

CAVIUM NETWORKS, INC.  
Form 10-Q  
October 29, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

**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, 2010

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-33435

**CAVIUM NETWORKS, INC.**

(Exact name of Registrant as specified in its charter)

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|  |  |
|--|--|
| <b>DELAWARE</b><br>(State or other jurisdiction of<br>incorporation or organization)                               | <b>77-0558625</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>805 E. Middlefield Road</b><br><br><b>Mountain View, California</b><br>(Address of principal executive offices) | <b>94043</b><br>(Zip Code)                                   |
| <b>Registrant's telephone number, including area code: (650) 623-7000</b>  |  |

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

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

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

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

The number of shares of the Registrant's Common Stock, \$.001 par value, outstanding at October 26, 2010 was: 45,101,487

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**CAVIUM NETWORKS, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****CAVIUM NETWORKS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except share and per share data)****(unaudited)**

|   | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|---|-------------------------------|------------------------------|
| <b>Assets</b>   |                               |                              |
| Current assets:   |                               |                              |
| Cash and cash equivalents   | \$ 83,255                     | \$ 58,918                    |
| Accounts receivable, net of allowances of \$408 and \$367, respectively                                       | 31,725                        | 21,958                       |
| Inventories   | 22,697                        | 17,965                       |
| Prepaid expenses and other current assets   | 3,440                         | 2,168                        |
| <b>Total current assets</b>   | <b>141,117</b>                | <b>101,009</b>               |
| Property and equipment, net   | 14,021                        | 14,972                       |
| Intangible assets, net  | 28,658                        | 25,388                       |
| Goodwill  | 55,789                        | 56,607                       |
| Other non-current assets  | 1,488                         | 1,819                        |
| <b>Total assets</b>   | <b>\$ 241,073</b>             | <b>\$ 199,795</b>            |
| <b>Liabilities and Stockholders Equity</b>  |                               |                              |
| Current liabilities:  |                               |                              |
| Accounts payable  | \$ 13,274                     | \$ 10,784                    |
| Accrued expenses and other current liabilities  | 6,855                         | 8,444                        |
| Deferred revenue  | 19,820                        | 12,613                       |
| Capital lease and technology license obligations, current portion   | 10,966                        | 3,271                        |
| <b>Total current liabilities</b>  | <b>50,915</b>                 | <b>35,112</b>                |
| Capital lease and technology license obligations, net of current portion                                      | 3,721                         | 5,741                        |
| Other non-current liabilities   | 1,949                         | 2,569                        |
| <b>Total liabilities</b>  | <b>56,585</b>                 | <b>43,422</b>                |
| <b>Commitments and contingencies (Note 11)</b>  |                               |                              |
| <b>Stockholders equity:</b>   |                               |                              |
| <b>Preferred stock, par value \$0.001:</b>  |                               |                              |
| 10,000,000 shares authorized, no shares issued and outstanding as of September 30, 2010 and December 31, 2009 |                               |                              |
| <b>Common stock, par value \$0.001:</b>   |                               |                              |
|   | 45                            | 44                           |

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200,000,000 shares authorized; 45,119,426 and 43,507,161 shares issued and outstanding as of September 30, 2010 and December 31, 2009, respectively

|  |            |            |
|--|------------|------------|
| Additional paid-in capital                 | 260,557    | 234,946    |
| Accumulated deficit                        | (76,114)   | (78,617)   |
| Total stockholders' equity                 | 184,488    | 156,373    |
| Total liabilities and stockholders' equity | \$ 241,073 | \$ 199,795 |

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

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## CAVIUM NETWORKS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|------------|------------------------------------|-------------|
|   | 2010                                | 2009       | 2010                               | 2009        |
| Net revenue   | \$ 55,207                           | \$ 25,894  | \$ 146,697                         | \$ 69,080   |
| Cost of revenue   | 20,811                              | 12,567     | 57,172                             | 35,520      |
| Gross profit  | 34,396                              | 13,327     | 89,525                             | 33,560      |
| Operating expenses:   |                                     |            |                                    |             |
| Research and development  | 15,807                              | 10,629     | 44,688                             | 30,894      |
| Sales, general and administrative                                   | 12,981                              | 6,647      | 40,552                             | 19,310      |
| Total operating expenses  | 28,788                              | 17,276     | 85,240                             | 50,204      |
| Income (loss) from operations                                       | 5,608                               | (3,949)    | 4,285                              | (16,644)    |
| Other (expense) income, net:  |                                     |            |                                    |             |
| Interest expense  | (93)                                | (54)       | (322)                              | (200)       |
| Interest income and other, net                                      | 94                                  | 4          | (1,115)                            | 228         |
| Total other (expense) income, net                                   | 1                                   | (50)       | (1,437)                            | 28          |
| Income (loss) before income taxes                                   | 5,609                               | (3,999)    | 2,848                              | (16,616)    |
| Provision for income taxes  | 643                                 | 167        | 345                                | 251         |
| Net income (loss)   | \$ 4,966                            | \$ (4,166) | \$ 2,503                           | \$ (16,867) |
| Net income (loss), per common share, basic                          | \$ 0.11                             | \$ (0.10)  | \$ 0.06                            | \$ (0.41)   |
| Shares used in computing basic net income (loss) per common share   | 44,888                              | 41,477     | 44,377                             | 41,250      |
| Net income (loss), per common share, diluted                        | \$ 0.10                             | \$ (0.10)  | \$ 0.05                            | \$ (0.41)   |
| Shares used in computing diluted net income (loss) per common share | 48,182                              | 41,477     | 47,921                             | 41,250      |

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

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## CAVIUM NETWORKS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2010                               | 2009        |
| <b>Cash flows from operating activities:</b>  |                                    |             |
| Net income (loss)   | \$ 2,503                           | \$ (16,867) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities |                                    |             |
| Stock-based compensation expense  | 15,749                             | 8,482       |
| Depreciation and amortization   | 10,830                             | 10,352      |
| Provision for a note receivable   | 1,000                              |             |
| Loss on disposal of fixed assets  |                                    | 55          |
| Changes in assets and liabilities, net of effects of acquisitions:                      |                                    |             |
| Accounts receivable, net  | (9,581)                            | 2,337       |
| Inventories   | (4,825)                            | (1,000)     |
| Prepaid expenses and other current assets   | (1,722)                            | (1,359)     |
| Other assets  | 294                                | 73          |
| Accounts payable  | 2,989                              | (118)       |
| Accrued expenses and other current and non-current liabilities                          | 224                                | 149         |
| Deferred revenue  | 7,206                              | (256)       |
| Net cash provided by operating activities   | 24,667                             | 1,848       |
| <b>Cash flows from investing activities:</b>  |                                    |             |
| Purchases of property and equipment   | (4,329)                            | (2,518)     |
| Proceeds from sales of property and equipment   |                                    | 43          |
| Purchases of IP licenses and intangible assets  | (637)                              | (583)       |
| Note receivable   | (550)                              |             |
| Acquisition of businesses, net of cash acquired   | (2,241)                            | (4,981)     |
| Net cash used in investing activities   | (7,757)                            | (8,039)     |
| <b>Cash flows from financing activities:</b>  |                                    |             |
| Proceeds from issuance of common stock upon exercise of options                         | 9,958                              | 1,821       |
| Principal payment of capital lease and technology license obligations                   | (2,529)                            | (1,949)     |
| Repurchases of shares of unvested common stock  | (2)                                | (15)        |
| Net cash provided by (used in) financing activities                                     | 7,427                              | (143)       |
| Net increase (decrease) in cash and cash equivalents                                    | 24,337                             | (6,334)     |
| Cash and cash equivalents, beginning of period  | 58,918                             | 77,027      |
| Cash and cash equivalents, end of period  | \$ 83,255                          | \$ 70,693   |

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





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**CAVIUM NETWORKS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Organization and Significant Accounting Policies**

*Organization*

Cavium Networks, Inc., (the Company), was incorporated in the State of California on November 21, 2000 and was reincorporated in the State of Delaware on February 6, 2007. The Company designs, develops and markets semiconductor processors for intelligent and secure networks.

In December 2009, the Company completed the purchase of MontaVista Software, Inc. (MontaVista) for approximately \$45.2 million in consideration. For a complete discussion of the MontaVista acquisition, see Note 5 Business Combinations.

*Summary of Significant Accounting Policies*

*Basis of Presentation*

The condensed consolidated financial statements include the accounts of Cavium Networks, Inc. and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. For further information, these financial statements should be read in conjunction with the Company's Annual Report on Form 10-K (File No. 001-33435) on file with the SEC for the year ended December 31, 2009.

The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly the Company's condensed consolidated financial position at September 30, 2010, and the condensed consolidated results of its operations for the three months and nine months ended September 30, 2010 and 2009, and condensed consolidated statement of cash flows for the nine months ended September 30, 2010 and 2009. The results of operations for the three months and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at December 31, 2009 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP.

*Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in its condensed consolidated financial statements and accompanying notes. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis of making judgments about the carrying values of assets and liabilities. Actual results could differ from those estimates. During the nine months ended September 30, 2010, there were no significant changes to the significant accounting policies and estimates discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

*Concentration of Risk*

The Company's products are currently manufactured, assembled and tested by third-party contractors in Asia. There are no long-term agreements with any of these contractors. A significant disruption in the operations of one or more of these contractors would impact the production of the Company's products for a substantial period of time, which could have a material adverse effect on the Company's business, financial condition

and results of operations.

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and accounts receivable. The Company deposits cash with credit worthy financial institutions. The Company has not experienced any losses on its deposits of cash. Management believes that the financial institutions are reputable and, accordingly, minimal credit risk exists. The Company follows an established investment policy and set of guidelines to monitor, manage and limit the Company's exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits the Company's exposure to any one issuer, as well as the maximum exposure to various asset classes.

The Company performs ongoing credit evaluations of its customers' financial condition and, generally, requires no collateral from its customers. The Company provides an allowance for doubtful accounts receivable based upon the expected collectability of accounts receivable. Summarized below are individual customers whose accounts receivable balances or end customers whose revenues were 10% or higher of respective total consolidated amounts.

|   | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|---|-----------------------------|----------------------------|
| Percentage of gross accounts receivable |                             |                            |
| Flextronics                             | 14%                         | 14%                        |
| Avnet                                   | 14%                         | *                          |

\* Represents less than 10% of the consolidated gross accounts receivable for the respective period end.

|                                 | For the three months ended<br>September 30, |      | For the nine months<br>ended<br>September 30, |      |
|---------------------------------|---|------|---|------|
|                                 | 2010  | 2009 | 2010  | 2009 |
| Percentage of total net revenue |   |      |   |      |
| Cisco                           | 20%   | 26%  | 23%   | 22%  |
| Actiontec                       | *   | 11%  | *   | 13%  |
| Sumitomo                        | *   | 10%  | *   | 10%  |

\* Represents less than 10% of the consolidated net revenue for the respective period end.

*Revenue Recognition*

The Company derives its revenue from sales of semiconductor products and sales of software licenses and services. The Company recognizes revenue when all of the following criteria have been met: (i) persuasive evidence of a binding arrangement exists, (ii) delivery has occurred, (iii) the price is deemed fixed or determinable and free of contingencies and significant uncertainties, and (iv) collection is probable. The price is considered fixed or determinable at the execution of an agreement, based on specific products and quantities to be delivered at specified prices, which is often memorialized with a customer purchase order. Agreements with non-distributor customers do not include rights of return or acceptance provisions. The Company assesses the ability to collect from the Company's customers based on a number of factors, including credit worthiness and any past transaction history of the customer.

Shipping charges billed to customers are included in product revenue and the related shipping costs are included in cost of revenue. The Company generally recognizes revenue at the time of shipment to the Company's customers. Revenue from the sales of semiconductor products

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consists of sales of the Company's products to networking original equipment manufacturers, or OEMs, their contract manufacturers or distributors. Initial sales of the Company's products for a new design are usually made directly to networking OEMs as they design and develop their product. Once their design enters production, they often outsource their manufacturing to contract manufacturers that purchase the Company's products directly from the Company or from the Company's distributors.

Revenue is recognized upon shipment for sales to distributors with limited rights of returns and price protection if the Company concludes it can reasonably estimate the credits for returns and price adjustments issuable. The Company records an estimated allowance, at the time of shipment, based on the Company's historical patterns of returns and pricing credits of sales recognized upon shipment. The credits issued to distributors or other customers were not material in the three and nine months ended September 30, 2010 and 2009.

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**CAVIUM NETWORKS, INC.**

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

**(unaudited)**

Revenue and costs relating to sales to distributors are deferred if the Company grants more than limited rights of returns and price credits or if it cannot reasonably estimate the level of returns and credits issuable. The Company has a distribution agreement with Avnet, Inc. to distribute the Company's products primarily in the United States. Given the terms of the distribution agreement, for sales to Avnet, revenue and costs are deferred until products are sold by Avnet to its end customers. For the three months ended September 30, 2010 and 2009, 7.4% and 4.5%, respectively, and for the nine months ended September 30, 2010 and 2009, 6.8% and 5.3%, respectively, of the Company's net revenues were from products sold by Avnet. Revenue recognition depends on notification from the distributor that product has been sold to Avnet's end customers. Avnet reports to the Company, on at least a monthly basis, the product resale price, quantity and end customer shipment information, as well as inventory on hand. Reported distributor inventory on hand is reconciled monthly to the Company's deferred revenue and cost balances. Accounts receivable from Avnet is recognized and inventory is relieved when title to inventories transfers, which typically takes place at the time of shipment, which is the point in time at which the Company has a legal enforceable right to collection under normal payment terms.

The Company also derives revenue from licensing software and providing software maintenance and support. Software arrangements typically include: (i) an end-user license fee paid in exchange for the use of the Company's products for a specified period of time, generally 12 months (time-based license); and (ii) a support arrangement that provides for technical support and product updates and upgrades over the period of the related license.

Revenue from software arrangements is recorded when all of the following criteria are met.

*Persuasive evidence of an arrangement exists* The Company requires either a written contract signed by both the customer and the Company, or a shrink-wrap or click-through contract whereby the customer agrees to the Company's standard license terms, together with a non-cancellable purchase order, or a purchase order from these customers that have previously negotiated an end-user license arrangement or volume purchase arrangement.

*Delivery has occurred* The Company delivers software to its customers electronically and considers delivery to have occurred once the access codes are provided that allow the customer to take immediate possession of the software.

*The fee is fixed or determinable* The Company's determination that an arrangement fee is fixed or determinable depends principally on the arrangement's payment terms.

*Collectibility is probable* The Company assesses the collectibility of an arrangement on a case-by-case basis, based on the financial condition of the customer as well as any established payment history.

The Company allocates revenue between elements in a multiple-element revenue arrangement based on vendor specific objective evidence of fair value (VSOE) for each undelivered element. VSOE is based on the price charged when an element is sold separately. The Company enters into multiple-element arrangements that generally include time-based licenses and support that are typically not sold separately. Revenue from such arrangements is deferred and recognized ratably over the term that support is offered, which is typically 12 months.

The software arrangement may also include professional services, and such services may be purchased separately. Professional services engagements are billed on either a fixed-fee or time-and-materials basis. For fixed-fee arrangements, professional services revenue is recognized under the proportional performance method, with the associated costs included in cost of revenue. The Company estimates the proportional performance of the arrangements based on an analysis of progress toward completion. The Company periodically evaluates the actual status of each project to ensure that the estimates to complete each contract remain accurate, and a loss is recognized when the total estimated project cost exceeds project revenue. If the amount billed exceeds the amount of revenue recognized, the excess amount is recorded as deferred revenue. Revenue recognized in any period is dependent on progress toward completion of projects in progress. To the extent the Company is unable to estimate the proportional performance then the revenue is recognized on a completed performance basis. Revenue for time-and-materials

engagements is recognized as the effort is incurred.

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

In addition, the Company also enters into multiple element arrangements, which consist of the combination of licensed software, support and professional services. Professional services in such arrangements do not involve significant customization, modification or development of software licensed under the time based licenses and are not essential to the functionality of such software. Provided that the total arrangement consideration is fixed and determinable at the inception of the arrangement, the Company allocates the total arrangement consideration to professional services and time based licenses bundled with support based on VSOE for professional services and VSOE for time based licenses bundled with support. Each unit of accounting is then accounted for under the applicable revenue recognition guidance.

If the Company is unable to establish VSOE for each undelivered element of the arrangement, revenue for the entire arrangement is deferred until the time the Company is able to establish VSOE for the undelivered elements or there is only one remaining undelivered element. When the revenue is deferred, the direct costs incurred in relation to the revenue is deferred and is recorded as deferred costs in prepaid expenses and other current assets.

*Deferred revenue*

The Company records deferred revenue for customer billings and advance payments received from customers before the performance obligations have been completed and/or services have been performed. In addition, the Company also records deferred revenue, net of deferred costs on shipments to Avnet. Total net deferred revenue was \$19.8 million as of September 30, 2010 and \$12.6 million as of December 31, 2009 and comprised of the following:

|                                    | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|------------------------------------|-----------------------------|----------------------------|
|                                    | (in thousands)              |                            |
| Services / Support and Maintenance | \$ 8,347                    | \$ 4,211                   |
| Software License / Subscription    | 8,080                       | 7,711                      |
| Distributors                       | 3,393                       | 691                        |
|                                    | \$ 19,820                   | \$ 12,613                  |

*Warranty Accrual*

The Company's products are subject to a one-year warranty period. The Company provides for the estimated future costs of replacement upon shipment of the product as cost of revenue. The warranty accrual is estimated based on historical claims compared to historical revenue. The following table presents a reconciliation of the Company's product warranty liability, which is included within accrued expenses and other current liabilities in the consolidated balance sheets:

|                                | Three Months Ended<br>September 30,<br>2010 |        | Nine Months Ended<br>September 30,<br>2009 |        |
|--------------------------------|---|--------|--|--------|
|                                | (in thousands)                              |        | (in thousands)                             |        |
| Beginning balance              | \$ 179                                      | \$ 250 | \$ 209                                     | \$ 154 |
| Accruals for warranties issued | 142   | 136    | 253  | 488    |

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|                  |        |        |        |        |
|------------------|--------|--------|--------|--------|
| Settlements made | (121)  | (78)   | (262)  | (334)  |
| Ending balance   | \$ 200 | \$ 308 | \$ 200 | \$ 308 |

### *Recent Accounting Pronouncements*

In April 2010, the FASB issued Update No. 2010-17, or ASU 2010-17, Revenue Recognition - Milestone Method, which updates the guidance currently included under topic 605, Revenue Recognition. ASU 2010-17 provides guidance on defining the milestone and determining when the use of the milestone method of revenue recognition for research or development transactions is appropriate. It provides criteria for evaluating if the milestone is substantive and clarifies that a vendor can recognize consideration that is contingent upon achievement of a milestone as revenue in the period in which the milestone is achieved, if the milestone meets all the criteria to be considered substantive. ASU 2010-17 is effective for milestones achieved in fiscal years, and interim periods within those years, beginning after June 15, 2010 and should be applied prospectively. Early adoption is permitted. This standard is applicable to the Company beginning January 1, 2011. The Company is currently evaluating the potential impact, if any, of the new accounting guidance on its consolidated financial statements.



**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

In October 2009, the FASB issued Update No. 2009-13 or ASU 2009-13, which updates the guidance currently included under topic ASC 605-25, Multiple Element Arrangements. ASU 2009-13 relates to the final consensus reached by FASB on a new revenue recognition guidance regarding revenue arrangements with multiple deliverables. The new accounting guidance addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and how the arrangement consideration should be allocated among the separate units of accounting. The new accounting guidance is effective for fiscal years beginning after June 15, 2010 and may be applied retrospectively or prospectively for new or materially modified arrangements. In addition, early adoption is permitted. This standard is applicable to the Company beginning January 1, 2011. The Company is currently evaluating the potential impact, if any, of the new accounting guidance on its consolidated financial statements.

**2. Net Income (Loss) Per Common Share**

The Company calculates basic net income (loss) per common share by dividing net income (loss) by the weighted average number of common shares outstanding during the reporting period (excluding shares subject to repurchase). Diluted net income (loss) per common share is computed by dividing net income (loss) by the weighted-average number of common and potentially dilutive shares outstanding during the reporting period. Potentially dilutive securities are composed of incremental common shares issuable upon the exercise of stock options, restricted stock units, and common stock subject to repurchase. The dilutive effect of outstanding shares is reflected in diluted earnings per share by application of the treasury stock method. This method includes consideration of the amounts to be paid by the employees if the instrument was exercised and the amount of unrecognized stock-based compensation related to future services. No potential dilutive common shares are included in the computation of any diluted per share amount when a net loss is reported.

The following table sets forth the computation of income (loss) per share:

|  | <b>Three Months Ended</b>                    |             | <b>Nine Months Ended</b> |             |
|--|--|-------------|--------------------------|-------------|
|  | <b>September 30,</b>                         |             | <b>September 30,</b>     |             |
|  | <b>2010</b>                                  | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
|  | <b>(in thousands, except per share data)</b> |             |                          |             |
| Net income (loss)                                    | \$ 4,966                                     | \$ (4,166)  | \$ 2,503                 | \$ (16,867) |
| Weighted average common shares outstanding - basic   | 44,888                                       | 41,477      | 44,377                   | 41,250      |
| Dilutive effect of employee stock plans              | 3,294  |             | 3,544                    |             |
| Weighted average common shares outstanding - diluted | 48,182                                       | 41,477      | 47,921                   | 41,250      |
| Basic net income (loss) per share                    | \$ 0.11                                      | \$ (0.10)   | \$ 0.06                  | \$ (0.41)   |
| Diluted net income (loss) per share                  | \$ 0.10                                      | \$ (0.10)   | \$ 0.05                  | \$ (0.41)   |

The Company excluded outstanding options of 204,000 and restricted stock units of 1.6 million for the three and nine months ended September 30, 2010 from the computation of diluted net income per share, because including them would have had an anti-dilutive effect. The Company excluded outstanding options of 7.5 million and restricted stock units of 469,000 for the three and nine months ended September 30, 2009 from the computation of diluted net loss per share, because including them would have had an antidilutive effect.

**3. Fair Value**

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At September 30, 2010, all of the Company's investments were classified as cash equivalents and are comprised of investments in a money market fund. In accordance with the guidance provided under fair value measurements and disclosures, the Company determined the fair value hierarchy of its financial assets (cash equivalents) in the money market fund as Level 1 input (Level 1 inputs are Quoted prices in active markets for identical assets or liabilities), which approximated \$58.1 million and \$49.1 million as of September 30, 2010 and December 31, 2009, respectively.

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****4. Balance Sheet Components*****Inventories***

Inventories are stated at the lower of cost (determined using the first-in, first-out method), or market value (estimated net realizable value) and are comprised of the following:

|                 | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|-----------------|-----------------------------|----------------------------|
|                 | (in thousands)              |                            |
| Work-in-process | \$ 17,755                   | \$ 14,492                  |
| Finished goods  | 4,942                       | 3,473                      |
|                 | \$ 22,697                   | \$ 17,965                  |

*Property and equipment, net, consist of the following:*

|  | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|--|-----------------------------|----------------------------|
|  | (in thousands)              |                            |
| Mask costs and test equipment                          | \$ 14,782                   | \$ 11,791                  |
| Software, computer and other equipment                 | 20,565                      | 19,352                     |
| Furniture, office equipment and leasehold improvements | 567                         | 466                        |
|  | 35,914                      | 31,609                     |
| Less: accumulated depreciation and amortization        | (21,893)                    | (16,637)                   |
|  | \$ 14,021                   | \$ 14,972                  |

Depreciation and amortization expense was \$2.3 million and \$1.8 million for the three months ended September 30, 2010 and 2009, respectively and \$6.0 million for each of the nine months ended September 30, 2010 and 2009.

The Company leases certain design tools under time-based capital lease arrangements which are included in property and equipment, and they were \$11.9 million and \$11.2 million at September 30, 2010 and December 31, 2009, respectively. Amortization expense related to assets recorded under capital leases was \$967,000 and \$815,000 for the three months ended September 30, 2010 and 2009, respectively, and \$2.8 million and \$2.3 million for the nine months ended September 30, 2010 and 2009, respectively.

*Accrued expenses and other current liabilities consist of the following:*

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|   | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|---|-----------------------------|----------------------------|
|   | (in thousands)              |                            |
| Accrued compensation and related benefits | \$ 3,106                    | \$ 3,577                   |
| Customer deposits                         | 823                         |                            |
| Professional fees                         | 764                         | 688                        |
| Restructuring related payables            | 610                         | 623                        |
| Acquisition related payables              | 27                          | 2,268                      |
| Income tax payable                        | 338                         | 567                        |
| Royalty payable                           | 347                         | 285                        |
| Accrued warranty                          | 200                         | 209                        |
| Other                                     | 640                         | 227                        |
|   | \$ 6,855                    | \$ 8,444                   |

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)***Other non-current liabilities consist of the following:*

|                                | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|--------------------------------|-----------------------------|----------------------------|
|                                | (in thousands)              |                            |
| Accrued rent                   | \$ 688                      | \$ 884                     |
| Restructuring related payables | 578                         | 1,036                      |
| Income tax payable             | 683                         | 649                        |
|                                | \$ 1,949                    | \$ 2,569                   |

**5. Business Combinations and Acquisitions***MontaVista Software, Inc.*

On December 14, 2009, the Company completed the acquisition of MontaVista. Pursuant to the merger agreement, the Company paid approximately \$10.9 million in cash and issued 1,592,193 common shares of the Company valued at approximately \$34.3 million based on the Company's December 14, 2009 closing stock price per share. Included in the purchase price was approximately \$1.1 million in cash and 160,000 shares of the Company's common stock that were placed in escrow for a limited period after closing in order to indemnify the Company for certain matters, including breaches of representations and warranties and covenants made by MontaVista in the merger agreement. In addition, per the merger agreement, the Company paid approximately \$6.0 million, consisting of a mix of shares of the Company's common stock and cash to certain individuals in connection with the termination of MontaVista's 2006 Retention Compensation Plan.

The Company accounted for this business combination by applying the acquisition method, and accordingly, the purchase price was allocated to the tangible assets and identifiable intangible assets acquired and liabilities assumed based on their relative fair values. The excess of the purchase price over the net tangible and identifiable intangible assets and liabilities assumed was recorded as goodwill. The final purchase price allocation may differ based upon the final purchase price. The purchase price allocation will be finalized in the fourth quarter of 2010. The total purchase price was as follows:

|                                       | Amount<br>(in thousands) |
|---------------------------------------|--------------------------|
| Cash consideration (1)                | \$ 10,948                |
| Value of Cavium's common stock issued | 34,296                   |
| Total purchase price                  | \$ 45,244                |

- (1) Of the total cash consideration of \$10.9 million, \$8.6 million was paid in 2009, \$2.3 million was paid on the nine months ended September 30, 2010 and the remaining \$27,000 was recorded as acquisition related liabilities in accrued expenses and other current

liabilities. This amount is expected to be paid in the remainder of 2010.

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The preliminary purchase price allocation was as follows (in thousands):

|   | <b>As adjusted<br/>(in thousands)</b> |
|---|---------------------------------------|
| Cash and cash equivalents                 | \$ 1,207                              |
| Accounts receivable                       | 1,370                                 |
| Prepaid expenses and other current assets | 1,262                                 |
| Property and equipment                    | 729                                   |
| Goodwill                                  | 42,756                                |
| Identifiable intangibles                  | 14,909                                |
| Accounts payable and accrued liabilities  | (9,819)                               |
| Deferred revenue                          | (7,170)                               |
| <b>Total purchase price</b>               | <b>\$ 45,244</b>                      |

| <b>Intangible Assets</b>             | <b>Estimated Useful<br/>Life (in<br/>Years)</b> | <b>Amount<br/>(in thousands)</b> |
|--------------------------------------|---|----------------------------------|
| Existing technology                  | 5.0   | \$ 1,295                         |
| Subscriber base                      | 7.0   | 10,485                           |
| Customer contracts and relationships | 6.0   | 2,215                            |
| Tradename/Trademarks                 | 5.0   | 914                              |
| <b>Total</b>                         |   | <b>\$ 14,909</b>                 |

The fair value of the subscriber base as well as the customer contracts and related relationships were determined based on an income approach using the discounted cash flow method. A discount rate of 12.0% was used to value the subscriber base as well as the customer contracts and related relationships. In each case, the discount rate was estimated using a discount rate based on the implied rate of return of the transaction, adjusted for the specific risk profile of each asset. The remaining useful life of the subscriber base as well as the customer contracts and related relationships were estimated based on projected customer attrition and new customer acquisition, and the pattern of projected economic benefit of the asset.

The fair values of the existing technology and the trade name / trademarks were determined using a variation of the income approach known as the profit allocation method. To estimate the fair value of the existing technology an estimated savings in profit was determined using a 3.0% profit allocation rate and a 12.0% discount rate. The remaining useful life for the existing technology was based on historical product development cycles, the projected rate of technology attrition, and the pattern of projected economic benefit of the asset. To estimate the fair value of the trade name / trademarks an estimated savings in profit was determined using a 1.0% profit allocation rate and a 14.0% discount rate. The remaining useful life for the trade name / trademarks was determined based on the future economic benefit expected to be received from the asset. In each case, the discount rate was estimated using a discount rate based on the implied rate of return of the transaction, adjusted for the specific risk profile of each asset.

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Of the total purchase price, \$42.8 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the underlying net tangible and identifiable intangible assets acquired and liabilities assumed and goodwill is not deductible for tax purposes. The acquisition of MontaVista is intended to complement the Company's broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market. These new opportunities, among other factors were the reasons for the establishment of the purchase price, resulting in the recognition of a significant amount of goodwill. Goodwill amounts are not amortized, but rather are tested for impairment at least annually. In the event that the Company determines that the value of goodwill has become impaired, the Company will record a charge for the amount of impairment during the fiscal quarter in which such determination is made.



**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)*****Pro forma financial information***

The unaudited financial information in the table below summarizes the combined results of operations of the Company and MontaVista, on a pro forma basis, as though the companies had been combined as of the beginning of each of the periods presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of each of the periods presented. The pro forma financial information for all periods presented includes amortization charges from acquired intangible assets and related tax effects.

The following unaudited pro forma financial information for the three months and nine months ended September 30, 2009 combines the results for the Company and MontaVista for the three months and nine months ended September 30, 2009 (in thousands, except per share amounts):

|  | <b>Three months ended<br/>September 30,<br/>2009</b> | <b>Nine months ended<br/>September 30, 2009</b> |
|--|--|---|
| Net revenue                                  | \$ 32,385  | \$ 90,258                                       |
| Net loss                                     | \$ (5,926)   | \$ (23,704)                                     |
| Net loss per common share, basic and diluted | \$ (0.14)  | \$ (0.55)                                       |

***Subsequent Acquisition***

On September 27, 2010, the Company through certain subsidiaries entered into asset purchase agreements to acquire intellectual property and certain equipment for an aggregate cash consideration of approximately \$4.4 million and a possible earn-out of approximately \$1.5 million in cash upon the achievement of certain milestones as set forth in the asset purchase agreements. The aforementioned asset purchase transactions were closed on October 5, 2010.

**6. Goodwill and Intangible Assets, Net*****Goodwill***

The following table presents the changes in the carrying amount of goodwill:

|                                    | <b>As of<br/>September 30, 2010</b> | <b>As of<br/>December 31, 2009</b> |
|------------------------------------|-------------------------------------|------------------------------------|
|                                    | <b>(in thousands)</b>               |                                    |
| Balance at beginning of the period | \$ 56,607                           | \$ 12,925                          |
| Additions                          |                                     | 43,574                             |
| Adjustments                        | (818)                               | 108                                |
| Balance at end of the period       | \$ 55,789                           | \$ 56,607                          |

The adjustments in goodwill of \$818,000 during the nine months ended September 30, 2010 were mainly related to purchase price allocation adjustments for the fair value of tangible assets and liabilities acquired in the MontaVista acquisition (See Note 5). The impact on previous

related financial information is not material.

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)***Intangible assets, net consisted of the following:*

|  | As of<br>September 30, 2010 | As of<br>December 31, 2009 |
|--|-----------------------------|----------------------------|
|  | (in thousands)              |                            |
| Existing and core technology - product | \$ 27,751                   | \$ 27,750                  |
| Technology license                     | 18,334                      | 10,196                     |
| Customer contracts and relationships   | 3,181                       | 3,181                      |
| Trade name                             | 996                         | 996                        |
| Order backlog                          | 540                         | 540                        |
|  | 50,802                      | 42,663                     |
| Less: accumulated amortization         |                             |                            |
| Existing and core technology - product | (11,150)                    | (8,027)                    |
| Technology license                     | (9,591)                     | (8,389)                    |
| Customer contracts and relationships   | (636)                       | (253)                      |
| Trade name                             | (227)                       | (66)                       |
| Order backlog                          | (540)                       | (540)                      |
|  | \$ 28,658                   | \$ 25,388                  |

Amortization expense was \$1.6 million and \$1.5 million for the three months ended September 30, 2010 and 2009, respectively and \$4.9 million and \$4.4 million for the nine months ended September 30, 2010 and 2009, respectively. The weighted-average remaining estimated useful lives for intangible assets are approximately 3.3 years for existing and core technology-product and 2.2 years for technology license. The weighted average remaining estimated life of intangible assets in total is approximately 2.8 years. Future amortization expense is estimated to be \$1.7 million for the remainder of 2010, \$5.8 million for 2011, \$5.2 million for 2012, \$4.2 million for 2013 and \$11.7 million thereafter.

**7. Restructuring Accrual**

In connection with the acquisition of W&W Communications, Inc. ( W&W ) in the fourth quarter of 2008, the Company recorded restructuring liabilities of approximately \$880,000. These liabilities are related to an operating lease commitment for one W&W facility, which the Company no longer occupies. In the third quarter of 2009, the Company made certain changes in estimates of approximately \$190,000 to its restructuring accrual as a result of completion of a sub-lease agreement. As of September 30, 2010, \$176,000 was recorded as restructuring related payables, net of sub lease income in accrued expenses and other current liabilities. The Company expects the W&W obligation to be settled by the end of January 2011 with payments of approximately \$155,000 in the remainder of 2010 and \$37,000 in 2011. The Company expects total sub-lease income of approximately \$15,000 in the remainder of 2010.

The Company assumed a facility related restructuring liability with a fair value of approximately \$1.3 million from MontaVista. The lease restructuring was initiated by MontaVista before the contemplation of the acquisition by the Company and was related to the operating lease for the portion of the facility that MontaVista no longer occupies. The Company expects the MontaVista obligation to be settled by the end of January 2013 with payments of approximately, \$108,000 in the remainder of 2010, \$434,000 in each of 2011 and 2012, and \$36,000 in 2013. Of the \$1.0 million net balance as of September 30, 2010, \$433,000 was recorded as restructuring related payables in accrued expenses and other current liabilities and the remaining \$578,000 was recorded in other non-current liabilities.



**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

A summary of the accrued restructuring liabilities, net of related activities during the nine months ended September 30, 2010 is as follows (in thousands):

|  | <b>Excess Facility<br/>related costs</b> |
|--|--|
| Accrued restructuring - December 31, 2009    | \$ 1,659                                 |
| Additions                                    |  |
| Cash payments and other non-cash adjustments | (471)                                    |
| Accrued restructuring - September 30, 2010   | 1,188                                    |
| Less: current portion                        | 610                                      |
| Long-term portion                            | \$ 578                                   |

**8. Stockholders' Equity****Equity Incentive Plans**

The description of the key features of the Company's 2007 Equity Incentive Plan and 2001 Stock Incentive Plan, may be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

The following table summarizes the details related to activity of early-exercise unvested shares of common stock granted under the 2001 Stock Incentive Plan:

|                                 | <b>Number of<br/>Unvested<br/>Shares<br/>Outstanding</b> | <b>Weighted-<br/>Average<br/>Exercise/Purchase<br/>Price</b> |
|---------------------------------|--|--|
| Balance as of December 31, 2009 | 41,671   | \$ 4.59  |
| Issued                          |  |  |
| Vested                          | (15,553)   | 4.23   |
| Cancelled and forfeited         |  |  |
| Balance as of March 31, 2010    | 26,118   | \$ 4.80  |
| Issued                          |  |  |
| Vested                          | (9,817)  | 4.86   |
| Cancelled and forfeited         | 250  | 3.04   |
| Balance as of June 30, 2010     | 16,551   | \$ 4.74  |

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|                                  |         |         |
|----------------------------------|---------|---------|
| Issued                           |         |         |
| Vested                           | (7,903) | 4.63    |
| Cancelled and forfeited          | 584     | 3.04    |
| Balance as of September 30, 2010 | 9,232   | \$ 4.73 |

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The following table summarizes the details related to stock options granted and outstanding under the 2007 Equity Incentive Plan and 2001 Stock Incentive Plan:

|                                  | <b>Number of<br/>Shares<br/>Outstanding</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>per Share</b> |
|----------------------------------|---|--|
| Balance at December 31, 2009     | 7,569,097                                   | \$ 9.84  |
| Options granted                  | 419,500                                     | 24.16  |
| Options exercised                | (686,906)                                   | 8.28   |
| Options cancelled and forfeited  | (238,944)                                   | 16.40  |
| Balance as of March 31, 2010     | 7,062,747                                   | \$ 10.62   |
| Options granted                  | 233,250                                     | 25.70  |
| Options exercised                | (312,081)                                   | 6.71   |
| Options cancelled and forfeited  | (32,526)                                    | 14.58  |
| Balance as of June 30, 2010      | 6,951,390                                   | \$ 11.28   |
| Options granted                  | 21,000                                      | 29.92  |
| Options exercised                | (323,320)                                   | 6.73   |
| Options cancelled and forfeited  | (37,590)                                    | 12.80  |
| Balance as of September 30, 2010 | 6,611,480                                   | \$ 11.55   |

The following table summarizes the details related to restricted stock units granted and outstanding under the 2007 Equity Incentive Plan:

|                                 | <b>Number of<br/>Shares</b> | <b>Weighted-<br/>Average Grant<br/>Date Fair<br/>Value Per<br/>Share</b> |
|---------------------------------|-----------------------------|--|
| Balance as of December 31, 2009 | 842,536                     | \$ 17.49   |
| Granted                         | 792,940                     | 24.16  |
| Issued and released             | (63,143)                    | 17.33  |
| Cancelled and forfeited         | (8,935)                     | 22.13  |
| Balance as of March 31, 2010    | 1,563,398                   | \$ 20.86   |
| Granted                         | 192,349                     | 25.79  |
| Issued and released             | (113,596)                   | 20.46  |
| Cancelled and forfeited         | (18,197)                    | 21.60  |
| Balance as of June 30, 2010     | 1,623,954                   | \$ 21.46   |
| Granted                         | 129,586                     | 29.92  |

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|                                  |           |          |
|----------------------------------|-----------|----------|
| Issued and released              | (114,053) | 20.76    |
| Cancelled and forfeited          | (27,992)  | 22.18    |
| Balance as of September 30, 2010 | 1,611,495 | \$ 22.18 |

For restricted stock units, or RSUs, stock-based compensation expense is calculated based on the market price of the Company's common stock on the date of grant, multiplied by the number of RSUs granted. The grant date fair value of RSUs, less estimated forfeitures, is recorded on a straight-line basis, over the vesting period.

As of September 30, 2010, there was \$30.4 million of unrecognized compensation costs, net of estimated forfeitures related to RSUs granted under the Company's 2007 Equity Incentive Plan. The unrecognized compensation cost is expected to be recognized over a weighted average period of 3.05 years.



**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Stock-Based Compensation**

The Company recognizes stock-based compensation for options and RSUs granted to employees in accordance with the fair value recognition provisions authoritative guidance as provided under stock-based compensation. The following table presents the detail of stock-based compensation expense amounts included in the consolidated statement of operations for each of the periods presented:

|                                   | Three Months                   |          | Nine Months Ended     |          |
|-----------------------------------|--------------------------------|----------|-----------------------|----------|
|                                   | Ended<br>September 30,<br>2010 | 2009     | September 30,<br>2010 | 2009     |
|                                   | (in thousands)                 |          |                       |          |
| Cost of revenue                   | \$ 423                         | \$ 95    | \$ 936                | \$ 262   |
| Research and development          | 2,765                          | 1,423    | 7,272                 | 4,036    |
| Sales, general and administrative | 2,681                          | 1,470    | 7,541                 | 4,184    |
|                                   | \$ 5,869                       | \$ 2,988 | \$ 15,749             | \$ 8,482 |

The total stock-based compensation cost capitalized as part of inventory as of September 30, 2010 and 2009 was \$115,000 and \$207,000, respectively.

The fair value of each employee option grant for the three months and nine months ended September 30, 2010 and 2009, respectively, was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

|                         | Three Months Ended    |                   | Nine Months Ended     |                   |
|-------------------------|-----------------------|-------------------|-----------------------|-------------------|
|                         | September 30,<br>2010 | 2009              | September 30,<br>2010 | 2009              |
| Risk-free interest rate | 1.03%                 | 1.96%             | 1.03% - 2.09%         | 1.52% - 2.19%     |
| Expected life           | 4.53 years            | 4.53 - 4.75 years | 4.53 years            | 4.53 - 4.75 years |
| Dividend yield          | None                  | None              | None                  | None              |
| Volatility              | 56.40%                | 62.4% - 62.7%     | 56.40% - 57.30%       | 62.4% - 63.7%     |

The estimated weighted-average grant date fair value of options granted were \$13.89 and \$9.84 for the three months ended September 30, 2010 and 2009, respectively, and \$11.95 and \$5.34 for the nine months ended September 30, 2010 and 2009, respectively.

As of September 30, 2010, there was \$20.4 million of unrecognized compensation costs, net of estimated forfeitures related to stock options granted under the Company's 2007 and 2001 Stock Incentive Plans. The unrecognized compensation cost is expected to be recognized over a weighted average period of 2.35 years.

**9. Income Taxes**

For the three months ended September 30, 2010 and 2009, the provision for (benefit from) income taxes was based on the estimated annual effective tax rate. The Company updates its estimate of its annual effective tax rate at the end of each quarterly period. The estimate takes into account estimations of annual pre-tax income, the geographic mix of pre-tax income and interpretations of tax laws and the possible outcomes of current and future audits.

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The following table presents the provision for (benefit from) income taxes and the effective tax rates for the three and nine months ended September 30, 2010 and 2009:

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
|   | (in thousands)            |             |                          |             |
| Income (loss) before provision for income taxes | \$ 5,609                  | \$ (3,999)  | \$ 2,848                 | \$ (16,616) |
| Provision for income taxes                      | 643                       | 167         | 345                      | 251         |
| Effective tax rate                              | 11.5%                     | -4.2%       | 12.1%                    | -1.5%       |

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**CAVIUM NETWORKS, INC.**

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

**(unaudited)**

In the three and nine months ended September 30, 2010, the Company recorded a tax provision of \$643,000 and \$345,000, respectively as compared to a provision for income taxes of \$167,000 and \$251,000 for the three and nine months ended September 30, 2009, respectively. The tax provision for the three and nine months ended September 30, 2010 was primarily related to international and state income taxes. The provision for the three and nine months ended September 30, 2009 was primarily related to federal alternative minimum taxes, international and state income taxes. The difference between the provision for income taxes that would be derived by applying the statutory rate to the Company's income (loss) before tax and the tax expense or benefit actually recorded for either period is primarily due to the impact of non-deductible stock-based compensation charges and other non-deductible items offset by the use of unbenefited net operating loss carryforwards available for use under applicable statutes.

The Company's net deferred tax assets relate predominantly to its United States tax jurisdiction. The valuation allowance is determined in accordance with the provisions of income taxes which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. The Company intends to maintain a full valuation allowance on its deferred tax assets in the United States until sufficient positive evidence exists to support reversal of the valuation allowance. The Company performs this evaluation on a quarterly basis. When sufficient positive evidence exists to support the reversal of the valuation allowance, the Company would recognize a benefit to the provision for income taxes in the period in which this determination is made. If such a benefit is recognized, subsequent periods may have a higher provision expense.

As of September 30, 2010 and December 31, 2009, the Company had unrecognized tax benefits of \$6.0 million and \$4.9 million, respectively. Of the \$6.0 million at September 30, 2010, approximately \$683,000 if recognized would reduce the Company's annual effective tax rate. The Company is not anticipating any significant decreases in unrecognized tax benefits due to the expiration of statute limitations within the next twelve months.

The Company's major tax jurisdictions are the United States federal government, the state of California, Japan and Singapore. The Company files income tax returns in the United States federal jurisdiction, the state of California and various state and foreign tax jurisdictions in which it has a subsidiary or branch operation. The United States federal corporation income tax returns beginning with the 2000 tax year remain subject to examination by the Internal Revenue Service, or IRS. The California corporation income tax returns beginning with the 2000 tax year remain subject to examination by the California Franchise Tax Board. There are no on-going tax audits in the major tax jurisdictions.

**10. Segment Information**

The Company's primary business has been its semiconductor processor business, which comes from the development and sale of our OCTEON, NITROX, ECONA and PureVu products. Historically, financial information was presented on a consolidated basis to the Company's chief executive officer who is the chief operating decision maker, or CODM, for the purpose of evaluating financial performance and allocating resources accompanied by information about revenue by customer and geography region. As such historically the Company reported one segment.

In the fourth quarter of 2009, the Company completed the acquisition of MontaVista. As a result of the MontaVista acquisition, the Company's total software and services now accounts for a more significant portion of its overall business. The financial model, type of products and services, nature of the production process and sales and distribution process for the Company's software and services business differs from that of its semiconductor processor business. In addition, the external reports that the Company uses to communicate its financial information to investors has now evolved to treat its software and services business separately. Furthermore, the CODM reviews financial information separately for the Company's software and services business for purpose of evaluating financial performance and allocating resources. As such, in accordance with segment reporting guidance, effective 2010, the Company has determined that it operates two reportable segments: (1) semiconductor products; and (2) software and services. The Company has updated its fiscal 2009 segment financial information to conform to fiscal 2010 measures used by the CODM.

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The two reportable segments are based upon the Company's internal organizational structure, the manner in which the operations are managed, the criteria used by the CODM to evaluate segment performance and the availability of separate financial information. The accounting policies for the segment reporting are the same as for the Company as a whole. The financial information used by the Company's CODM to evaluate segments results are net revenue and income (loss) from segment operations.

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Segment financial information for the Company's reportable segments was as follows:

|                                      | For the three months ended<br>September 30, |           | For the nine months ended<br>September 30, |           |
|--------------------------------------|---|-----------|--|-----------|
|                                      | 2010  | 2009      | 2010                                       | 2009      |
|                                      | (in thousands)                              |           | (in thousands)                             |           |
| <b>Net revenue:</b>                  |   |           |  |           |
| Semiconductor products               | \$ 48,078                                   | \$ 25,128 | \$ 127,377                                 | \$ 65,110 |
| Software and services                | 7,129                                       | 766       | 19,320                                     | 3,970     |
| Total consolidated net revenue       | \$ 55,207                                   | \$ 25,894 | \$ 146,697                                 | \$ 69,080 |
| <b>Segment income (loss):</b>        |   |           |  |           |
| Semiconductor products               | \$ 14,153                                   | \$ 1,928  | \$ 34,610                                  | \$ (322)  |
| Software and services                | 1,738                                       | 584       | 2,355                                      | 3,186     |
| Total segment income from operations | \$ 15,891                                   | \$ 2,512  | \$ 36,965                                  | \$ 2,864  |

The following is a reconciliation of the total segment income (loss) from operations to the amounts reported on the condensed consolidated financial statements:

|  | For the three months ended<br>September 30, |            | For the nine months ended<br>September 30, |             |
|--|---|------------|--|-------------|
|  | 2010  | 2009       | 2010                                       | 2009        |
|  | (in thousands)                              |            | (in thousands)                             |             |
| Segment income (loss) from reportable segments             | \$ 15,891                                   | \$ 2,512   | \$ 36,965                                  | \$ 2,864    |
| Unallocated stock compensation and related taxes           | (6,097)                                     | (3,109)    | (16,750)                                   | (8,713)     |
| Amortization of acquired intangible assets                 | (1,217)                                     | (1,042)    | (3,665)                                    | (3,203)     |
| Acquisition related expenses                               | (248)                                       | (773)      | (5,713)                                    | (3,017)     |
| Unallocated corporate, general and administrative expenses | (2,721)                                     | (1,537)    | (6,552)                                    | (4,575)     |
| Total consolidated income (loss) from operations           | 5,608                                       | (3,949)    | 4,285                                      | (16,644)    |
| Other (expense) income, net                                | 1   | (50)       | (1,437)                                    | 28          |
| Total consolidated income (loss) before income taxes       | \$ 5,609                                    | \$ (3,999) | \$ 2,848                                   | \$ (16,616) |

The following table is based on the geographic location of the original equipment manufacturers or the distributors who purchased the Company's products. For sales to the distributors, their geographic location may be different from the geographic locations of the ultimate end customers. Sales by geography for the periods indicated were as follows:

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|                 | For the three months ended<br>September 30,<br>2010 |                  | For the nine months ended<br>September 30,<br>2009 |                  |
|-----------------|---|------------------|--|------------------|
|                 | (in thousands)                                      |                  | (in thousands)                                     |                  |
| United States   | \$ 17,907   | \$ 9,002         | \$ 51,136  | \$ 27,198        |
| China           | 18,706  | 6,653            | 41,055   | 17,853           |
| Taiwan          | 8,095   | 4,407            | 22,656   | 9,526            |
| Japan           | 4,322   | 3,241            | 13,278   | 8,262            |
| Malaysia        | 2,387   | 1,585            | 8,232  | 2,749            |
| Other countries | 3,790   | 1,006            | 10,340   | 3,492            |
| <b>Total</b>    | <b>\$ 55,207</b>                                    | <b>\$ 25,894</b> | <b>\$ 146,697</b>                                  | <b>\$ 69,080</b> |

**Table of Contents****CAVIUM NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****11. Commitments and Contingencies**

The Company is not currently a party to any legal proceedings that management believes would have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

The Company leases its facilities under non-cancelable operating leases, which contain renewal options and escalation clauses, and expire on varying dates ending in April 2013. The Company also acquires certain assets under capital leases.

Minimum commitments under non-cancelable operating and capital lease agreements, excluding accrued restructuring liability (See Note 7) as of September 30, 2010 were as follows:

|  | <b>Capital lease<br/>and technology<br/>license<br/>obligations</b> | <b>Operating<br/>leases<br/>(in thousands)</b> | <b>Total</b> |
|--|---|--|--------------|
| 2010                                   | \$ 3,718  | \$ 720   | \$ 4,438     |
| 2011                                   | 8,320   | 2,126  | 10,446       |
| 2012                                   | 3,028   | 1,386  | 4,414        |
| 2013                                   |   | 310  | 310          |
|  | \$ 15,066   | \$ 4,542                                       | \$ 19,608    |
| Less: Interest component               | (379)   |  |              |
| Present value of minimum lease payment | 14,687  |  |              |
| Less: current portion                  | (10,966)  |  |              |
| Long-term portion of obligations       | \$ 3,721  |  |              |

In addition to the contractual obligations in the table above, as of September 30, 2010, the Company has a funding commitment in relation to the asset purchase agreements entered into in September 2010 to acquire intellectual property and certain equipment for an aggregate consideration of approximately \$4.4 million and a possible earn-out of approximately \$1.5 million in cash upon achievement of certain milestones as set forth in the asset purchase agreements. The aggregate consideration of \$4.4 million was paid on October 5, 2010.

Rent expense incurred under operating leases was \$767,000 and \$481,000 for the three months ended September 30, 2010 and 2009, respectively, and \$2.3 million and \$1.5 million for the nine months ended September 30, 2010 and 2009, respectively.

The capital lease and technology license obligations include future cash payments payable primarily for license agreements with outside vendors. The significant obligations which have outstanding payments as of September 30, 2010 relates to a license agreement, which was entered into in October 2009 for certain design tools totaling \$9.5 million, with 12 installment payments. The term of the license will expire in October 2012. The present value of the installment payments has been capitalized and is amortized over three years, and included within capital lease and technology license obligations on consolidated balance sheets. As of September 30, 2010, \$3.1 million of the total \$9.5 million due under the license agreement was paid. Further, the Company entered into a licensing agreement in April 2010 for certain design tools totaling

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\$950,000, which has been capitalized and is amortized over three years, and included within capital lease and technology license obligations on the consolidated balance sheet. As of September 30, 2010, \$100,000 of the total \$950,000 due under the license agreement was paid.

On September 29, 2010, the Company renewed an agreement with MIPS to use certain licensed technology. Pursuant to the agreement, which will expire in September 2026, the Company can use the licensed technology in exchange for license fees and royalties on the Company's products that incorporate the licensed technology. The full license fees have been capitalized as intangible assets, which will be amortized over the license term.



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

*The following discussion should be read in conjunction with the Consolidated Condensed Financial Statements and the related notes that appear elsewhere in this document.*

*The information in this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended ( Securities Act ), and Section 21E of the Securities Exchange Act of 1934, as amended ( Exchange Act ), which are subject to the safe harbor created by those sections. Forward-looking statements are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, estimate, project, predict, potential, continue, strategy, believe, anticipate, plan, expect, intend and similar expression intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. We discuss many of these risks, uncertainties and other factors in this Quarterly Report on Form 10-Q in greater detail under the heading Risk Factors. Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this Quarterly Report on Form 10-Q completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.*

*Octeon®*, *Octeon Plus®*, *Octeon II®*, *Nitrox®* and *Pure Vu™* are trademarks or registered trademarks of Cavium Networks, Inc.

**Overview**

We are a provider of highly integrated semiconductor processors that enable intelligent processing for networking, communications, storage, wireless, security, video and connected home and office applications. We refer to our products as enabling intelligent processing because they allow customers to develop networking, wireless, storage and electronic equipment that is application-aware and content-aware and securely processes voice, video and data traffic at high speeds. Our products also include a rich suite of embedded security protocols that enable unified threat management, or UTM, secure connectivity, network perimeter protection, Deep Packet Inspection or DPI, network virtualization, broadband gateways, 3G/4G wireless infrastructure, storage systems, wireless HDMI cable replacement and embedded video applications. Our products are systems on a chip, or SoCs, which incorporate single or multiple processor cores, a highly integrated architecture and customizable software that is based on a broad range of standard operating systems. As a result, our products offer high levels of performance and processing intelligence while reducing product development cycles for our customers and lowering power consumption for end market equipment. We focus our resources on the design, sales and marketing of our products, and outsource the manufacturing of our products.

From our incorporation in 2000 through 2003, we were primarily engaged in the design and development of our first processor family, NITROX, which we began shipping commercially in 2003. In 2004, we introduced and commenced commercial shipments of NITROX Soho. In 2006, we commenced our first commercial shipments of our OCTEON family of multi-core MIPS64® processors. We introduced a number of new products within all three of these product families in 2006. In 2007 we introduced our new line of OCTEON based storage services processors designed to address the specific needs in the storage market, as well as other new products in the OCTEON and NITROX families. In 2008, we expanded our OCTEON and NITROX product families with new products including wireless services processors to address the needs for wireless infrastructure equipment. In 2009, we announced the next generation OCTEON II Internet Application Processor ( IAP ) family multi-core MIPS64® processors, with one to 32 cores to address next generation networking applications supporting converged voice, video, data mobile traffic and services. In addition, in 2009, we expanded our NITROX product family offering to include the NITROX DPI processor, which facilitates several significant enhancements and increased performance.

In the third quarter of 2008, we acquired substantially all of the assets of Star Semiconductor Corporation ( Star ) for a purchase price of approximately \$9.6 million. With the acquisition of Star, we also added the Star ARM-based processors to our portfolio to address connected home and office applications and have since introduced our ECONA line of dual-core ARM processors that address a large variety of connected home and office applications.

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In the fourth quarter of 2008, we acquired W&W Communications, Inc. for a total purchase price of approximately \$8.3 million. This acquisition launched us into the video processor market with a broad product line called PureVu. The PureVu family of video processors and modules incorporate proprietary and patent pending video technology that produces perceptual lossless video quality and delivers sub-frame latency with extremely low power and cost. These products address the need for video processing in wireless displays, teleconferencing, gaming and other applications.

In the fourth quarter of 2009, we acquired MontaVista for a total purchase price of approximately \$45.2 million. In addition, per the merger agreement, we paid approximately \$6.0 million, consisting of a mix of shares of our common stock and cash to certain individuals in connection with the termination of MontaVista's 2006 Retention Compensation Plan. This acquisition complements our broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market.

Since inception, we have invested heavily in new product development and our net revenue has grown from \$19.4 million in 2005 to \$34.2 million in 2006, \$54.2 million in 2007, \$86.6 million in 2008, \$101.2 million in 2009 and \$146.7 million in the nine months ended September 30, 2010, driven primarily by demand in the enterprise network and data center markets, and more recently and in 2009 the revenue growth was mainly due to increased demand in the broadband and consumer markets. We expect sales of our products for use in the enterprise network and data center markets to continue to represent a significant portion of our revenue in the foreseeable future, however, we do expect growth in the broadband and consumer as well as the access and service provider markets.

We primarily sell our semiconductor products to OEMs, either directly or through their contract manufacturers. Contract manufacturers purchase our products only when an OEM incorporates our product into the OEM's product, not as commercial off-the-shelf products. Our customers' products are complex and require significant time to define, design and ramp to volume production. Accordingly, our sales cycle is long. This cycle begins with our technical marketing, sales and field application engineers engaging with our customers' system designers and management, which is typically a multi-month process. If we are successful, a customer will decide to incorporate our product in its product, which we refer to as a design win. Because the sales cycles for our products are long, we incur expenses to develop and sell our products, regardless of whether we achieve the design win and well in advance of generating revenue, if any, from those expenditures. We do not have long-term purchase commitments from any of our customers, as sales of our products are generally made under individual purchase orders. However, once one of our products is incorporated into a customer's design, it is likely to remain designed in for the life cycle of the product.

We believe this to be the case because a redesign would generally be time consuming and expensive. We have experienced revenue growth due to an increase in the number of our products, an expansion of our customer base, an increase in the number of average design wins within any one customer and an increase in the average revenue per design win.

In addition, with the acquisition of MontaVista in December 2009, our total software and services revenue now accounts for a more significant portion of our total revenue. The net revenue for our software and services are primarily derived from the sales of time-based software licenses, software maintenance and support, and from professional services arrangements and training. Our MontaVista offerings include open source, commercial-grade Linux operating systems, support, and a complete set of development tools and professional services, designed to allow our customers to develop, run, and manage their device products faster, better, at lower cost and more reliably. The revenue generated from the software products acquired in our MontaVista acquisition in December 2009 contributed to our overall growth in the three and nine months ended September 30, 2010.

### ***Key Business Metrics for Semiconductor Products***

***Design Wins.*** We closely monitor design wins by customer and end market on a periodic basis. We consider design wins to be a key ingredient in our future success, although the revenue generated by each design can vary significantly. Our long-term sales expectations are based on internal forecasts from specific customer design wins based upon the expected time to market for end customer products deploying our products and associated revenue potential.

***Pricing and Margins.*** Pricing and margins depend on the features of the products we provide to our customers. In general, products with more complex configurations and higher performance tend to be priced higher and have higher gross margins. These configurations tend to be used in high performance applications that are focused on the enterprise network, data center, and access and service provider markets. We tend to experience price decreases over the life cycle of our products, which can vary by market and application. In general, we experience less pricing volatility with customers that sell to the enterprise and data center markets.

***Sales Volume.*** A typical design win can generate a wide range of sales volumes for our products, depending on the end market demand for our customers' products. This can depend on several factors, including the reputation, market penetration, the size of the end market that the product addresses, and the marketing and sales effectiveness of our customer. In general, our customers with greater market penetration and better

branding tend to develop products that generate larger volumes over the product life cycle. In addition, some markets generate large volumes if the end market product is adopted by the mass market.

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**Customer Product Life Cycle.** We typically commence commercial shipments from nine months to three years following the design win. Once our product is in production, revenue from a particular customer may continue for several years. We estimate our customers' product life cycles based on the customer, type of product and end market. In general, products that go into the enterprise network and data center take longer to reach volume production but tend to have longer lives. Products for other markets, such as broadband and consumer, tend to ramp relatively quickly, but generally have shorter life cycles. We estimate these life cycles based on our management's experience with providers of networking equipment and the semiconductor market as a whole.

**Results of Operations**

*Three and nine months ended September 30, 2010 and 2009*

**Net Revenue.** Our net revenue consists primarily of sales of our semiconductor products to providers of networking equipment and their contract manufacturers and distributors. Initial sales of our products for a new design are usually made directly to providers of networking equipment as they design and develop their product. Once their design enters production, they often outsource their manufacturing to contract manufacturers that purchase our products directly from us or from our distributors. We price our products based on market and competitive conditions and periodically reduce the price of our products, as market and competitive conditions change, and as manufacturing costs are reduced. We do not experience different margins on direct sales to providers of networking equipment and indirect sales through contract manufacturers because in all cases we negotiate product pricing directly with the providers of networking equipment. In addition, we also derive revenue from the sales of time-based software licenses, software maintenance and support, and from professional services arrangements and training. To date, most of our revenue is denominated in U.S. dollars.

Our end customers representing greater than 10% of net revenue for each of the periods were:

|                                 | For the three months ended<br>September 30, |      | For the nine months ended<br>September 30, |      |
|---------------------------------|---|------|--|------|
|                                 | 2010  | 2009 | 2010                                       | 2009 |
| Percentage of total net revenue |   |      |  |      |
| Cisco                           | 20%   | 26%  | 23%  | 22%  |
| Actiontec                       | *   | 11%  | *  | 13%  |
| Sumitomo                        | *   | 10%  | *  | 10%  |

\* Represents less than 10% of the consolidated net revenue for the respective period end.

Revenue and costs relating to sales to distributors are deferred if we grant more than limited rights of returns and price credits or if we cannot reasonably estimate the level of returns and credits issuable. During the quarter ended June 30, 2007, we signed a distribution agreement with Avnet, Inc. to distribute our products primarily in the United States. Given the terms of the distribution agreement, for sales to Avnet, revenue and costs are deferred until products are sold by Avnet to their end customers. For the three months ended September 30, 2010 and 2009, 7.4% and 4.5%, respectively, and for the nine months ended September 30, 2010 and 2009, 6.8% and 5.3%, respectively, of our net revenues were from products sold by Avnet. Revenue recognition depends on notification from Avnet that product has been sold to Avnet's end customers.

Our distributors, other than Avnet, are used primarily to support international sale logistics in Asia, including importation and credit management. Total net revenue through distributors was \$18.3 million and \$10.6 million for the three months ended September 30, 2010 and 2009 respectively, which accounted for 33.2% and 40.9% of net revenue, respectively, and \$49.6 million and \$25.8 million for the nine months ended September 30, 2010 and 2009, respectively, which accounted for 33.8% and 37.3% of net revenue, respectively. While we have purchase agreements with our distributors, the distributors do not have long-term contracts with any of the equipment providers. Our distributor agreements limit the distributor's ability to return product up to a portion of purchases in the preceding quarter. Given our experience, along with our distributors' limited contractual return rights, we believe we can reasonably estimate expected returns from our distributors. Accordingly, we recognize sales through distributors at the time of shipment, reduced by our estimate of expected returns.

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The following table is based on the geographic location of the original equipment manufacturers or the distributors who purchased our products. For sales to our distributors, their geographic location may be different from the geographic locations of the ultimate end customers. Sales by geography for the periods indicated were:

|                 | Three months ended<br>September 30,<br>2010 |                  | Nine months ended<br>September 30,<br>2009 |                  |
|-----------------|---|------------------|--|------------------|
|                 | 2010  | 2009             | 2010                                       | 2009             |
|                 | (in thousands)                              |                  |  |                  |
| United States   | \$ 17,907                                   | \$ 9,002         | \$ 51,136                                  | \$ 27,198        |
| China           | 18,706                                      | 6,653            | 41,055                                     | 17,853           |
| Taiwan          | 8,095                                       | 4,407            | 22,656                                     | 9,526            |
| Japan           | 4,322                                       | 3,241            | 13,278                                     | 8,262            |
| Malaysia        | 2,387                                       | 1,585            | 8,232                                      | 2,749            |
| Other countries | 3,790                                       | 1,006            | 10,340                                     | 3,492            |
| <b>Total</b>    | <b>\$ 55,207</b>                            | <b>\$ 25,894</b> | <b>\$ 146,697</b>                          | <b>\$ 69,080</b> |

*Cost of Revenue and Gross Margin.* We outsource wafer fabrication, assembly and test functions of our products. A significant portion of our cost of revenue consists of payments for the purchase of wafers and for assembly and test services, amortization of acquired intangibles, and amortization related to capitalized mask costs. To a lesser extent, cost of revenue includes expenses associated with professional services arrangements, stock-based compensation, the cost of shipping and logistics, royalties, inventory valuation expenses for excess and obsolete inventories, warranty costs and changes in product cost due to changes in sort, assembly and test yields. In general, our cost of revenue associated with a particular product declines over time as a result of yield improvements, primarily associated with design and test enhancements.

We use third-party foundries and assembly and test contractors, which are primarily located in Asia, to manufacture, assemble and test our semiconductor products. We purchase processed wafers on a per wafer basis from our fabrication suppliers, which are currently TSMC, UMC, Fujitsu and Samsung. We also outsource the sort, assembly, final testing and other processing of our product to third-party contractors, primarily ASE and ISE. We negotiate wafer fabrication on a purchase order basis and do not have long-term agreements with any of our third-party contractors. A significant disruption in the operations of one or more of these contractors would impact the production of our products which could have a material adverse effect on our business, financial condition and results of operations.

Our gross margin has been and will continue to be affected by a variety of factors, including the product mix, average sales prices of our products, the amortization expense associated with the acquired intangible assets, the timing of cost reductions for fabricated wafers and assembly and test service costs, inventory valuation charges, the cost of fabrication masks that are capitalized and amortized, and the timing and changes in sort, assembly and test yields. Overall product margin is impacted by the mix between higher performance, higher margin products and lower performance, lower margin products. In addition, we typically experience lower yields and higher associated costs on new products, which improve as production volumes increase.

Our net revenue, cost of revenue, gross profit and gross margin for the three and nine months ended September 30, 2010 and 2009 were:

|                 | For the three months<br>ended September 30,<br>2010 |           |           |          | For the nine months<br>ended September 30,<br>2009 |           |           |          |
|-----------------|---|-----------|-----------|----------|--|-----------|-----------|----------|
|                 | 2010  | 2009      | change    | % change | 2010   | 2009      | change    | % change |
|                 | (in thousands)                                      |           |           |          | (in thousands)                                     |           |           |          |
| Net revenue     | \$ 55,207   | \$ 25,894 | \$ 29,313 | 113.2%   | \$ 146,697   | \$ 69,080 | \$ 77,617 | 112.4%   |
| Cost of revenue | 20,811  | 12,567    | 8,244     | 65.6%    | 57,172   | 35,520    | 21,652    | 61.0%    |
| Gross Profit    | \$ 34,396   | \$ 13,327 | \$ 21,069 | 158.1%   | \$ 89,525  | \$ 33,560 | \$ 55,965 | 166.8%   |
| Gross Margin    | 62.3%   | 51.5%     | 10.8%     | 21.1%    | 61.0%  | 48.6%     | 12.4%     | 25.6%    |

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*Three and Nine Months ended September 30, 2010 Compared to the Three and Nine Months Ended September 30, 2009: Net Revenue.* Our net revenue was \$55.2 million in the three months ended September 30, 2010, as compared to \$25.9 million in the three months ended September 30, 2009, an increase of \$29.3 million, or 113.2%. Our net revenue was \$146.7 million in the nine months ended September 30, 2010, as compared to \$69.1 million in the nine months ended September 30, 2009, an increase of

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\$77.6 million, or 112.4%. The increase in net revenue in the three and nine months ended September 30, 2010 was mainly attributable to the increase in sales of \$21.8 million and \$59.2 million, respectively, from our enterprise network, data center and access and service provider markets, combined as a result of the increase in demand for our new and existing products generally from our top five customers. Net revenue in our software and services segment increased in the three and nine months ended September 30, 2010, by \$6.4 million and \$15.4 million, respectively, due mainly to software products resulting from our acquisition of MontaVista completed in 2009. In addition, net revenue increase of \$1.3 and \$3.1 million, in the three and nine months ended September 30, 2010, respectively, in broadband and consumer markets contributed to our overall growth.

*Three and Nine Months Ended September 30, 2010 Compared to the Three and Nine Months Ended September 30, 2009: Cost of Revenue and Gross Margin.* Gross margin increased from 51.5% in the three months ended September 30, 2009 to 62.3 % in the three months ended September 30, 2010, an increase of 10.8 percentage points and from 48.6% in the nine months ended September 30, 2009 to 61.0% in the nine months ended September 30, 2010, an increase of 12.4 percentage points. The increase in gross margin in the three and nine months ended September 30, 2010 compared to the three and nine months ended September 30, 2009 was primarily due to decreased product cost associated with fabricated wafers and assembly and test costs. In addition, to a lesser extent, gross margin improvement was a result of a favorable product sales mix, with increased sales of higher margin products and services.

**Research and Development Expenses**

Research and development expenses primarily include personnel costs, engineering design development software and hardware tools, allocated facilities expenses and depreciation of equipment used in research and development, and stock-based compensation.

Total research and development expenses for the three and nine months ended September 30, 2010 and 2009 were:

|                                   | For the three months ended September 30, |           | change   | % change | For the nine months ended September 30, |           | change    | % change |
|-----------------------------------|--|-----------|----------|----------|---|-----------|-----------|----------|
|                                   | 2010                                     | 2009      |          |          | 2010                                    | 2009      |           |          |
|                                   | (in thousands)                           |           |          |          | (in thousands)                          |           |           |          |
| Research and development expenses | \$ 15,807                                | \$ 10,629 | \$ 5,178 | 48.7%    | \$ 44,688                               | \$ 30,894 | \$ 13,794 | 44.6%    |
| Percent of total net revenue      | 28.6%                                    | 41.0%     | -12.4%   | -30.2%   | 30.5%                                   | 44.7%     | -14.2%    | -31.9%   |

*Three and Nine Months Ended September 30, 2010 Compared to the Three and Nine Months Ended September 30, 2009:* Research and development expenses increased by \$5.2 million and \$13.8 million, or 48.7% and 44.6% to \$15.8 million and \$44.7 million, in the three and nine months ended September 30, 2010 from \$10.6 million and \$30.9 million in the three and nine months ended September 30, 2009, respectively. Of the \$5.2 million and \$13.8 million increase in the three and nine months ended September 30, 2010 and 2009, respectively, salaries and benefits accounted for \$2.0 million and \$5.2 million, respectively and stock-based compensation expense accounted for \$1.3 million and \$3.7 million, respectively in each case due to increased headcount mainly as a result of the acquisition of Monta Vista which was completed in 2009. Research and development headcount increased to 349 at September 30, 2010 from 232 September 30, 2009. Consulting services, depreciation, amortization of intangible assets, facilities cost and other miscellaneous expenses accounted for \$1.9 million and \$4.9 million of the increase in the three and nine months ended September 30, 2010 and 2009 respectively.

**Table of Contents****Sales, General and Administrative Expenses**

Sales, general and administrative expenses primarily include personnel costs, accounting and legal fees, information systems, sales commissions, trade shows, marketing programs, depreciation, allocated facilities expenses and stock-based compensation. Total sales, general and administrative costs for the three and nine months ended September 30, 2010 and 2009 were:

|                                   | For the three months<br>ended September 30,<br>2010 |          | change   | % change | For the nine months<br>ended September 30,<br>2010 |           | change    | % change |
|-----------------------------------|---|----------|----------|----------|--|-----------|-----------|----------|
|                                   | (in thousands)                                      |          |          |          | (in thousands)                                     |           |           |          |
| Sales, general and administrative | \$ 12,981   | \$ 6,647 | \$ 6,334 | 95.3%    | \$ 40,552  | \$ 19,310 | \$ 21,242 | 110.0%   |
| Percent of total net revenue      | 23.5%   | 25.7%    | -2.2%    | -8.4%    | 27.6%  | 28.0%     | -0.4%     | -1.5%    |

*Three and Nine Months Ended September 30, 2010 Compared to the Three and Nine Months Ended September 30, 2009:* Sales, general and administrative expenses increased \$6.3 million and \$21.2 million, or 95.3% and 110.0% to \$13.0 million and \$40.6 million, respectively, in the three and nine months ended September 30, 2010 from \$6.6 million and \$19.3 million, respectively in the three and nine months ended September 30, 2009. Of the \$6.3 million and \$21.2 million increase in the three and nine months ended September 30, 2010, respectively, salaries, benefits and commissions accounted for \$2.8 million and \$11.5 million, respectively, and stock-based compensation expense accounted for \$1.3 million, and \$3.6 million, respectively, in each case due to increased headcount. Sales, general and administrative headcount increased to 197 at the end of September 2010 from 102 at the end of September 2009. Professional services, and other miscellaneous expenses accounted for \$2.2 million and \$6.1 million of the increase in the three and nine months ended September 30, 2010, respectively.

**Other Income, Net.** Other income, net, primarily includes the interest expense component associated with the installment payment of capitalized licenses and, to a lesser extent, includes interest income on cash and cash equivalents.

|                                   | For the three months<br>ended September 30,<br>2010 |         | change | % change | For the nine months<br>ended September 30,<br>2010 |        | change     | % change |
|-----------------------------------|---|---------|--------|----------|--|--------|------------|----------|
|                                   | (in thousands)                                      |         |        |          | (in thousands)                                     |        |            |          |
| Interest income and other, net    | \$ 94   | \$ 4    | \$ 90  | 2250.0%  | \$ (1,115)   | \$ 228 | \$ (1,343) | -589.0%  |
| Interest expense                  | (93)  | (54)    | (39)   | 72.2%    | (322)  | (200)  | (122)      | 61.0%    |
| Total other (expense) income, net | \$ 1  | \$ (50) | \$ 51  | -102.0%  | \$ (1,437)   | \$ 28  | \$ (1,465) | -5232.1% |

*Three and Nine Months Ended September 30, 2010 Compared to the Three and Nine Months Ended September 30, 2009:* Interest income and other, net increased in the three months ended September 30, 2010 compared to the three months ended September 30, 2009. The increase was primarily due to higher foreign exchange gain resulting from balance sheet remeasurement. For the nine months ended September 30, 2010 compared to the same period ended September 30, 2009, interest income and other, net decreased. The decrease was primarily due to the provision for a note receivable of \$1.0 million that was deemed uncollectible at the end of June 30, 2010 and, to a lesser extent due to lower interest income resulting from lower short-term U.S. interest rates and lower foreign exchange gain from balance sheet remeasurement. Interest expense for the three months and nine months ended September 30, 2010 increased compared to the same periods ended September 30, 2009 primarily due to higher interest expense associated with the installment payment of capitalized leases.



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**Provision for (benefit from) Income Taxes.** For the three and nine months ended September 30, 2010 and 2009, respectively, the provision for (benefit from) income taxes was based on our estimated annual effective tax rate in compliance with the guidance provided under income taxes. We update our estimate of our annual effective tax rate at the end of each quarterly period. Our estimate takes into account estimations of annual pre-tax income, the geographic mix of pre-tax income and our interpretations of tax laws and the possible outcomes of current and future audits.

The following table presents the provision for (benefit from) income taxes and the effective tax rates for the three and nine months ended September 30, 2010 and 2009:

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|------------|------------------------------------|-------------|
|   | 2010                                | 2009       | 2010                               | 2009        |
|   | (in thousands)                      |            |                                    |             |
| Income (loss) before provision for income taxes | \$ 5,609                            | \$ (3,999) | \$ 2,848                           | \$ (16,616) |
| Provision for income taxes                      | 643                                 | 167        | 345                                | 251         |
| Effective tax rate                              | 11.5%                               | -4.2%      | 12.1%                              | -1.5%       |

In the three and nine months ended September 30, 2010, we recorded a tax provision of \$643,000 and \$345,000, respectively, as compared to a provision for income taxes of \$167,000 and \$251,000 for the three and nine months ended September 30, 2009, respectively. The tax provision for the three and nine months ended September 30, 2010 was primarily related to international and state income taxes. The tax provision for the three and nine months ended September 30, 2009 was primarily related to federal alternative minimum taxes, international and state income taxes. The difference between the provision for income taxes that would be derived by applying the statutory rate to our income (loss) before tax and the tax expense or benefit actually recorded for either period is primarily due to the impact on non-deductible stock based compensation charges and other non-deductible items offset by the use of net operating loss carryforwards available for use under applicable statutes.

We continue to maintain a full valuation allowance on our U.S. net deferred tax assets in the United States until sufficient positive evidence exists, including history of taxable income, to support reversal of the valuation allowance. When sufficient positive evidence exists to support the reversal of the valuation allowance, we would recognize a benefit to the provision for income taxes in the period in which this determination is made. If such benefit is recognized, subsequent periods may have a higher provision expense.

As of September 30, 2010 and December 31, 2010, we had unrecognized tax benefits of \$6.0 million and \$4.9 million, respectively. Of the \$6.0 million at September 30, 2010, approximately \$683,000 if recognized would reduce our annual effective tax rate. We are not anticipating any significant decreases in unrecognized tax benefits due to the expiration of statute limitations within the next twelve months.

**Liquidity and Capital Resources**

As of September 30, 2010, we had cash and cash equivalents of \$83.3 million and net accounts receivable of \$31.7 million.

Following is a summary of our working capital and cash and cash equivalents as of September 30, 2010 and December 31, 2009:

|                           | As of                 |                      |
|---------------------------|-----------------------|----------------------|
|                           | September 30,<br>2010 | December 31,<br>2009 |
|                           | (in thousands)        |                      |
| Working capital           | \$ 90,202             | \$ 65,897            |
| Cash and cash equivalents | \$ 83,255             | \$ 58,918            |

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Following is a summary of our cash flows from operating activities, investing activities and financing activities for the nine months ended September 30, 2010 and 2009:

|   | Nine Months Ended<br>September 30, |            |
|---|------------------------------------|------------|
|   | 2010                               | 2009       |
|   | (in thousands)                     |            |
| Net cash provided by (used in) operating activities | \$ 24,667                          | \$ 1,848   |
| Net cash used in investing activities               | \$ (7,757)                         | \$ (8,039) |
| Net cash provided by (used in) financing activities | \$ 7,427                           | \$ (143)   |

*Cash Flows from Operating Activities*

Net cash from operating activities increased by \$22.8 million in the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009. The increase in our cash flows from operations was primarily due to cash inflow from net income of \$2.5 million compared to a cash outflow from a net loss of \$16.9 million for the nine months ended September 30, 2010 and 2009, respectively. In addition, non-cash expenses increased to \$27.6 million in the nine months ended September 30, 2010 from \$18.9 million in the nine months ended September 30, 2009. The increase in non-cash expenses was mainly attributable to higher stock-based compensation of \$7.3 million mainly due to increased headcount resulting from the acquisition of MontaVista completed in 2009, provision for a note receivable of \$1.0 million which we deemed uncollectible and higher depreciation and amortization expense of \$478,000. The increase in cashflows from operations as a result of the increase in net income and non-cash expenses in the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009 was partially offset by the decrease in the changes in assets and liabilities of \$5.2 million. The decrease was mainly due to increase in accounts receivable and inventories which were partially offset by the increase in accounts payable and deferred revenue from subscription-based licenses and professional service arrangements resulting from our acquisition of Monta Vista.

*Cash Flows from Investing Activities*

Net cash used in investing activities decreased by \$282,000 in the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009. The decrease was primarily due to lower acquisition related cash payments made which were partially offset by an increase in purchases of property and equipment during the nine months ended September 30, 2010 compared to the same period ended September 30, 2009.

*Cash Flows from Financing Activities*

Net cash from financing activities increased by \$7.6 million in the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009. The increase was mainly due to higher proceeds from exercises of stock options for the nine months ended September 30, 2010 compared to the same period ended September 30, 2009.

Cash equivalents consist primarily of an investment in a money market fund. As of September 30, 2010, we have not experienced any impairment charges due to such concentration of credit risk. We believe that our \$83.3 million of cash and cash equivalents at September 30, 2010 and expected cash flows from operations will be sufficient to fund our projected operating requirements for at least 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our engineering, sales and marketing activities, the timing and extent of our expansion into new territories, the timing of introductions of new products and enhancements to existing products and the continuing market acceptance of our products. Although we currently are not a party to any agreement with respect to potential material investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

*Indemnities*

In the ordinary course of business, we have entered into agreements with customers that include indemnity provisions. Based on historical experience and information known as of September 30, 2010, we believe our exposure related to the indemnities at September 30, 2010 is not material. We also enter into indemnification agreements with our officers and directors and our certificate of incorporation and bylaws include similar indemnification obligations to our officers and directors. It is not possible to determine the amount of our liability related to these indemnification agreements and obligations to our officers and directors due to the limited history of prior indemnification claims and the unique

facts and circumstances involved in each particular agreement.

**Table of Contents****Off-Balance Sheet Arrangements**

During the periods presented, we did not have, nor do we currently have, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

**Contractual Obligations**

The following table describes our commitments to settle contractual obligations in cash as of September 30, 2010 (in thousands):

|                             | Payments Due at Remainder of the Calendar Year |                  |                 |                         | Total            |
|-----------------------------|--|------------------|-----------------|-------------------------|------------------|
|                             | Less Than<br>1 Year                            | 1 to 2<br>Years  | 3 to 5<br>Years | More<br>Than 5<br>Years |                  |
| Operating lease obligations | \$ 720   | \$ 3,512         | \$ 310          | \$                      | \$ 4,542         |
| Capital lease obligations   | 3,718  | 11,348           |                 |                         | 15,066           |
| <b>Total</b>                | <b>\$ 4,438</b>                                | <b>\$ 14,860</b> | <b>\$ 310</b>   | <b>\$</b>               | <b>\$ 19,608</b> |

As of September 30, 2010, the liability for uncertain tax positions was \$683,000. The timing of any payments which could result from these unrecognized tax benefits will depend upon a number of factors. Accordingly, the timing of payment cannot be estimated.

In addition to the contractual obligations in the table above, as of September 30, 2010, the Company has a funding commitment in relation to the asset purchase agreements entered into in September 2010 to acquire intellectual property and certain equipment for an aggregate consideration of approximately \$4.4 million and a possible earn-out of approximately \$1.5 million in cash upon achievement of certain milestones as set forth in the asset purchase agreements. The aggregate consideration of \$4.4 million was paid on October 5, 2010.

**Critical Accounting Policies and Estimates**

The preparation of our financial statements and accompanying disclosures in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and the accompanying notes. The SEC has defined a company's critical accounting policies as policies that are most important to the portrayal of a company's financial condition and results of operations, and which require a company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have identified our most critical accounting policies and estimates to be as follows: (1) revenue recognition; (2) stock-based compensation; (3) inventory valuation; (4) accounting for income taxes; (5) mask costs; (6) business combinations and (7) goodwill and purchased intangible assets. Although we believe that our estimates, assumptions and judgments are reasonable, they are based upon information not presently available. Actual results may differ significantly from these estimates if the assumptions, judgments and conditions upon which they are based turn out to be inaccurate. Management believes that there have been no significant changes during the nine months ended September 30, 2010 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations, in our Annual Report on Form 10-K for the year ended December 31, 2009 filed on March 1, 2010.

**Recent Accounting Pronouncements**

Please refer to the recent accounting pronouncements listed in the footnote 1 of the financial statements.

**Item 3. Quantitative and Qualitative Disclosure About Market Risk**

During the nine months ended September 30, 2010, there were no material changes to our quantitative and qualitative disclosures about market risk related to our investment activities as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the SEC on March 1, 2010.

**Item 4. Controls and Procedures**

***Disclosure Controls and Procedures***

Our Chief Executive Officer and our Chief Financial Officer evaluated with the participation of our management, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of September 30, 2010. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

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

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recently completed second quarter ending on September 30, 2010. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that there has not been any change in our internal control over financial reporting during that quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we may become involved in legal proceedings arising in the ordinary course of our business. We are not presently a party to any legal proceedings the outcome of which, if determined adversely against us, would individually or in the aggregate have a material adverse effect on our business, operating results, financial condition or cash flows.

**Item 1A. Risk Factors**

*The following risks and uncertainties may have a material adverse effect on our business, financial condition or results of operations. Investors should carefully consider the risks described below before making an investment decision. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also significantly impair our business operations. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks, and investors may lose all or part of their investment.*

We have marked with an asterisk(\*) those risks described below that reflect substantive changes from the risks described under Item 1A. Risk Factors included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 1, 2010.

***Risks Related to Our Business and Industry***

***We have a limited history of profitability, and we may not achieve or sustain profitability in the future, on a quarterly or annual basis.\****

We were established in 2000. Our first quarter of profitability since then was the quarter ended September 30, 2007 and we remained profitable until the quarter ended December 31, 2008. For the year ended December 31, 2009, we incurred net loss of \$21.4 million. For the nine months ended September 30, 2010, we reported net income of \$2.5 million. As of September 30, 2010, our accumulated deficit was \$76.1 million. We expect to make significant expenditures related to the development of our products and expansion of our business, including research and development and sales and administrative expenses. As a public company, we also incur significant legal, accounting and other expenses. Additionally, we may encounter unforeseen difficulties, complications, product delays and other unknown factors that require additional expenditures. As a result of these increased expenditures, we may have to generate and sustain substantially increased revenue to achieve profitability. Our revenue growth trends in prior periods may not be sustainable. Accordingly, we may not be able to achieve or maintain profitability and we may continue to incur losses in the future.

***We face intense competition and expect competition to increase in the future, which could reduce our revenue and customer base.***

The market for our products is highly competitive and we expect competition to intensify in the future. This competition could make it more difficult for us to sell our products, and result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses and failure to increase, or the loss of, market share or expected market share, any of which would likely seriously harm our business, operating results and financial condition. For instance, semiconductor products have a history of declining prices as the cost of production is reduced. However, if market prices decrease faster than product costs, gross and operating margins can be adversely affected. Currently, we face competition from a number of established companies, including

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Broadcom Corporation, Freescale Semiconductor, Inc., Intel Corporation, Marvell Technology Group Ltd., PMC-Sierra, Inc., and NetLogic Microsystems, Inc. In addition, in the video capture, process and display market segments we consider our competition to be companies that provide video encode and decode solutions, including Texas Instruments digital signal processors and SOCs for H.264 encoding and Amimon for wireless replacement of HDMI cables and wireless video displays.

A few of our current competitors operate their own fabrication facilities and have, and some of our potential competitors could have, longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we have. Potential customers may prefer to purchase from their existing suppliers rather than a new supplier regardless of product performance or features.

We expect increased competition from other established and emerging companies both domestically and internationally. Our current and potential competitors may also establish cooperative relationships among themselves or with third parties. If so, new competitors or alliances that include our competitors may emerge that could acquire significant market share. We expect these trends to continue as companies attempt to strengthen or maintain their market positions in an evolving industry. In the future, further development by our competitors could cause our products to become obsolete. We expect continued competition from incumbents as well as from new entrants into the markets we serve. Our ability to compete depends on a number of factors, including:

our success in identifying new and emerging markets, applications and technologies;

our products performance and cost effectiveness relative to that of our competitors products;

our ability to deliver products in large volume on a timely basis at a competitive price;

our success in utilizing new and proprietary technologies to offer products and features previously not available in the marketplace;

our ability to recruit design and application engineers and sales and marketing personnel; and

our ability to protect our intellectual property.

In addition, we cannot assure you that existing customers or potential customers will not develop their own products, purchase competitive products or acquire companies that use alternative methods to enable networking, communication or security applications to facilitate network-aware processing in their systems. Any of these competitive threats, alone or in combination with others, could seriously harm our business, operating results and financial condition.

***Our customers may cancel their orders, change production quantities or delay production, and if we fail to forecast demand for our products accurately, we may incur product shortages, delays in product shipments or excess or insufficient product inventory.***

We generally do not obtain firm, long-term purchase commitments from our customers. Because production lead times often exceed the amount of time required to fulfill orders, we often must build in advance of orders, relying on an imperfect demand forecast to project volumes and product mix. Our demand forecast accuracy can be adversely affected by a number of factors, including inaccurate forecasting by our customers, changes in market conditions, adverse changes in our product order mix and demand for our customers products. Even after an order is received, our customers may cancel these orders or request a decrease in production quantities. Any such cancellation or decrease subjects us to a number of risks, most notably that our projected sales will not materialize on schedule or at all, leading to unanticipated revenue shortfalls and excess or obsolete inventory which we may be unable to sell to other customers. Alternatively, if we are unable to project customer requirements accurately, we may not build enough products, which could lead to delays in product shipments and lost sales opportunities in the near term, as well as force our customers to identify alternative sources, which could affect our ongoing relationships with these customers. We have in the past had customers dramatically increase their requested production quantities with little or no advance notice. If we do not timely fulfill customer demands, our customers may cancel their orders. Either underestimating or overestimating demand would lead to insufficient, excess or obsolete inventory, which could harm our operating results, cash flow and financial condition, as well as our relationships with our customers.





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***Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our operating results.***

As our business has grown to both customers located in the United States as well as customers located outside of the United States, we have become increasingly subject to the risks arising from adverse changes in both the domestic and global economic and political conditions. For example, the direction and relative strength of the U.S. and international economies remains uncertain due to softness in the housing markets, difficulties in the financial services sector and credit markets and continuing geopolitical uncertainties. If economic growth in the United States and other countries' economies continues to slow, the demand for our customers' products could decline, which would then decrease demand for our products. Furthermore, if economic conditions in the countries into which our customers sell their products continue to deteriorate, some of our customers may decide to postpone or delay certain development programs, which would then delay their need to purchase our products. This could result in a reduction in sales of our products or in a reduction in the growth of our product sales. Any of these events would likely harm investors' view of our business, and our results of operations and financial condition.

***We receive a substantial portion of our revenues from a limited number of customers, and the loss of, or a significant reduction in, orders from one or a few of our major customers would adversely affect our operations and financial condition. \****

We receive a substantial portion of our revenues from a limited number of customers. We received an aggregate of approximately 42.5% and 57.9% of our net revenues from our top five customers for the nine months ended September 30, 2010 and 2009, respectively. We anticipate that we will continue to be dependent on a limited number of customers for a significant portion of our revenues in the immediate future and in some cases the portion of our revenues attributable to certain customers may increase in the future. However, we may not be able to maintain or increase sales to certain of our top customers for a variety of reasons, including the following:

our agreements with our customers do not require them to purchase a minimum quantity of our products;

some of our customers can stop incorporating our products into their own products with limited notice to us and suffer little or no penalty; and

many of our customers have pre-existing or concurrent relationships with our current or potential competitors that may affect the customers' decisions to purchase our products.

In the past, we have relied in significant part on our strategic relationships with customers that are technology leaders in our target markets. We intend to continue expanding such relationships and forming new strategic relationships but we cannot assure you that we will be able to do so. These relationships often require us to develop new products that may involve significant technological challenges. Our customers frequently place considerable pressure on us to meet their tight development schedules. Accordingly, we may have to devote a substantial amount of our resources to our strategic relationships, which could detract from or delay our completion of other important development projects. Delays in development could impair our relationships with our other strategic customers and negatively impact sales of the products under development. Moreover, it is possible that our customers may develop their own product or adopt a competitor's solution for products that they currently buy from us. If that happens, our sales would decline and our business, financial condition and results of operations could be materially and adversely affected.

In addition, our relationships with some customers may also deter other potential customers who compete with these customers from buying our products. To attract new customers or retain existing customers, we may offer certain customers favorable prices on our products. In that event, our average selling prices and gross margins would decline. The loss of a key customer, a reduction in sales to any key customer or our inability to attract new significant customers could seriously impact our revenue and materially and adversely affect our results of operations.

***We expect our operating results to fluctuate.***

We expect our revenues and expense levels to vary in the future, making it difficult to predict our future operating results. In particular, we experience variability in demand for our products as our customers manage their product introduction dates and their inventories. Given the current global economic uncertainty, the demand for our products may be more varied and difficult to ascertain in a timely and efficient manner.



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Additional factors that could cause our results to fluctuate include, among other things:

our ability to retain, recruit and hire key executives, technical personnel and other employees in the positions and numbers, and with the experience and capabilities that we need;

fluctuations in demand, sales cycles, product mix and prices for our products;

the timing of our product introductions, and the variability in lead time between the time when a customer begins to design in one of our products and the time when the customer's end system goes into production and they begin purchasing our products;

the forecasting, scheduling, rescheduling or cancellation of orders by our customers;

our ability to successfully define, design and release new products in a timely manner that meet our customers' needs;

changes in manufacturing costs, including wafer, test and assembly costs, mask costs, manufacturing yields and product quality and reliability;

the timing and availability of adequate manufacturing capacity from our manufacturing suppliers;

the timing of announcements by our competitors or us;

future accounting pronouncements and changes in accounting policies;

volatility in our stock price, which may lead to higher stock compensation expenses;

general economic and political conditions in the countries where we operate or our products are sold or used; costs associated with litigation, especially related to intellectual property; and

productivity and growth of our sales and marketing force.

Unfavorable changes in any of the above factors, most of which are beyond our control, could significantly harm our business and results of operations.

***We may not sustain our growth rate, and we may not be able to manage any future growth effectively.***

We have experienced significant growth in a short period of time. Our net revenues increased from approximately \$7.4 million in 2004 to approximately \$19.4 million in 2005, \$34.2 million in 2006, \$54.2 million in 2007, \$86.6 million in 2008 and \$101.2 million in 2009. We may not achieve similar growth rates in future periods. One should not rely on our operating results for any prior quarterly or annual periods as an indication of our future operating performance. If we are unable to maintain adequate revenue growth, our financial results could suffer and our stock price could decline.

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To manage our growth successfully and to continue handling the responsibilities of being a public company, we believe we must effectively, among other things:

recruit, hire, train and manage additional qualified engineers for our research and development activities, especially in the positions of design engineering, product and test engineering, and applications engineering;

enhance our information technology support for enterprise resource planning and design engineering by adapting and expanding our systems and tool capabilities, and properly training new hires as to their use;

expand our administrative, financial and operational systems, procedures and controls; and

add additional sales personnel and expand sales offices.

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If we are unable to manage our growth effectively, we may not be able to take advantage of market opportunities or develop new products and we may fail to satisfy customer requirements, maintain product quality, execute our business plan or respond to competitive pressures.

***The average selling prices of products in our markets have historically decreased over time and will likely do so in the future, which could harm our revenues and gross profits.***

Average selling prices of semiconductor products in the markets we serve have historically decreased over time. Our gross profits and financial results will suffer if we are unable to offset any reductions in our average selling prices by reducing our costs, developing new or enhanced products on a timely basis with higher selling prices or gross profits, or increasing our sales volumes. Additionally, because we do not operate our own manufacturing, assembly or testing facilities, we may not be able to reduce our costs as rapidly as companies that operate their own facilities, and our costs may even increase, which could also reduce our margins.

***We may be unsuccessful in developing and selling new products or in penetrating new markets.***

We operate in a dynamic environment characterized by rapidly changing technologies and industry standards and technological obsolescence. Our competitiveness and future success depend on our ability to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost effective basis. A fundamental shift in technologies in any of our product markets could harm our competitive position within these markets. Our failure to anticipate these shifts, to develop new technologies or to react to changes in existing technologies could materially delay our development of new products, which could result in product obsolescence, decreased revenues and a loss of design wins to our competitors. The success of a new product depends on accurate forecasts of long-term market demand and future technological developments, as well as on a variety of specific implementation factors, including:

timely and efficient completion of process design and transfer to manufacturing, assembly and test processes;

the quality, performance and reliability of the product; and

effective marketing, sales and service.

If we fail to introduce new products that meet the demand of our customers or penetrate new markets that we target our resources on, our revenues will likely decrease over time and our financial condition could suffer. Additionally, if we concentrate resources on a new market that does not prove profitable or sustainable, our financial condition could decline.

***Fluctuations in the mix of products sold may adversely affect our financial results.***

Because of the wide price differences among our processors, the mix and types of performance capabilities of processors sold affect the average selling price of our products and have a substantial impact on our revenue. Generally, sales of higher performance products have higher gross margins than sales of lower performance products. We currently offer both higher and lower performance products in our NITROX, OCTEON, ECONA ARM and PureVu Video product families. During 2008 and in the first two quarters of 2009, we experienced a sales mix shift towards increased sales of lower performance, lower margin products, which negatively affected our overall gross margins. In the third and fourth quarters of 2009 compared to the first two quarters of 2009, the product mix moved towards higher performance and higher margin products. If the sales mix shifts back to lower performance, lower margin products, our overall gross margins will be negatively affected. Fluctuations in the mix and types of our products may also affect the extent to which we are able to recover our fixed costs and investments that are associated with a particular product, and as a result can negatively impact our financial results.

***The semiconductor and communications industries have historically experienced significant fluctuations with prolonged downturns, which could impact our operating results, financial condition and cash flows.***

The semiconductor industry has historically exhibited cyclical behavior, which at various times has included significant downturns in customer demand, including in late 2008 through 2009. Because a significant portion of our expenses is fixed in the near term or is incurred in advance of anticipated sales, we may not be able to decrease our expenses rapidly enough to offset any unanticipated shortfall in revenues. If this situation were to occur, it could adversely affect our operating results, cash flow and financial condition. Furthermore, the semiconductor industry has periodically experienced periods of increased demand and production constraints. If this happens in the future, we may not be able to produce

sufficient quantities of our products to meet the

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increased demand. We may also have difficulty in obtaining sufficient wafer, assembly and test resources from our subcontract manufacturers. Any factor adversely affecting the semiconductor industry in general, or the particular segments of the industry that our products target, may adversely affect our ability to generate revenue and could negatively impact our operating results.

The communications industry has, in the past, experienced pronounced downturns, and these cycles may continue in the future. To respond to a downturn, many networking equipment providers may slow their research and development activities, cancel or delay new product development, reduce their inventories and take a cautious approach to acquiring our products, which would have a significant negative impact on our business. If this situation were to occur, it could adversely affect our operating results, cash flow and financial condition. In the future, any of these trends may also cause our operating results to fluctuate significantly from year to year, which may increase the volatility of the price of our stock.

***Our products must meet exact specifications, and defects and failures may occur, which may cause customers to return or stop buying our products.***

Our customers generally establish demanding specifications for quality, performance and reliability that our products must meet. However, our products are highly complex and may contain defects and failures when they are first introduced or as new versions are released. If defects and failures occur in our products during the design phase or after, we could experience lost revenues, increased costs, including warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments, product returns or discounts, diversion of management resources or damage to our reputation and brand equity, and in some cases consequential damages, any of which would harm our operating results. In addition, delays in our ability to fill product orders as a result of quality control issues may negatively impact our relationship with our customers. We cannot assure you that we will have sufficient resources, including any available insurance, to satisfy any asserted claims.

***We may have difficulty selling our products if our customers do not design our products into their systems, and the nature of the design process requires us to incur expenses prior to recognizing revenues associated with those expenses which may adversely affect our financial results.***

One of our primary focuses is on winning competitive bid selection processes, known as design wins, to develop products for use in our customers' products. We devote significant time and resources in working with our customers' system designers to understand their future needs and to provide products that we believe will meet those needs and these bid selection processes can be lengthy. If a customer's system designer initially chooses a competitor's product, it becomes significantly more difficult for us to sell our products for use in that system because changing suppliers can involve significant cost, time, effort and risk for our customers. Thus, our failure to win a competitive bid can result in our foregoing revenues from a given customer's product line for the life of that product. In addition, design opportunities may be infrequent or may be delayed. Our ability to compete in the future will depend, in large part, on our ability to design products to ensure compliance with our customers' and potential customers' specifications. We expect to invest significant time and resources and to incur significant expenses to design our products to ensure compliance with relevant specifications.

We often incur significant expenditures in the development of a new product without any assurance that our customers' system designers will select our product for use in their applications. We often are required to anticipate which product designs will generate demand in advance of our customers expressly indicating a need for that particular design. Even if our customers' system designers select our products, a substantial period of time will elapse before we generate revenues related to the significant expenses we have incurred.

The reasons for this delay generally include the following elements of our product sales and development cycle timeline and related influences:

our customers usually require a comprehensive technical evaluation of our products before they incorporate them into their designs;

it can take from nine months to three years from the time our products are selected to commence commercial shipments; and our customers may experience changed market conditions or product development issues. The resources devoted to product development and sales and marketing may not generate material revenue for us, and from time to time, we may need to write off excess and obsolete inventory if we have produced product in anticipation of expected demand. We may spend resources on the development of products that our customers may not adopt. If we incur significant expenses and investments in inventory in the future that we are not able to recover, and we are not able to compensate for those expenses, our operating results could be adversely affected. In addition, if we sell our products at reduced prices in anticipation of cost reductions but still hold higher cost products in inventory, our operating results would be harmed.





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Additionally, even if system designers use our products in their systems, we cannot assure you that these systems will be commercially successful or that we will receive significant revenue from the sales of processors for those systems. As a result, we may be unable to accurately forecast the volume and timing of our orders and revenues associated with any new product introductions.

***If customers do not believe our products solve a critical need, our revenues will decline.***

Our products are used in networking and security equipment including routers, switches, UTM appliances, intelligent switches, application-aware gateways, triple-play gateways, WLAN and 3G access and aggregation devices, storage networking equipment, servers, intelligent network interface cards, IP surveillance systems, wireless HDMI cable replacement systems, video conferencing systems and connected home and office equipment.

In order to meet our growth and strategic objectives, providers of networking equipment must continue to incorporate our products into their systems and the demands for their systems must grow as well. Our future depends in large part on factors outside our control, and the sale of next-generation networks may not meet our revenue growth and strategic objectives.

***Because a significant portion of our software and licenses revenues is derived from subscription-based software licenses, we are dependent upon the ability of our customers to develop and penetrate new markets successfully, and to develop new products for existing markets.\****

Our subscription-based license revenues depend both upon our ability to successfully negotiate such license agreements with our customers and, in turn, upon our customers' successful commercialization of their underlying products. As our open source business grows, we may not be able to rely on receiving per unit fees from our customers. For our open source business, we may instead need to rely on other fees to compensate for the subscription-based license fees that we have traditionally received for our proprietary products. Also, we derive significant revenues from customers that develop products in highly competitive and technologically complex markets such as the internet infrastructure, server and storage, digital consumer, aerospace and defense, industrial control, medical equipment, gaming, office automation and automotive markets. If these customers sell fewer products or otherwise face significant economic difficulties, particularly in the current global economic recession, our revenues may decline.

***In the event we terminate one of our distributor arrangements, it could lead to a loss of revenues and possible product returns.***

A portion of our sales is made through third-party distribution agreements. Termination of a distributor relationship, either by us or by the distributor, could result in a temporary or permanent loss of revenues, until a replacement distributor can be established to service the affected end-user customers. We may not be successful in finding suitable alternative distributors on satisfactory terms or at all and this could adversely affect our ability to sell in certain locations or to certain end-user customers. Additionally, if we terminate our relationship with a distributor, we may be obligated to repurchase unsold products. We record a reserve for estimated returns and price credits. If actual returns and credits exceed our estimates, our operating results could be harmed. Our arrangements with our distributors typically also include price protection provisions if we reduce our list prices.

***We rely on our ecosystem partners to enhance our product offerings and our inability to continue to develop or maintain such relationships in the future would harm our ability to remain competitive.***

We have developed relationships with third parties, which we refer to as ecosystem partners, which provide operating systems, tool support, reference designs and other services designed for specific uses with our SoCs. We believe that these relationships enhance our customers' ability to get their products to market quickly. If we are unable to continue to develop or maintain these relationships, we might not be able to enhance our customers' ability to commercialize their products in a timely fashion and our ability to remain competitive would be harmed.

***The loss of any of our key personnel could seriously harm our business, and our failure to attract or retain specialized technical, management or sales and marketing talent could impair our ability to grow our business.***

We believe our future success will depend in large part upon our ability to attract, retain and motivate highly skilled managerial, engineering, sales and marketing personnel. The loss of any key employees or the inability to attract, retain or motivate qualified personnel, including engineers and sales and marketing personnel could delay the development and introduction of and harm our ability to sell our products. We believe that our future success is highly dependent on the contributions of Syed Ali, our

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co-founder, President and Chief Executive Officer, and others. None of our employees have fixed-term employment contracts; they are all at-will employees. The loss of the services of Mr. Ali, other executive officers or certain other key personnel could materially and adversely affect our business, financial condition and results of operations. For instance, if any of these individuals were to leave our company unexpectedly, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity during the search for and while any such successor is integrated into our business and operations.

There is currently a shortage of qualified technical personnel with significant experience in the design, development, manufacturing, marketing and sales of integrated circuits. In particular, there is a shortage of engineers who are familiar with the intricacies of the design and manufacture of multi-core networking processors, and competition for these engineers is intense. Our key technical personnel represent a significant asset and serve as the source of our technological and product innovations. We may not be successful in attracting, retaining and motivating sufficient numbers of technical personnel to support our anticipated growth.

To date, we have relied primarily on our direct marketing and sales force to drive new customer design wins and to sell our products. Because we are looking to expand our customer base and grow our sales to existing customers, we will need to hire additional qualified sales personnel in the near term and beyond if we are to achieve revenue growth. The competition for qualified marketing and sales personnel in our industry, and particularly in Silicon Valley, is very intense. If we are unable to hire, train, deploy and manage qualified sales personnel in a timely manner, our ability to grow our business will be impaired. In addition, if we are unable to retain our existing sales personnel, our ability to maintain or grow our current level of revenues will be adversely affected. Further, if we are unable to integrate and retain personnel acquired through our various acquisitions, we may not be able to fully capitalize on such acquisitions.

Stock options and restricted stock units generally comprise a significant portion of our compensation packages for all employees. The FASB requirement to expense the fair value of stock options awarded to employees beginning in the first quarter of our fiscal 2006 has increased our operating expenses and may cause us to reevaluate our compensation structure for our employees. Our inability to attract, retain and motivate additional key employees could have an adverse effect on our business, financial condition and results of operations.

In addition, we rely on stock-based awards as one means for recruiting, motivating and retaining highly skilled talent. If the value of such stock awards does not appreciate as measured by the performance of the price of our common stock or if our share-based compensation otherwise ceases to be viewed as a valuable benefit, our ability to attract, retain, and motivate employees could be weakened, which could harm our results of operations. The decline in the trading price of our common stock would result in the exercise price of a portion of our outstanding options to exceed the current trading price of our common stock, thus lessening the effectiveness of these stock-based awards. Consequently, we may not continue to successfully attract and retain key personnel which would harm our business.

***We have a limited operating history, and we may have difficulty accurately predicting our future revenues for the purpose of appropriately budgeting and adjusting our expenses. \****

We were established in 2000. Since we have had only seven quarters of operating profitability, we do not have an extended history from which to predict and manage profitability. Our limited operating experience, a dynamic and rapidly evolving market in which we sell our products, our dependence on a limited number of customers, as well as numerous other factors beyond our control, including general market conditions, impede our ability to forecast quarterly and annual revenues accurately. As a result, we could experience budgeting and cash flow management problems, unexpected fluctuations in our results of operations and other difficulties, any of which could make it difficult for us to attain and maintain profitability and could increase the volatility of the market price of our common stock.

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*Some of our operations and a significant portion of our customer s contract manufacturers are located outside of the United States, which subjects us to additional risks, including increased complexity and costs of managing international operations and geopolitical instability.*

We have international sales offices and research and development facilities and we conduct, and expect to continue to conduct, a significant amount of our business with companies that are located outside the United States, particularly in Asia and Europe. Even customers of ours that are based in the United States often use contract manufacturers based in Asia to manufacture their systems, and it is the contract manufacturers that purchase products directly from us. As a result of our international focus, we face numerous challenges, including:

increased complexity and costs of managing international operations;

longer and more difficult collection of receivables;

difficulties in enforcing contracts generally;

geopolitical and economic instability and military conflicts;

limited protection of our intellectual property and other assets;

compliance with local laws and regulations and unanticipated changes in local laws and regulations, including tax laws and regulations;

trade and foreign exchange restrictions and higher tariffs;

travel restrictions;

timing and availability of import and export licenses and other governmental approvals, permits and licenses, including export classification requirements;

foreign currency exchange fluctuations relating to our international operating activities;

transportation delays and limited local infrastructure and disruptions, such as large scale outages or interruptions of service from utilities or telecommunications providers;

difficulties in staffing international operations;

heightened risk of terrorism;

local business and cultural factors that differ from our normal standards and practices;

differing employment practices and labor issues;

regional health issues (e.g., SARS) and natural disasters; and

work stoppages.

***We outsource our wafer fabrication, assembly, testing, warehousing and shipping operations to third parties, and rely on these parties to produce and deliver our products according to requested demands in specification, quantity, cost and time.***

We rely on third parties for substantially all of our manufacturing operations, including wafer fabrication, assembly, testing, warehousing and shipping. We depend on these parties to supply us with material of a requested quantity in a timely manner that meets our standards for yield, cost and manufacturing quality. We do not have any long-term supply agreements with our manufacturing suppliers. Any problems with our manufacturing supply chain could adversely impact our ability to ship our products to our customers on time and in the quantity required, which in turn could cause an unanticipated decline in our sales and possibly damage our customer relationships.

The fabrication of integrated circuits is a complex and technically demanding process. Our foundries could, from time to time, experience manufacturing defects and reduced manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. Poor yields from our foundries, or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems, harm our financial results and result in financial or other damages to our customers. Our customers could also seek damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly to defend.

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Our products are manufactured at a limited number of locations. If we experience manufacturing problems at a particular location, we would be required to transfer manufacturing to a backup location or supplier. Converting or transferring manufacturing from a primary location or supplier to a backup fabrication facility could be expensive and could take one to two quarters. During such a transition, we would be required to meet customer demand from our then-existing inventory, as well as any partially finished goods that can be modified to the required product specifications. We do not seek to maintain sufficient inventory to address a lengthy transition period because we believe it is uneconomical to keep more than minimal inventory on hand. As a result, we may not be able to meet customer needs during such a transition, which could delay shipments, cause a production delay or stoppage for our customers, result in a decline in our sales and damage our customer relationships. In addition, we have no long-term supply contracts with the foundries that we work with. Availability of foundry capacity has in the recent past been reduced due to strong demand. The ability of each foundry to provide us with semiconductor devices is limited by its available capacity and existing obligations. Foundry capacity may not be available when we need it or at reasonable prices which could cause us to be unable to meet customer needs, delay shipments, because a production delay or stoppage for our customers, result in a decline in our sales and harm our financial results.

In addition, a significant portion of our sales are to customers that practice just-in-time order management from their suppliers, which gives us a very limited amount of time in which to process and complete these orders. As a result, delays in our production or shipping by the parties to whom we outsource these functions could reduce our sales, damage our customer relationships and damage our reputation in the marketplace, any of which could harm our business, results of operations and financial condition.

***Any increase in the manufacturing cost of our products could reduce our gross margins and operating profit.***

The semiconductor business exhibits ongoing competitive pricing pressure from customers and competitors. Accordingly, any increase in the cost of our products, whether by adverse purchase price variances or adverse manufacturing cost variances, will reduce our gross margins and operating profit. We do not have any long-term supply agreements with our manufacturing suppliers and we typically negotiate pricing on a purchase order by purchase order basis. Consequently, we may not be able to obtain price reductions or anticipate or prevent future price increases from our suppliers.

Some of our competitors may be better financed than we are, may have long-term agreements with our main foundries and may induce our foundries to reallocate capacity to those customers. This reallocation could impair our ability to secure the supply of components that we need. Although we use several independent foundries to manufacture substantially all of our semiconductor products, most of our components are not manufactured at more than one foundry at any given time, and our products typically are designed to be manufactured in a specific process at only one of these foundries. Accordingly, if one of our foundries is unable to provide us with components as needed, we could experience significant delays in securing sufficient supplies of those components. We cannot assure you that any of our existing or new foundries will be able to produce integrated circuits with acceptable manufacturing yields, or that our foundries will be able to deliver enough semiconductor devices to us on a timely basis, or at reasonable prices. These and other related factors could impair our ability to meet our customers' needs and have a material and adverse effect on our operating results.

In order to secure sufficient foundry capacity when demand is high and mitigate the risks described in the foregoing paragraph, we may enter into various arrangements with suppliers that could be costly and harm our operating results, such as nonrefundable deposits with or loans to foundries in exchange for capacity commitments and contracts that commit us to purchase specified quantities of integrated circuits over extended periods. We may not be able to make any such arrangement in a timely fashion or at all, and any arrangements may be costly, reduce our financial flexibility, and not be on terms favorable to us. Moreover, if we are able to secure foundry capacity, we may be obligated to use all of that capacity or incur penalties. These penalties may be expensive and could harm our financial results.

***If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud.***

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. Any inability to provide reliable financial reports or prevent fraud could harm our business. The Sarbanes-Oxley Act of 2002 requires management and our independent registered public accounting firm to evaluate and assess the effectiveness of our internal control over financial reporting. These Sarbanes-Oxley Act requirements may be modified, supplemented or amended from time to time. Implementing these changes may take a significant amount of time and may require specific compliance training of our personnel. In the future, we may discover areas of our internal control over financial reporting that need improvement. If our independent

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registered public accounting firm or we discover a material weakness, the disclosure of that fact, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our stock price. We may not be able to effectively and timely implement necessary control changes and employee training to ensure continued compliance with the Sarbanes-Oxley Act and other regulatory and reporting requirements. Our rapid growth in recent years and our possible future expansion through acquisitions, present challenges to maintain the internal control and disclosure control standards applicable to public companies. If we fail to maintain effective internal controls, we could be subject to regulatory scrutiny and sanctions and investors could lose confidence in the accuracy and completeness of our financial reports.

***Our acquisition strategy may result in unanticipated accounting charges or otherwise adversely affect our results of operations, and result in difficulties in assimilating and integrating the operations, personnel, technologies and products of acquired companies or businesses, or be dilutive to existing shareholders.***

In May 2008, we acquired certain assets of Parallogic Corporation, in August 2008 we acquired substantially all of the assets of Star Semiconductor Corporation, in December 2008, we acquired W&W Communications, Inc., in December 2009 we acquired MontaVista Software, Inc. and we may in the future acquire companies or assets of companies that we believe to be complementary to our business, including for the purpose of expanding our new product design capacity, introducing new design, market or application skills or enhancing and expanding our existing product lines. In connection with any such future acquisitions, we may need to use a significant portion of our available cash, issue additional equity securities that would dilute current stockholders' percentage ownership and incur substantial debt or contingent liabilities. Such actions could adversely impact our operating results and the market price of our common stock. In addition, difficulties may occur in assimilating and integrating the operations, personnel, technologies, and products of acquired companies or businesses. In addition, key personnel of an acquired company may decide not to work for us. Moreover, to the extent we acquire a company with existing products; those products may have lower gross margins than our customary products, which could adversely affect our gross margin and operating results. If an acquired company also has inventory that we assume, we will be required to write up the carrying value of that inventory to fair value. When that inventory is sold, the gross margins for those products are reduced and our gross margins for that period are negatively affected. Furthermore, the purchase price of any acquired businesses may exceed the current fair values of the net tangible assets of such acquired businesses. As a result, we would be required to record material amounts of goodwill, and acquired in-process research and development charges and other intangible assets, which could result in significant impairment and acquired in-process research and development charges and amortization expense in future periods. These charges, in addition to the results of operations of such acquired businesses and potential restructuring costs associated with an acquisition, could have a material adverse effect on our business, financial condition and results of operations. We cannot forecast the number, timing or size of future acquisitions, or the effect that any such acquisitions might have on our operating or financial results.

***We rely on third-party technologies for the development of our products and our inability to use such technologies in the future would harm our ability to remain competitive.***

We rely on third parties for technologies that are integrated into our products, such as wafer fabrication and assembly and test technologies used by our contract manufacturers, as well as licensed MIPS and ARM architecture technologies. If we are unable to continue to use or license these technologies on reasonable terms, or if these technologies fail to operate properly, we may not be able to secure alternatives in a timely manner and our ability to remain competitive would be harmed. In addition, if we are unable to successfully license technology from third parties to develop future products, we may not be able to develop such products in a timely manner or at all.

***Our failure to protect our intellectual property rights adequately could impair our ability to compete effectively or to defend ourselves from litigation, which could harm our business, financial condition and results of operations. \****

We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality and nondisclosure agreements and other methods, to protect our proprietary technologies and know-how. We have been issued 24 patents in the United States and 4 patents in foreign countries and have an additional 22 patent applications pending in the United States and 20 patent applications pending in foreign countries. Even if the pending patent applications are granted, the rights granted to us may not be meaningful or provide us with any commercial advantage. For example, these patents could be opposed, contested, circumvented or designed around by our competitors or be declared invalid or unenforceable in judicial or administrative proceedings. The failure of our patents to adequately protect our technology might make it easier for our competitors to offer similar products or technologies. Our foreign patent protection is generally not as comprehensive as our U.S. patent protection and may not protect our intellectual property in some countries where our products are sold or may be sold in the future. Many U.S.-based companies have encountered substantial intellectual property infringement in foreign countries, including countries where we sell products. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

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Monitoring unauthorized use of our intellectual property is difficult and costly. Although we are not aware of any unauthorized use of our intellectual property in the past, it is possible that unauthorized use of our intellectual property may have occurred or may occur without our knowledge. We cannot assure you that the steps we have taken will prevent unauthorized use of our intellectual property.

Our failure to effectively protect our intellectual property could reduce the value of our technology in licensing arrangements or in cross-licensing negotiations, and could harm our business, results of operations and financial condition. We may in the future need to initiate infringement claims or litigation. Litigation, whether we are a plaintiff or a defendant, can be expensive, time consuming and may divert the efforts of our technical staff and managerial personnel, which could harm our business, whether or not such litigation results in a determination favorable to us.

***Our open source business could be seriously harmed by the outcome of lawsuits challenging the use and distribution of Linux-based software products.\****

We rely on Linux system software as the basis of our software products. Several lawsuits have been filed challenging the right to use and/or distribute Linux system software and software applications based on Linux. We expect that further lawsuits could be filed in the future. It is impossible to estimate or anticipate all of the financial or other impacts the results of these litigation matters could have on our business. Success by a plaintiff in one or more of these lawsuits could have a material adverse effect on our open source business.

***Legal uncertainty surrounding the use and distribution of open source software may cause the market for Linux-based products to disappear, fail to further develop or fail to develop at a rate sufficient to sustain our business.\****

The majority of our open source software products are licensed from third parties under the GNU General Public License (the GPL), and similar open source licenses. There remains some significant confusion among our customers about the scope of their obligations and rights with respect to using and distributing Linux-based products. One element of this confusion is whether the GPL and other open source licenses require customers to (i) make all of the source code for their products available to the public, and/or (ii) license all of the code underlying such products under an open source license. There is little or no legal precedent for interpreting the terms of the GPL and similar open source licenses, including the determination of which types of programs or products would be considered derived works and thus potentially subject to the terms of such open source licenses. If this confusion remains, increases or is prolonged by litigation, the market for Linux-based products may disappear, fail to further develop or fail to develop at a rate sufficient to sustain our open source business.

***Our open source business depends on Linux developers to continue to improve Linux and Linux-based applications that are incorporated into our open source products.\****

Our ability to release major upgrades of MontaVista Linux is largely dependent upon the release of new versions of the Linux kernel. The Linux kernel is the heart of the Linux system software. Linus Torvalds and a small group of engineers are primarily responsible for the development, evolution and maintenance of the Linux kernel. In addition, other individuals and small groups of developers are largely responsible for Linux programs tailored to specific tasks or computer architectures. If Mr. Torvalds or other key developers fail to further develop the Linux kernel or other programs on which we rely, we will have to either develop them ourselves or rely on another party for development. This development effort could be costly and time consuming, and could delay or entirely prevent our open source product release and upgrade schedule.

***We may be unsuccessful in marketing our open source products because we encounter widespread negative perceptions about Linux and open source software in general.\****

Some people still falsely believe that anyone who writes a software program that runs on Linux will necessarily have to publicly disclose the source code for that software. If a potential customer believes their source code will need to be made public if they use our open source product, they may be less likely to purchase our open source product. We devote substantial time and attention helping potential customers understand the legal implications of using our open source products, including that fact that in most instances, applications developed to run on Linux may be distributed under a proprietary license. In many cases, we are required to address these issues at different levels across an organization (such as at the engineering, managerial and executive levels), which can be very time consuming. We are sometimes unsuccessful at convincing a potential customer that using Linux-based system software will not have negative consequences for that customer. Furthermore, many potential customers believe that

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they should not be required to pay for our open source products, since our open-source products are based on open source (also sometimes called free ) software. They believe that open source products are all publicly available at no charge. There is also the misconception that distributors of Linux software cannot offer warranties or indemnifications with respect to Linux software. Each of these customer fears or misperceptions could cause us to lose potential orders or cause our customers to delay purchase decisions, which could significantly lengthen our sales cycle. These misperceptions could cause the market for Linux-based products to disappear, fail to further develop, or fail to develop at a rate sufficient to sustain our open source business.

***Our open source software may contain errors or defects that could delay introduction of new products, result in costly remedial expenditures or cause disputes with customers.\****

Most of the open source software that we sell and distribute is developed by third parties with whom we have no business relationship, including thousands of individual software programmers. In order to successfully release our open source products, we must assemble and test software developed by thousands of disparate sources. Despite our efforts, errors have been and may continue to be found in our open source products. If errors are discovered, we may not be able to successfully correct them in a timely manner or at all. Errors and failures in our open source products could result in a loss of, or delay in, market acceptance of our open-source products and could damage our reputation and our ability to convince commercial users of the benefits of Linux-based systems software and other open source software products. In addition, we may need to make significant expenditures of capital resources in order to reduce errors and failures.

***We face intense competition related to our open source products, and expect competition to increase in the future, which could reduce our open source-related revenue and customer base. \****

The market for Linux-based systems software is highly competitive, and we expect competition to intensify in the future. We consider the primary competitors for our Monta Vista software products to be Wind River Systems, Inc., a subsidiary of Intel Corporation and, to a lesser extent, Canonical Programming, inc. and Mentor Graphics Corporation. In addition, potential customers for our open source products may believe that they can build their own open - source product cheaper or more efficiently than purchasing our products.

In addition to competitors in the business of distributing a commercial Linux-based operating system, we face competition from certain hardware companies who offer Linux-based operating systems and related software components at little or no charge. We also face competition from Linux-based software distributions provided by new and emerging consortiums and software stacks such as Meego, Linaro, Moblin and Android. And because, apart from such hardware vendors and consortiums, there is a large Linux code base generally available at no charge, certain customers or potential customers have made, and will continue to make, efforts to develop their own Linux-based operating system without purchasing or otherwise obtaining it from a third-party vendor. To the extent that the quality and availability of non-commercial Linux-based operating system software continues to improve, it could have a material adverse effect on our ability to sell open source software.

***Assertions by third parties of infringement by us of their intellectual property rights could result in significant costs and cause our operating results to suffer.***

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights and positions, which has resulted in protracted and expensive litigation for many companies. We expect that in the future we may receive communications from various industry participants alleging our infringement of their patents, trade secrets or other intellectual property rights. Any lawsuits resulting from such allegations could subject us to significant liability for damages and invalidate our proprietary rights. Any potential intellectual property litigation also could force us to do one or more of the following:

stop selling products or using technology that contain the allegedly infringing intellectual property;

lose the opportunity to license our technology to others or to collect royalty payments based upon successful protection and assertion of our intellectual property against others; incur significant legal expenses;

pay substantial damages to the party whose intellectual property rights we may be found to be infringing;



redesign those products that contain the allegedly infringing intellectual property; or

attempt to obtain a license to the relevant intellectual property from third parties, which may not be available on reasonable terms or at all.

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Any significant impairment of our intellectual property rights from any litigation we face could harm our business and our ability to compete.

Our customers could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger technical support and indemnification obligations in some of our licenses or customer agreements. These obligations could result in substantial expenses, including the payment by us of costs and damages relating to claims of intellectual property infringement. In addition to the time and expense required for us to provide support or indemnification to our customers, any such litigation could disrupt the businesses of our customers, which in turn could hurt our relationships with our customers and cause the sale of our products to decrease. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business, operating results or financial conditions.

***Our third-party contractors are concentrated primarily in Taiwan and Japan, an area subject to earthquake and other risks. Any disruption to the operations of these contractors could cause significant delays in the production or shipment of our products.***

Substantially all of our products are manufactured by third-party contractors located in Taiwan and to a lesser extent manufactured by third party contractors located in Japan, Malaysia and Korea. The risk of an earthquake in any of those countries or elsewhere in Asia is significant due to the proximity of major earthquake fault lines to the facilities of our foundries and assembly and test subcontractors. For example, several major earthquakes have occurred in Taiwan and Japan since our incorporation in 2000. Although our third-party contractors did not suffer any significant damage as a result of these most recent earthquakes, the occurrence of additional earthquakes or other natural disasters could result in the disruption of our foundry or assembly and test capacity. Any disruption resulting from such events could cause significant delays in the production or shipment of our products until we are able to shift our manufacturing, assembling or testing from the affected contractor to another third-party vendor. We may not be able to obtain alternate capacity on favorable terms, if at all.

***We may experience difficulties in transitioning to new wafer fabrication process technologies or in achieving higher levels of design integration, which may result in reduced manufacturing yields, delays in product deliveries and increased expenses.***

In order to remain competitive, we expect to continue to transition our semiconductor products to increasingly smaller line width geometries. This transition requires us to modify our designs to work with the manufacturing processes of our foundries. We periodically evaluate the benefits, on a product-by-product basis, of migrating to new process technologies to reduce cost and improve performance. We may face difficulties, delays and expenses as we continue to transition our products to new processes. We are dependent on our relationships with our foundry contractors to transition to new processes successfully. We cannot assure you that the foundries that we use will be able to effectively manage the transition or that we will be able to maintain our existing foundry relationships or develop new ones. If any of our foundry contractors or we experience significant delays in this transition or fail to efficiently implement this transition, we could experience reduced manufacturing yields, delays in product deliveries and increased expenses, all of which could harm our relationships with our customers and our results of operations. As new processes become more prevalent, we expect to continue to integrate greater levels of functionality, as well as customer and third-party intellectual property, into our products. However, we may not be able to achieve higher levels of design integration or deliver new integrated products on a timely basis.

***Our investment portfolio may become impaired by further deterioration of the capital markets. \****

Our cash equivalents at September 30, 2010 consisted primarily of an investment in a money market fund, which is invested primarily in United States treasury securities, bonds of government agencies, and corporate bonds. We follow an established investment policy and set of guidelines to monitor, manage and limit our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes.

As a result of current adverse financial market conditions, investments in some financial instruments, such as structured investment vehicles, sub-prime mortgage-backed securities and collateralized debt obligations, may pose risks arising from liquidity and credit concerns. As of September 30, 2010, we had no direct holdings in these categories of investments and believe that our indirect exposure to these financial instruments through our holdings in money market instruments was immaterial. As of September 30, 2010, we had no impairment charge associated with our cash equivalents relating to such adverse financial market conditions. Although we believe our current investment portfolio has little risk of impairment, we cannot predict future market conditions or market liquidity and can provide no assurance that our investment portfolio will remain unimpaired.

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***We may need to raise additional capital, which might not be available or which, if available, may be on terms that are not favorable to use.***

We believe our existing cash balances and cash expected to be generated from our operations will be sufficient to meet our working capital, capital expenditures and other needs for at least the next 12 months. In the future, we may need to raise additional funds, and we cannot be certain that we will be able to obtain additional financing on favorable terms, if at all. If we issue equity securities to raise additional funds, the ownership percentage of our stockholders would be reduced, and the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If we borrow money, we may incur significant interest charges, which could harm our profitability. Holders of debt would also have rights, preferences or privileges senior to those of existing holders of our common stock. If we cannot raise needed funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could harm our business, operating results and financial condition.

***We may incur impairments to goodwill or long-lived assets.***

We review our long-lived assets, including goodwill and other intangible assets, for impairment annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable.

Significant negative industry or economic trends, including a significant decline in the market price of our common stock, reduced estimates of future cash flows for our reporting units or disruptions to our business could lead to an impairment charge of our long-lived assets, including goodwill and other intangible assets.

Our valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and to rely heavily on projections of future operating performance. We operate in highly competitive environments and projections of future operating results and cash flows may vary significantly from results. Additionally, if our analysis results in impairment to our goodwill, we may be required to record a charge to earnings in our financial statements during a period in which such impairment is determined to exist, which may negatively impact our results of operations.

***The complexity of accounting regulations and related interpretations and policies, particularly those related to revenue recognition, could materially affect our financial results for a given period.\****

Although we use standardized agreements designed to meet current revenue recognition criteria under generally accepted accounting principles, we must often negotiate and revise terms and conditions of these standardized agreements, particularly in multi-element license and services transactions. As we increase our transactions to more complex multi-element transactions, negotiation of mutually acceptable terms and conditions may require us to defer recognition of revenue on such licenses. We believe that we are in compliance with the guidance as provided under *software revenue recognition*; however, bigger and more complex, multi-element transactions may require additional accounting analysis to account for them accurately. Errors in such analysis in any period could lead to unanticipated changes in our revenue accounting practices and may affect the timing of revenue recognition, which could adversely affect our financial results. If we later discover that we have interpreted and applied revenue recognition rules differently than prescribed by generally accepted accounting principles in the U.S., we could be required to devote significant management resources, and incur the expense associated with an audit, restatement or other examination of our financial statements.

***Our future effective tax rates could be affected by the allocation of our income among different geographic regions, which could affect our future operating results, financial condition and cash flows.***

We may further expand our international operations and staff to better support our international markets. As a result, we anticipate that our consolidated pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the United States federal statutory rate. Our future effective income tax rates could be adversely affected if tax authorities challenge our international tax structure or if the relative mix of United States and international income changes for any reason, or US tax laws were to change in the future. Accordingly, there can be no assurance that our income tax rate will be less than the United States federal statutory rate.

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### ***Risks Related to our Common Stock***

***The market price of our common stock may be volatile, which could cause the value of your investment to decline. \****

The trading prices of the securities of technology companies have been highly volatile. Further, our common stock has a limited trading history. Since our initial public offering in May 2007 through September 30, 2010, our stock price has fluctuated from a low of \$7.61 to a high of \$35.60. We cannot predict the extent to which the trading market will continue to develop or how liquid the market may become. The trading price of our common stock is therefore likely to be highly volatile and could be subject to wide fluctuations in price in response to various factors, some of which are beyond our control. These factors include:

quarterly variations in our results of operations or those of our competitors;

general economic conditions and slow or negative growth of related markets;

announcements by us or our competitors of design wins, acquisitions, new products, significant contracts, commercial relationships or capital commitments;

our ability to develop and market new and enhanced products on a timely basis;

commencement of, or our involvement in, litigation;

disruption to our operations;

the emergence of new sales channels in which we are unable to compete effectively;

any major change in our board of directors or management;

changes in financial estimates including our ability to meet our future revenue and operating profit or loss projections;

changes in governmental regulations; and

changes in earnings estimates or recommendations by securities analysts.

Furthermore, the stock market in general, and the market for semiconductor and other technology companies in particular, have experienced price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may seriously harm the market price of our common stock, regardless of our actual operating performance. These trading price fluctuations may also make it more difficult for us to use our common stock as a means to make acquisitions or to use options to purchase our common stock to attract and retain employees. In addition, in the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

***Future sales of our common stock in the public market could cause our stock price to fall. \****

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Sales of a substantial number of shares of our common stock in the public market, or the perception that these sales might occur, could depress the market price of our common stock and could impair our ability to raise capital through the sale of additional equity securities. As of September 30, 2010, we had 45,119,426 shares of common stock outstanding, all of which shares were eligible for sale in the public market, subject in some cases to the volume limitations and manner of sale requirements under Rule 144.

In addition, we have filed registration statements on Form S-8 under the Securities Act of 1933, as amended, to register the shares of our common stock reserved for issuance under our stock option plans, and intend to file additional registration statements on Form S-8 to register the shares automatically added each year to the share reserves under these plans.

Pursuant to the terms of a Registration Rights Agreement dated December 14, 2009 we entered into with the selling stockholders, we have filed a registration statement under the Securities Act, registering the resale of the 1,467,612 shares of common stock we issued to the selling stockholders pursuant to that certain Agreement and Plan of Merger and Reorganization, dated November 6, 2009, among Cavium Networks, MV Acquisition Corporation, a Delaware corporation and wholly owned subsidiary of Cavium Networks, Mantra, LLC, a Delaware limited liability company and wholly owned subsidiary of Cavium Networks, MontaVista Software, Inc., a Delaware corporation and with respect to sections 9 and 10.1 of the Merger Agreement, Thomas Kelly as the MontaVista stockholders agent.

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*Delaware law and our amended and restated certificate of incorporation and bylaws contain provisions that could delay or discourage takeover attempts that stockholders may consider favorable.*

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

the division of our board of directors into three classes;

the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or due to the resignation or departure of an existing board member;

the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;

the requirement for the advance notice of nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders' meeting;

the ability of our board of directors to alter our bylaws without obtaining stockholder approval;

the ability of the board of directors to issue, without stockholder approval, up to 10,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of our common stock;

the elimination of the rights of stockholders to call a special meeting of stockholders and to take action by written consent in lieu of a meeting;

the required approval of at least 66 2/3% of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or repeal the provisions of our amended and restated certificate of incorporation regarding the election and removal of directors, and the inability of stockholders to take action by written consent in lieu of a meeting; and

the required approval of at least a majority of the shares entitled to vote at an election of directors to remove directors without cause. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, particularly those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our amended and restated certificate of incorporation and bylaws and under Delaware law could discourage potential takeover attempts, could reduce the price that investors are willing to pay for shares of our common stock in the future and could potentially result in the market price being lower than they would without these provisions.

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

None.

*Use of Proceeds from Sale of Registered Securities*

Our initial public offering of common stock was effected through a Registration Statement on Form S-1 (File No. 333-140660), that was declared effective by the SEC on May 1, 2007. As of September 30, 2010, \$52.8 million of the approximately \$94.7 million in net proceeds received by us in the offering, after deducting approximately \$7.3 million in underwriting discounts, commissions, and \$2.8 million in other offering costs, were invested in various interest-bearing instruments, and \$41.9 million of the net proceeds had been used for acquisitions, general corporate purposes, including the repayment of the outstanding balances under a term loan with Silicon Valley Bank, general and administrative and manufacturing expenses.

**Table of Contents*****Issuer Purchases of Equity Securities***

The following table provides information regarding repurchases of our common stock during the three months ending September 30, 2010:

| <b>Period</b>                          | <b>Total Number of<br/>Shares<br/>Purchased<br/>(1)</b> | <b>Average<br/>Price Paid<br/>per<br/>Share</b> | <b>Total Number of<br/>Shares<br/>Purchased as<br/>Part of<br/>Publicly<br/>Announced<br/>Plans or<br/>Programs</b> | <b>Approximate Dollar<br/>Value of Shares that<br/>May Yet Be Purchased<br/>Under the Plans or<br/>Programs</b> |
|--|---|---|---|---|
| July 1, 2010 - July 31, 2010           |   |   | Not applicable  | Not applicable  |
| August 1, 2010 - August 31, 2010       |   |   | Not applicable  | Not applicable  |
| September 1, 2010 - September 30, 2010 | 584   | \$ 3.04   | Not applicable  | Not applicable  |
|  | 584   | \$ 3.04   |   |   |

(1) Represents shares of our common stock repurchased by us from employees upon termination of service pursuant to the terms and conditions of our 2001 Stock Incentive Plan, which permits us to elect to purchase such shares at the original issuance price.

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Removed and Reserved****Item 5. Other Information**

None



**Table of Contents****Item 6. Exhibits****Exhibit**

| <b>Number</b> | <b>Description</b>   |
|---------------|--|
| 3.1           | Amended and Restated Certificate of Incorporation of the Registrant (1)  |
| 3.2           | Amended and Restated Bylaws of the Registrant(2)   |
| 4.1           | Reference is made to Exhibits 3.1 and 3.2  |
| 4.2           | Form of the Registrant's Common Stock Certificate (3)  |
| 101.#         | MIPS Core Technology Schedule, dated as of September 29, 2010, by and among the Registrant and MIPS Technologies, Inc.   |
| 31.1          | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer   |
| 31.2          | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Arthur D. Chadwick, Chief Financial Officer  |
| 32.1*         | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer and Arthur D. Chadwick, Chief Financial Officer |
| 101.INS**     | XBRL Instance Document   |
| 101.SCH**     | XBRL Taxonomy Extension Schema Document  |
| 101.CAL**     | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.LAB**     | XBRL Taxonomy Extension Labels Linkbase Document   |
| 101.PRE**     | XBRL Taxonomy Extension Presentation Linkbase Document   |

- (1) Filed as Exhibit 3.1 to the Registrant's Annual Report on Form 10-K (No. 001-33435), filed with the SEC on March 2, 2009, and incorporated herein by reference.
- (2) Filed as Exhibit 3.5 to the Registrant's registration statement on Form S-1 (No. 333-140660), filed with the SEC on February 13, 2007, as amended, and incorporated herein by reference.
- (3) Filed as Exhibit 4.2 to the Registrant's registration statement on Form S-1 (No. 333-140660), filed with the SEC on February 13, 2007, as amended, and incorporated herein by reference.

\* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Registrant under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

\*\* Pursuant to applicable securities laws and regulations, the Registrant is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and is not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Registrant has made a good faith attempt to comply with the submission requirements and promptly amends the interactive data files after becoming aware that the interactive data files fails to comply with the submission requirements. In accordance with Rule 406T of Regulation S-T, the information in these exhibits is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, except as expressly set forth by specific reference in such filing.

# Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the Securities and Exchange Commission.



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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.

CAVIUM NETWORKS, INC.

Date: October 29, 2010

By:

*/s/* ARTHUR D. CHADWICK  
**Arthur D. Chadwick**  
**Chief Financial Officer and Vice President of**  
**Finance and Administration and Secretary**

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**Table of Contents****EXHIBIT INDEX**

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