |
|-------------------------|----------|------------------------|----------------|----------------|----------------------|
|                         |          | Less than<br>1 year    | 1 - 3<br>years | 3 - 5<br>years | More than<br>5 years |
| Line of credit          | \$ 3,000 | \$ 3,000               | \$             | \$             | \$                   |
| Debt                    | 18       |                        | 18             |                |                      |
| Operating leases        | 2,045    | 321                    | 509            | 556            | 659                  |
| Less: Sublease income   | (31)     | (31)                   |                |                |                      |
| Tenant improvement loan | 660      | 79                     | 189            | 189            | 203                  |
| Purchase obligation     | 1,245    | 1,245                  |                |                |                      |
| Total                   | \$ 6,937 | \$ 4,614               | \$ 716         | \$ 745         | \$ 862               |

We lease certain office space, manufacturing facilities and property under long-term operating leases expiring at various dates through March 2013. Total rent payments under these operating leases were approximately \$0.2 million and \$0.5 million for the three month periods ended September 30, 2008 and 2007, respectively. On July 2, 2008, we entered into a new lease agreement with T. Drive Partners, L.P., a California partnership of the facility located at 4281 Technology Drive, Fremont California with approximately 27,760 square feet. The new lease shall commence on December 1, 2008 for a term of seven years, with an option by us to cancel after five years, upon forfeiture of the security deposit and payment of one-half of the fifth year's rent. The base rent for the new lease shall be \$0.72 per square foot per month triple net, with annual rental increases of 4.5% per annum, payment of \$50,000 security deposit, and tenant improvements of \$575,000 to be amortized over seven years at 4% per annum.

On February 27, 2007, we entered into an agreement with Recapture Metals Limited of Ontario, Canada ( Recapture ), pursuant to which Recapture will supply our subsidiary in the PRC with one thousand kilograms per month of 99.99999% pure gallium, during the eighteen month period beginning July 1, 2007. Under the terms of the agreement, we are required to purchase a minimum of eighteen thousand kilograms of gallium, unless the agreement is terminated prior to the expiration of the eighteen month period on December 31, 2008.

**Recent Accounting Pronouncements**

In May 2008, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard ( SFAS ) No. 162 The Hierarchy of Generally Accepted Accounting Principles ( SFAS No. 162 ). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS No. 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The FASB has stated that it does not expect that SFAS No. 162 will result in a change in current practice.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS 161 ). SFAS 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Based on our current operations, we do not expect that the adoption of SFAS 161 will have a material impact on our consolidated financial position or results of operations.

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In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*, ( SFAS 141R ). SFAS 141R establishes the principles and requirements for how an acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) will be applicable beginning with our fiscal 2009. The impact of the adoption of SFAS 141(R) on our results of operations and financial position will depend on the nature and extent of business combinations that we complete, if any, in or after fiscal 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* ( SFAS 160 ). SFAS 160 requires that minority interest be separately reported in the consolidated entity's equity section and

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that no gain or loss shall be reported when transactions occur between the controlling interest and the non-controlling interests. Furthermore, the acquisition of non-controlling interest by the controlling interest is not treated as a business combination. SFAS 160 is effective for fiscal years beginning after December 15, 2008. We have not yet evaluated the impact that the adoption of SFAS 160 will have on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We do not have any instruments eligible for election of the fair value option. Therefore, the adoption of SFAS 159 in the first quarter of fiscal 2008 did not impact our consolidated financial position, results of operations or cash flows

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods of those fiscal years. In February 2008, the FASB released a FASB Staff Position (FSP FAS 157-2 *Effective Date of FASB Statement No. 157*) which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. These non-financial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and non-financial assets acquired and liabilities assumed in a business combination. The partial adoption of SFAS 157 as of January 1, 2008 for financial assets and liabilities did not have a material impact on our condensed consolidated financial position, results of operations or cash flows. See Note 3 of the Notes to Condensed Consolidated Financial Statements.

On October 10, 2008, the FASB issued FASB Staff Position ( FSP ) No. 157-3 ( FSP 157-3 ), *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* ( FSP 157-3 ), to clarify the application of SFAS 157 in a market that is not active, providing an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurement in accordance with SFAS 157 and is effective upon issuance. We have determined there is no impact from adopting the provisions of FSP 157-3 on our consolidated financial position, results of operations or cash flows.

In various areas, including revenue recognition, stock option accounting, accounting standards and practices continue to evolve. Additionally, the SEC and the FASB's Emerging Issues Task Force continue to address revenues, stock option accounting related accounting issues. We believe that we are in compliance with all of the rules and related guidance as they currently exist. However, any changes to accounting principles generally accepted in the United States of America in these areas could impact the future accounting of our operations.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

*Foreign Currency Risk*

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A significant portion of our business is conducted in currencies other than the U.S. dollar. The functional currency for our foreign operations is the Renminbi, the local currency of China, where our operating expenses are predominantly in the local currency. Since most of our operations are conducted in China, most of our costs are incurred in Chinese currency, which subjects us to fluctuations in the exchange rates between the U.S. dollar and the Chinese Renminbi. We incur transaction gains or losses resulting from consolidation of expenses incurred in local currencies for these subsidiaries, as well as in translation of the assets and liabilities of these assets at each balance sheet date. These risks may be increased by the fluctuations and revaluations of the Chinese Renminbi. Our financial results could be adversely affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets, including the revaluation by China of the Renminbi, and any future adjustments that China may make to its currency such as any move it might make to a managed float systems with opportunistic interventions. We also have certain trade accounts receivable denominated in Japanese Yen. In the future we may experience foreign exchange losses on our non-functional currency denominated receivables and payables to the extent that we have not mitigated our exposure utilizing foreign currency forward exchange contracts. Foreign exchange losses could have a materially adverse effect on our operating results and cash flows.

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We do not currently use short-term forward exchange contracts for hedging purposes to reduce the effects of adverse foreign exchange rate movements. We had previously purchased foreign exchange contracts to hedge against certain trade accounts receivable denominated in Japanese yen. The change in the fair value of the forward contracts was recognized as part of the related foreign currency transactions as they occur. As of September 30, 2008, we had no outstanding commitments with respect to foreign exchange contracts.

In the three months ended September 30, 2008, we recorded net realized foreign exchange losses of \$69,000, included as part of other expense in our consolidated statements of operations. The foreign exchange losses were primarily due to fluctuation in the Japanese Yen versus the U.S. dollar on our Yen-denominated accounts receivables. During the third quarter of 2008, we recorded unrealized foreign currency gains of \$28,000 in cumulative other comprehensive income on our condensed consolidated balance sheets.

Table of Contents***Interest Rate Risk***

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

| <b>Instrument</b>                            | <b>Balance as of<br/>September 30,<br/>2008</b> | <b>Current<br/>Interest<br/>Rate</b> | <b>Projected Annual<br/>Interest<br/>Income/(Expense)</b> | <b>Proforma 10%<br/>Interest Rate<br/>Decline<br/>Income/(Expense)</b> | <b>Proforma 10%<br/>Interest Rate<br/>Increase<br/>Income/(Expense)</b> |
|--|---|--------------------------------------|---|--|---|
| Cash   | \$ 11,577                                       | 0.50%                                | \$ 58   | \$ 64  | \$ 52   |
| Investment in debt and equity<br>instruments | 20,895  | 2.32%                                | 485   | 534  | 437   |
| Long-term debt                               | (3,000)   | 4.06%                                | (138)   | (152)  | (124)   |
|  |   |                                      | \$ 405  | \$ 446   | \$ 365  |

The primary objective of our investment activities is to preserve principal while maximizing income without significantly increasing risk. Financial instruments that potentially subject us to concentration of credit risk consist primarily of cash equivalents, short-term investments, and trade accounts receivable. We invest primarily in money market accounts, commercial paper instruments, and investment grade securities. We are exposed to credit risks in the event of default by the issuers to the extent of the amount recorded on the consolidated balance sheets. These securities are generally classified as available-for-sale and consequently are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income, net of estimated tax. Our cash, cash equivalents and short-term investments are in high-quality securities placed with major banks and financial institutions and commercial paper. We have no investments in auction rate securities.

***Equity Risk***

We maintain minority investments in privately-held companies. These investments are reviewed for other than temporary declines in value on a quarterly basis. These investments are classified as other assets in the condensed consolidated balance sheets and are accounted for either under the cost method or under the equity method as we do not have the ability to exercise significant influence over their operations. We monitor our investments for impairment and record reductions in carrying value when events or changes in circumstances indicate that the carrying value may not be recoverable. Reasons for other than temporary declines in value include whether the related company would have insufficient cash flow to operate for the next twelve months, significant changes in the operating performance and changes in market conditions. As of September 30, 2008, the minority investments accounted for under the cost method totaled \$0.4 million, while minority investments accounted for under the equity method totaled \$3.7 million.

**ITEM 4. CONTROLS AND PROCEDURES*****Disclosure Controls and Procedures***

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

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

No change in our internal control over financial reporting was made in the three months ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

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

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On October 15, 2004, a purported securities class action lawsuit was filed in the United States Court for the Northern District of California, City of Harper Woods Employees Retirement System v. AXT, Inc. et al., No. C 04 4362 MJJ. The Court consolidated the case with a subsequent related case and appointed a lead plaintiff. On April 5, 2005, the lead plaintiff filed a consolidated complaint, captioned as Morgan v. AXT, Inc. et al., No. C 04 4362 MJJ. The lawsuit named AXT, Inc. and our former chief technology officer as defendants, and was brought on behalf of a class of all purchasers of our securities from February 6, 2001 through April 27, 2004. The complaint alleged that we announced financial results during this period that were false and misleading. No specific amount of damages was claimed. On September 23, 2005, the Court granted our motion to dismiss the complaint, with leave to amend. The lead plaintiff filed an amended complaint, which we had moved to dismiss. On April 24, 2007, we reached a settlement of this litigation. On February 27, 2008, the district court approved the settlement, and subsequently entered a judgment of dismissal.

**Item 1A. Risk Factors**

In addition to the risk factors set forth under Part I, Item 1A. Risk Factors in our Annual Report on Form 10K for the fiscal year ended December 31, 2007, we believe the following risk factors also apply to AXT during 2008:

*The average selling prices of our products may decline over relatively short periods, which may reduce our gross margins.*

The market for our products is characterized by declining average selling prices resulting from factors such as increased competition, overcapacity, the introduction of new products and decreased sales of products incorporating our products and average selling prices for our products may decline over relatively short time periods. We have in the past experienced, and in the future may experience, substantial period-to-period fluctuations in operating results due to declining average selling prices. On average, we have experienced average selling price declines over the course of the last twelve months of anywhere from approximately 5 to 20% per year depending on the product. It is also possible for the pace of average selling price declines to accelerate beyond these levels for certain products in a commoditizing market. We anticipate that average selling prices will decrease in the future in response to product introductions by competitors or us, or by other factors, including pricing pressures from significant customers. When our average selling prices decline, our gross profits decline unless we are able to sell more products or reduce the cost to manufacture our products. We generally attempt to combat average selling price declines by improving yields, manufacturing efficiency and working to reduce the costs of our raw materials and of manufacturing our products. We have in the past and may in the future experience declining sales prices, which could negatively impact our revenues, gross profits and financial results. We therefore need to sell our current products in increasing volumes to offset any decline in their average selling prices, and introduce new products, which we may not be able to do, or do on a timely basis.

We may be unable to reduce the cost of our products sufficiently to enable us to compete with others. Our cost reduction efforts may not allow us to keep pace with competitive pricing pressures and could adversely affect our margins. In order to remain competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in delivering our products to market in a timely manner. We cannot assure you that any changes effected by us will result in sufficient cost reductions to allow us to reduce the price of our products to remain competitive or improve our gross margins.

*Shifts in our product mix may result in declines in gross margins.*



Our gross profit margins vary among our product families, and are generally higher on our larger diameter wafers. In addition, historically our gross margins have been higher on our raw materials sales. Accordingly, our overall gross margins have fluctuated from period to period as a result of shifts in product mix, the introduction of new products, decreases in average selling prices for products and our ability to reduce product costs, and these fluctuations are expected to continue in the future.

We do not control the prices at which our joint venture companies sell their raw materials products to other third parties. However, as we consolidate the results of three of these companies with our own, any reduction in their gross margins could have a significant, adverse impact on our overall gross margins. One or more of our joint venture companies has in the past and may in the future sell raw materials at significantly reduced prices in order to gain volume sales, or sales to new customers. In such an event, our gross margin may be adversely impacted.

***Ongoing financial market volatility and adverse changes in the domestic and global economic environment could have a significant adverse impact on our business, financial condition and operating results***

Our business and operating results could be significantly impacted by general economic conditions. In recent months, the U.S. and global economy has experienced a significant downturn due to the effects of the credit market crisis, slower economic activity and a generally negative economic outlook, a decrease in consumer and business confidence and liquidity concerns. Global market and economic conditions continue to be disruptive and volatile. The possible duration and severity of this adverse economic cycle is unknown. Although the Company remains well-capitalized and has not suffered any liquidity issues as a result of these recent events, the cost and availability of funds may be adversely affected by illiquid credit markets. Continued turbulence in U.S. and international markets and economies may adversely affect the Company's liquidity, financial condition and profitability. A severe or prolonged economic downturn could result in a variety of risks to our business, including:

- increased volatility in our stock price;
- increased volatility in foreign currency exchange rates;
- delays in, or curtailment of, purchasing decisions by our customers or potential customers either as a result of overall economic uncertainty or as a result of their inability to access the liquidity necessary to engage in purchasing initiatives;
- increased credit risk associated with our customers or potential customers, particularly those that may operate in industries most affected by the economic downturn, such as financial services; and
- impairment of our intangible or other assets.

We have experienced and expect to continue to experience delays in customer purchasing decisions or disruptions in normal volume of customer orders that we believe are in part due to the uncertainties in the global economy and an adverse impact on consumer spending. To the extent that the current economic downturn worsens or persists, or any of the above risks occur, our business and operating results could be significantly and adversely affected.

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

None

**Item 3. Defaults upon Senior Securities**

None

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

None

**Item 5. Other Information**

None

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**Item 6. Exhibits**

**a. Exhibits**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 3.1(1)                    | Restated Certificate of Incorporation  |
| 3.2(2)                    | Certificate of Designation, Preferences and Rights of Series A Preferred Stock.  |
| 3.3(3)                    | Second Amended and Restated By Laws  |
| 4.2(4)                    | Rights Agreement dated April 24, 2001 by and between AXT, Inc. and ComputerShare Trust Company, Inc.   |
| 10.28(5)                  | Lease Agreement executed July 2, 2008 by and between AXT, Inc. and T. Drive Partners, L.P. a California partnership.                               |
| 31.1                      | Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2                      | Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1                      | Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2                      | Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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

(2) Incorporated by reference to Exhibit 3.1 to our Form 8-K as filed with the SEC on June 14, 1999.

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

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

(5) Incorporated by reference to the exhibit of the same number as filed with the SEC in our Form 8-K on July 8, 2008.



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

AXT, INC.

Dated: November 10, 2008

By:

/s/ Philip C. S. Yin  
Philip C. S. Yin  
Chairman of the Board and  
Chief Executive Officer  
(Principal Executive Officer)

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

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**EXHIBIT INDEX**

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 3.1(1)                | Restated Certificate of Incorporation  |
| 3.2(2)                | Certificate of Designation, Preferences and Rights of Series A Preferred Stock (which is incorporated herein by reference to Exhibit 2.1 to the registrant's form 8-K dated May 28, 1999). |
| 3.3(3)                | Second Amended and Restated By Laws  |
| 4.2(4)                | Rights Agreement dated April 24, 2001 by and between AXT, Inc. and ComputerShare Trust Company, Inc.   |
| 10.28(5)              | Lease Agreement executed July 2, 2008 by and between AXT, Inc. and T. Drive Partners, L.P. a California partnership.   |
| 31.1                  | Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2                  | Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
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