

AXT INC  
Form 10-Q  
November 07, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC. 20549

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**FORM 10-Q**

(Mark One)

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

**for the quarterly period ended September 30, 2007**

or

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

**for the transition period from            to**

**Commission File Number 000-24085**

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**AXT, INC.**

(Exact name of registrant as specified in its charter)

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

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

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4281 Technology Drive, Fremont, California 94538

(Address of principal executive offices) (Zip code)

(510) 683-5900

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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

Class	Outstanding at October 22, 2007
Common Stock, \$0.001 par value	30,287,889

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AXT, INC.

FORM 10-Q

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

AXT, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share data)

	September 30, 2007	December 31, 2006
<b>Assets:</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 17,067	\$ 16,116
Short-term investments	18,174	19,428
Accounts receivable, net of allowances of \$560 and \$140 as of September 30, 2007 and December 31, 2006, respectively	11,948	9,658
Inventories, net	25,124	20,263
Prepaid expenses and other current assets	3,590	3,985
Assets held for sale	5,140	4,659
<b>Total current assets</b>	<b>81,043</b>	<b>74,109</b>
Property, plant and equipment, net	15,072	12,775
Restricted deposits	6,700	7,150
Other assets	5,036	4,298
<b>Total assets</b>	<b>\$ 107,851</b>	<b>\$ 98,332</b>
<b>Liabilities and stockholders' equity:</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 2,770	\$ 3,764
Accrued liabilities	3,877	3,358
Current portion of long-term debt	450	450
Income taxes payable	446	178
<b>Total current liabilities</b>	<b>7,543</b>	<b>7,750</b>
Long-term debt, net of current portion	6,295	6,839
Other long-term liabilities	3,129	2,543
<b>Total liabilities</b>	<b>16,967</b>	<b>17,132</b>
<b>Commitments and contingencies (Note 11)</b>		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.001 par value per share; 2,000 shares authorized; 883 shares issued and outstanding as of September 30, 2007 and December 31, 2006.	3,532	3,532
Common stock, \$0.001 par value per share; 70,000 shares authorized; 30,288 and 29,011 shares issued and outstanding as of September 30, 2007 and December 31, 2006, respectively	30	29
Additional paid-in capital	185,666	180,936
Accumulated deficit	(100,417)	(103,832)
Accumulated other comprehensive income	2,073	535
<b>Total stockholders' equity</b>	<b>90,884</b>	<b>81,200</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 107,851</b>	<b>\$ 98,332</b>

See accompanying notes to condensed consolidated financial statements.

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AXT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Revenue	\$ 14,474	\$ 12,547	\$ 40,639	\$ 31,373
Cost of revenue	9,944	9,068	25,672	23,625
Gross profit	4,530	3,479	14,967	7,748
Operating expenses:				
Selling, general and administrative	3,083	2,641	10,529	9,724
Research and development	382	392	1,190	1,497
Impairment (recovery of impairment) on assets held for sale		1,417	(481)	1,417
Restructuring benefit				(2)
Total operating expenses	3,465	4,450	11,238	12,636
Income (loss) from continuing operations	1,065	(971)	3,729	(4,888)
Interest income, net	102	103	551	342
Other income (expense), net	(156)	641	(439)	1,693
Income (loss) before provision for income taxes	1,011	(227)	3,841	(2,853)
Provision (benefit) for income taxes	153	(862)	426	(406)
Income (loss) from continuing operations	858	635	3,415	(2,447)
Discontinued operations:				
Gain from discontinued operations, net of tax		4		7
Net income (loss)	\$ 858	\$ 639	\$ 3,415	\$ (2,440)
Basic income (loss) per share:				
Income (loss) from continuing operations	\$ 0.03	\$ 0.03	\$ 0.11	\$ (0.11)
Gain from discontinued operations, net of tax				
Net income (loss)	\$ 0.03	\$ 0.03	\$ 0.11	\$ (0.11)
Shares used in computing basic income (loss) per share	30,150	23,158	29,940	23,066
Diluted income (loss) per share:				
Income (loss) from continuing operations	\$ 0.03	\$ 0.02	\$ 0.10	\$ (0.11)
Gain from discontinued operations, net of tax				
Net income (loss)	\$ 0.03	\$ 0.02	\$ 0.10	\$ (0.11)
Shares used in computing diluted income (loss) per share	31,464	24,378	31,287	23,066

See accompanying notes to condensed consolidated financial statements.

## AXT, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	Nine Months Ended September 30,	
	2007	2006
Cash flows from operating activities:		
Net income (loss)	\$ 3,415	\$ (2,440)
Adjustments to reconcile net income (loss) to net cash used in operations:		
Depreciation	1,064	2,365
Accretion of marketable securities premium/discount	(51)	(55)
Loss on disposal of property, plant and equipment		89
Stock-based compensation	341	649
Realized loss (gain) on sale of investments	83	(2,032)
Impairment (recovery of impairment) on assets held for sale	(481)	1,417
Changes in assets and liabilities:		
Accounts receivable, net	(2,193)	(3,574)
Inventories	(4,712)	(1,203)
Prepaid expenses	512	(2,278)
Other assets	(696)	26
Accounts payable	(1,050)	1,008
Accrued liabilities	475	(773)
Income taxes payable	251	(1313)
Other long-term liabilities	467	340
Net cash used in operating activities	(2,575)	(7,774)
Cash flows from investing activities:		
Purchases of property, plant and equipment	(2,786)	(2,157)
Proceeds from disposal of property, plant and equipment	6	161
Purchases of marketable securities	(22,704)	(7,924)
Proceeds from sale of marketable securities	24,508	10,174
Decrease in restricted deposits	450	300
Net cash (used in)/ provided by investing activities	(526)	554
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	4,390	528
Long-term debt payments	(546)	(467)
Net cash provided by financing activities	3,844	61
Effect of exchange rate changes on cash and cash equivalents	208	274
Net increase (decrease) in cash and cash equivalents	951	(6,885)
Cash and cash equivalents at the beginning of the period	16,116	17,472
Cash and cash equivalents at the end of the period	\$ 17,067	\$ 10,587

See accompanying notes to condensed consolidated financial statements.

AXT, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**Note 1. Basis of Presentation**

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

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

The results of operations are not necessarily indicative of the results to be expected in the future or for the full fiscal year. It is recommended that these condensed consolidated financial statements be read in conjunction with our consolidated financial statements and the notes thereto included in our 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission ( SEC ) on March 23, 2007 and our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2007 and June 30, 2007 filed with the SEC on May 11, 2007 and August 13, 2007, respectively.

Certain reclassifications have been made to the prior period consolidated financial statements to conform to current period presentation. These reclassifications had no impact on previously reported total assets, stockholders' equity or net income (loss).

**Note 2. Discontinued Operations**

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

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2007	2006	2007	2006	
Revenue	\$	\$	\$	\$	
Cost of revenue					
Gross profit					
Operating expenses:					
Selling, general and administrative		(4)		(7)	
Total operating expenses		(4)		(7)	
Gain from operations, net of tax		4		7	
Net income	\$	\$	4 \$	\$	7

In the first quarter of 2007, we dissolved the corporation that previously operated our discontinued operations and transferred the cash balance to our continuing operations. Accordingly, we no longer have discontinued operations. In the three and nine months ended September 30, 2006, the \$4,000 and \$7,000, respectively, in income was interest earned on cash balances held in discontinued operations.



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

	September 30, 2007	December 31, 2006
Current assets:		
Cash	\$	\$ 395
Total current assets		395
Total assets	\$	\$ 395
Net assets		395
Total liabilities and net assets	\$	\$ 395

**Note 3. Accounting for Stock-Based Compensation**

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

We elected the modified prospective transition method for adopting SFAS 123(R). Under this method, the provisions of SFAS 123(R) apply to all awards granted or modified after the date of adoption. The unrecognized expense of awards not yet vested at the date of adoption will be recognized in net income (loss) in the periods after the date of adoption using the same Black-Scholes valuation method and assumptions determined under the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as disclosed in our previous quarterly and annual reports.

**Impact of the Adoption of SFAS 123(R)**

Under the modified prospective application transition method as provided by SFAS 123(R), we recorded \$130,000 and \$206,000 of stock compensation expense in our unaudited condensed consolidated statements of operations for the three months ended September 30, 2007, and 2006, respectively, and \$341,000 and \$649,000 of stock compensation expense in our unaudited condensed consolidated statements of operations for the nine months ended September 30, 2007, and 2006, respectively. We elected not to capitalize any stock-based compensation to inventory as of January 1, 2006 when the provisions of SFAS 123(R) were initially adopted. We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted both before and after the adoption of SFAS 123(R). The following table summarizes the compensation expense related to our stock-based compensation plan (in thousands, except per share data):

Three Months Ended September 30,		Nine Months Ended September 30,	
2007	2006	2007	2006

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Stock-based compensation in the form of employee stock options,  
included in:

Cost of revenue	\$	12	\$	20	\$	38	\$	80
Selling, general and administrative		96		148		245		412
Research and development		22		38		58		156
Total stock-based compensation		130		206		341		649
Tax effect on stock-based compensation								
Net effect on net income (loss)	\$	130	\$	206	\$	341	\$	649
Effect on basic net income (loss) per share	\$	0.00	\$	(0.01)	\$	0.01	\$	(0.03)
Effect on diluted net income (loss) per share	\$	0.00	\$	(0.01)	\$	0.01	\$	(0.03)

*Stock options*

As of September 30, 2007, the total compensation costs related to unvested stock-based awards granted to employees under our stock option plan but not yet recognized was approximately \$811,000, net of estimated forfeitures of \$60,000, and will be adjusted for subsequent changes in estimated forfeitures. This cost will be amortized on a straight-line basis over a weighted-average period of approximately 2.1 years. We elected not to capitalize any stock-based compensation to inventory as of September 30, 2007 and 2006, due to the immateriality of the amount.

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

We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), Securities and Exchange Commission Staff Accounting Bulletin No. 107 and our prior period pro forma disclosures of net income (loss), including stock-based compensation (determined under a fair value method as prescribed by SFAS No. 123). The fair value of our stock options granted to employees for the three and nine months ended September 30, 2007, and 2006, was estimated using the following weighted-average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Expected term (in years)	4.0	5.0	4.0	5.0
Volatility	64.08%	82.26%	64.08%	84.86%
Expected dividend	0.00%	0.00%	0.00%	0.00%
Risk-free interest rate	4.62%	4.59%	4.62%	4.80%
Estimated forfeitures	5.99%	1.49%	5.99%	12.33%
Weighted-average fair value	\$ 4.92	\$ 2.17	\$ 4.92	\$ 1.82

The following table summarizes the stock option transactions during the nine months ended September 30, 2007 (in thousands, except per share data):

	Shares	Weighted-average Exercise Price	Weighted-average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding as of December 31, 2006	2,728	\$ 2.51		
Granted	31	4.92		
Exercised	(391)	1.98		

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Canceled	(127)	4.59		
Options outstanding as of September 30, 2007	2,241 \$	2.52	6.64 \$	9,092
Options vested and expected to vest as of September 30, 2007	2,177 \$	2.53	6.60 \$	8,838
Options exercisable as of September 30, 2007	1,594 \$	2.58	6.05 \$	6,622

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The options outstanding and exercisable as of September 30, 2007 were in the following exercise price ranges:

Range of Exercise Price	Options Outstanding as of September 30, 2007			Options Exercisable as of September 30, 2007	
	Shares	Weighted-average Exercise Price	Weighted-average Remaining Contractual Life	Shares	Weighted-Average Exercise Price
\$1.17 - \$ 1.38	1,287,010	\$ 1.28	6.97	875,972	\$ 1.29
\$1.39 - \$ 1.44	11,500	\$ 1.41	7.64	6,605	\$ 1.41
\$1.45 - \$ 2.24	473,530	\$ 2.17	5.66	440,176	\$ 2.18
\$2.25 - \$ 5.00	371,468	\$ 4.00	7.81	174,031	\$ 3.16
\$5.01 - \$41.50	97,500	\$ 15.03	2.46	97,500	\$ 15.03
	2,241,008	\$ 2.52	6.64	1,594,284	\$ 2.58

The total intrinsic value of options exercised for the three and nine months ended September 30, 2007 was \$929,000 and \$1,089,000, respectively. Cash received from option exercises for the three and nine months ended September 30, 2007 was \$548,000 and \$776,000, respectively. The total intrinsic value of options exercised for the three and nine months ended September 30, 2006 was \$203,000 and \$395,000, respectively. Cash received from option exercises for the three and nine months ended September 30, 2006 was \$229,000 and \$527,000, respectively.

**Restricted stock awards**

A summary of activity related to restricted stock awards for the three months ended September 30, 2007 is presented below:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested restricted stock shares outstanding at beginning of the quarter	10,608	\$ 3.77
Restricted stock shares granted	12,872	\$ 4.66
Restricted stock shares vested		\$
Non-vested restricted stock shares outstanding as of September 30, 2007	23,480	\$ 4.26

A summary of activity related to restricted stock awards for the nine months ended September 30, 2007 is presented below:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested restricted stock shares outstanding at beginning of the year		\$
Restricted stock shares granted	23,480	\$ 4.26
Restricted stock shares vested		\$
Non-vested restricted stock shares outstanding as of September 30, 2007	23,480	\$ 4.26

As of September 30, 2007, we had \$92,000 of unrecognized compensation expense, net of forfeitures, related to restricted stock awards, which will be recognized over the weighted average period of 2.76 years. During the three and nine months ended September 30, 2007, no shares of restricted stock were vested.



**Note 4. Cash, Cash Equivalents and Investments**

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

	September 30, 2007			December 31, 2006				
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized (Loss)	Fair Value	Amortized Cost	Gross Unrealized Gain	Gross Unrealized (Loss)	Fair Value
<b>Classified as:</b>								
Cash	\$ 6,800	\$	\$	\$ 6,800	\$ 6,892	\$	\$	\$ 6,892
<b>Cash equivalents:</b>								
Money market fund	8,075			8,075	7,045			7,045
U.S. Treasury and agency securities	2,192			2,192	2,179			2,179
<b>Total cash equivalents</b>	<b>10,267</b>			<b>10,267</b>	<b>9,224</b>			<b>9,224</b>
<b>Total cash and cash equivalents</b>	<b>17,067</b>			<b>17,067</b>	<b>16,116</b>			<b>16,116</b>
<b>Investments:</b>								
U.S. Treasury and agency securities	1,400			1,400	12,277		(39)	12,238
Asset-backed securities	3,985		(10)	3,975	809		(1)	808
Commercial paper	3,300		(115)	3,185	500			500
Corporate bonds	15,650	665	(1)	16,314	13,035		(3)	13,032
<b>Total investments</b>	<b>24,335</b>	<b>665</b>	<b>(126)</b>	<b>24,874</b>	<b>26,621</b>		<b>(43)</b>	<b>26,578</b>
<b>Total cash, cash equivalents and investments</b>	<b>\$ 41,402</b>	<b>\$ 665</b>	<b>\$ (126)</b>	<b>\$ 41,941</b>	<b>\$ 42,737</b>	<b>\$</b>	<b>\$ (43)</b>	<b>\$ 42,694</b>
<b>Contractual maturities on investments:</b>								
Mature within 1 year	\$ 2,048			\$ 2,048	\$ 13,767			\$ 13,727
Mature after 1 through 5 years	18,302			18,851	12,854			12,851
Mature after 5 years	3,985			3,975				
	\$ 24,335			\$ 24,874	\$ 26,621			\$ 26,578

The investments include \$6.7 million and \$7.2 million recorded as restricted deposits on the condensed consolidated balance sheets as of September 30, 2007 and December 31, 2006, respectively, as a result of the outstanding principal amount on our industrial revenue bonds.

We manage our investments as a single portfolio of highly marketable securities that is intended to be available to meet our current cash requirements. For the three and nine months ended September 30, 2007, we had \$54,000 and \$83,000 in gross realized losses on sales of our available-for-sale securities. For the three and nine months ended September 30, 2006, we had \$0.7 million and \$2.0 million, respectively, in gross realized gains on sales of our available-for-sale securities.

The gross unrealized losses related to our portfolio of available-for-sale securities were primarily due to a decrease in the fair value of debt securities as a result of an increase in interest rates during 2006 and the first nine months of 2007. We have determined that the gross unrealized losses on our available-for-sale securities as of September 30, 2007 are temporary in nature. We reviewed our investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.





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The following table provides a breakdown of our available-for-sale securities with unrealized losses as of September 30, 2007 (in thousands):

	In Loss Position < 12 months		In Loss Position > 12 months		Total In Loss Position	
	Fair Value	Gross Unrealized (Loss)	Fair Value	Gross Unrealized (Loss)	Fair Value	Gross Unrealized (Loss)
<b>Investments:</b>						
U.S. Treasury and agency securities	\$	\$	\$ 3,975	\$ (10)	\$ 3,975	\$ (10)
Asset-backed securities			3,185	(115)	3,185	(115)
Corporate bonds	298	(1)			298	(1)
<b>Total in loss position</b>	<b>\$ 298</b>	<b>\$ (1)</b>	<b>\$ 7,160</b>	<b>\$ (125)</b>	<b>\$ 7,458</b>	<b>\$ (126)</b>

**Note 5. Inventories, Net**

Inventories are stated at the lower of cost or market. The components of inventories are summarized below (in thousands):

	September 30, 2007	December 31, 2006
<b>Inventories, net:</b>		
Raw materials	\$ 11,426	\$ 8,419
Work in process	11,614	11,222
Finished goods	2,084	622
	<b>\$ 25,124</b>	<b>\$ 20,263</b>

**Note 6. Recovery of Impairment on Assets Held for Sale**



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During the three months ended June 30, 2007, we benefited from a recovery of impairment on assets held for sale in connection with our adjustment of the fair value of our U.S. property located in Fremont, California, which has been decontaminated and is being prepared for sale. Accordingly, we recorded a \$481,000 market value adjustment after we entered into an agreement with an independent third party purchaser to purchase the property for estimated net proceeds of \$5.1 million, after deducting estimated commission and selling expenses. Subsequent to the three and nine months ended September 30, 2007, we received a notice from this third party purchaser terminating the agreement to purchase the property. On October 22, 2007, we entered into a new agreement with a different independent third party purchaser to purchase the property for \$5.65 million, subject to certain contingencies. See Note 14 below. This property has been classified as assets held for sale in the amount of \$5.1 million on the condensed consolidated balance sheet as of September 30, 2007.

### **Note 7. Net Income (Loss) Per Share**

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>Numerator:</b>				
Net income (loss)	\$ 858	\$ 639	\$ 3,415	\$ (2,440)
Less: Preferred stock dividends	(44)	(44)	(132)	(132)
Net income (loss) available to common stockholders	\$ 814	\$ 595	\$ 3,283	\$ (2,572)
<b>Denominator:</b>				
Denominator for basic net income (loss) per share - weighted average common shares	30,150	23,158	29,940	23,066
<b>Effect of dilutive securities:</b>				
Common stock options	1,314	1,220	1,347	
Denominator for dilutive net income (loss) per common share	31,464	24,378	31,287	23,066
Basic net income (loss) per share	\$ 0.03	\$ 0.03	\$ 0.11	\$ (0.11)
Diluted net income (loss) per share	\$ 0.03	\$ 0.02	\$ 0.10	\$ (0.11)
Options excluded from diluted net loss per share as the impact is anti-dilutive	98	120	822	2,589

**Note 8. Comprehensive Income (Loss)**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income (loss)	\$ 858	\$ 639	\$ 3,415	\$ (2,440)
Foreign currency translation gain	357	196	956	274
Unrealized gain on available-for-sale investments	110	151	582	1,997
Less: reclassification adjustment for realized gain included in net income (loss)		(650)		(2,032)
Comprehensive income (loss)	\$ 1,325	\$ 336	\$ 4,953	\$ (2,201)

**Note 9. Segment Information and Foreign Operations**

*Segment Information*



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

*Geographical Information*





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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net revenues:				
North America*	\$ 2,820	\$ 3,033	\$ 8,918	\$ 7,704
Europe	2,521	2,012	7,163	5,684
Japan	3,301	842	8,699	2,638
Taiwan	2,444	2,869	6,512	5,782
Asia Pacific	3,388	3,791	9,347	9,565
Consolidated	\$ 14,474	\$ 12,547	\$ 40,639	\$ 31,373

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\* Primarily the United States

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

	As of	
	September 30, 2007	December 31, 2006
Long-lived assets:		
North America	\$ 139	\$ 426
China	14,933	12,349
	\$ 15,072	\$ 12,775

### *Significant Customers*



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No customer represented more than 10% of revenue for the three months ended September 30, 2007. One customer represented 18.4% of revenue for the three months ended September 30, 2006. No customer represented more than 10% of revenue for the nine months ended September 30, 2007. One customer represented 15.0% of revenue for the nine months ended September 30, 2006. Our top five customers represented 30.9% and 44.1% of revenue for the three months ended September 30, 2007, and 2006, respectively. Our top five customers represented 31.8% and 40.3% of revenue for the nine months ended September 30, 2007, and 2006, respectively.

### Note 10. Investments in Privately-held Companies

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

Company	Investment Balance as of		Accounting Method	Ownership Percentage
	September 30, 2007	December 31, 2006		
Beijing Ji Ya Semiconductor Material Co., Ltd	\$ 996	\$ 996	Consolidated	46%
Nanjing Jin Mei Gallium Co., Ltd	592	592	Consolidated	83
Beijing BoYu Manufacturing Co., Ltd	410	410	Consolidated	70
Xilingol Tongli Ge Co. Ltd	1,998	1,304	Equity	25
Emeishan Jia Mei High Pure Metals Co., Ltd	721	670	Equity	25

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

both companies have sustainable businesses of their own;

our voting power is proportionate to our ownership interests;

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

we do not have a controlling financial interest in, do not maintain operational or management control of, do not control the board of directors of, and are not required to provide additional investment or financial support to, either company.

Undistributed retained earnings relating to our investments were \$6.7 million and \$4.4 million as of September 30, 2007 and December 31, 2006, respectively. Net income recorded from our investments was \$729,000 and \$609,000 for the three months ended September 30, 2007 and 2006, respectively. Net income recorded from our investments was \$2.3 million and \$1.3 million for the nine months ended September 30, 2007 and 2006, respectively.

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

#### **Note 11. Commitments and Contingencies**

##### ***Indemnification Agreements***

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

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

##### ***Product Warranty***



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We warrant our products for a specific period of time, generally twelve months, against material defects. We provide for the estimated future costs of warranty obligations in cost of sales when the related revenue is recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that we expect to incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. On a quarterly basis, we review the accrued balances and update these based on the historical warranty cost trends. The following table reflects the change in our warranty accrual, which is included in accrued liabilities on the condensed consolidated balance sheets, during the three months and nine months ended September 30, 2007 and 2006 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Beginning accrued warranty and related costs	\$ 949	\$ 204	\$ 459	\$ 120
Charged (credited) to cost of revenue	(116)	553	580	699
Actual warranty expenditures	(14)	(186)	(220)	(248)
Ending accrued warranty and related costs	\$ 819	\$ 571	\$ 819	\$ 571

***Purchase Commitment***

On February 27, 2007, we entered into an agreement with Recapture Metals Limited of Ontario, Canada ( Recapture ), pursuant to which Recapture will supply our subsidiary in the People's Republic of China with one thousand kilograms per month of 99.99999% pure gallium, during the eighteen month period beginning July 1, 2007. Under the terms of the agreement, we are required to purchase a minimum of eighteen thousand kilograms of gallium, unless the agreement is terminated prior to the expiration of the eighteen month period on December 31, 2008. As of September 30, 2007, our total remaining commitment under this agreement is approximately \$6.1 million.

**Note 12. Foreign Exchange Transaction Gains/Losses**

We incurred foreign currency transaction exchange gains of \$162,000 and losses of \$59,000 for the three months ended September 30, 2007, and 2006, respectively. We incurred foreign currency transaction exchange losses of \$128,000 and \$48,000 for the nine months ended September 30, 2007, and 2006, respectively. These amounts are included in other income (expense), net on the condensed consolidated statements of operations.

**Note 13. Income Taxes**

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

**Note 14. Subsequent Events**

On October 4, 2007, we received a notice from Mr. and Mrs. Allen and Janette Blazick (collectively, the Original Buyers ) terminating the Purchase and Sale Agreement (the Old Agreement ) dated June 15, 2007, under section 2.2.1 of the Old Agreement. Pursuant to the Old Agreement, AXT had agreed to sell its property and building at 4311 Solar Way in Fremont, California to the Original Buyers, in return of a cash payment of \$5.35 million, subject to certain contingencies.

On October 19, 2007, our board of directors appointed our chief executive officer, Dr. Philip C.S. Yin, as chairman of the board, succeeding Jesse Chen. Mr. Chen has been named as lead independent director of the company. Both appointments are effective October 19, 2007.



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On October 22, 2007, we entered into a Purchase and Sale Agreement (the "New Agreement") with SBC&D Co., Inc., a California corporation, dba South Bay Development (the "Buyer") under which it agreed to sell its property and building at 4311 Solar Way in Fremont, California in return for a cash payment of \$5.65 million, subject to certain contingencies. In connection with the execution of the New Agreement, the Buyer deposited \$250,000 with an escrow agent, which shall be fully refundable to Buyer prior to the expiration of the 30-day Due Diligence Period, then, after the expiration of the Due Diligence Period, the deposit shall be deemed non-refundable to Buyer for any reason other than as a result of a breach or default by Seller or the occurrence of certain casualty or condemnation events prior to the close of escrow. The closing of the sale of the property is to occur within fifteen days of the lapse of the Due Diligence Period.

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

This quarterly report on Form 10-Q, including the following sections, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, particularly statements relating to our expectations regarding results of operations, customer demand, improvements in our product quality, our ability to expand our markets and increase sales, customer qualifications of our products, gross margins, favorable pricing, reliable supply and enhanced sourcing lead-times of raw materials, and our reserve balances. These forward-looking statements are based upon management's current views with respect to future events and financial performance, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated in such forward-looking statements. Such risks and uncertainties include those set forth under Item 1A Risk Factors below, which identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in this Form 10-Q and other filings we have made with the Securities and Exchange Commission. Forward-looking statements may be identified by the use of terms such as anticipates, believes, estimates, expects, intends, and similar expressions. Statements concerning our future or expected financial results and condition, business strategy and plans or objectives for future operations are forward-looking statements.

These forward-looking statements are not guarantees of future performance. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. This discussion should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2006 and the condensed consolidated financial statements included elsewhere in this report.

**Overview**

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

<b>Product Substrates</b>	<b>Diameter</b>	<b>Applications</b>
GaAs (semi-insulating)	2 , 4 , 6	Power amplifiers and integrated circuits for wireless handsets Direct broadcast television High-performance transistors Satellite communications
GaAs (semi-conducting)	2 , 4	LEDs Lasers Optical couplers
InP	2 , 4 , 6	Broadband and Fiber optic communications
Ge	2 , 4	Satellite solar cells

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

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

Revenue increased \$9.3 million, or 29.5%, to \$40.6 million for the nine months ended September 30, 2007 from \$31.4 million for the same period of 2006 primarily from an increase in raw material sales and higher customer demands for smaller diameter wafers, offset by inventory adjustments of select handset manufacturers and foundaries. As of September 30, 2007, we had available cash, cash equivalents and short-term investments of \$35.2 million, excluding restricted deposits.

***Recovery of Impairment on Assets Held for Sale***



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During the three months ended June 30, 2007, we benefited from a recovery of impairment on assets held for sale in connection with our adjustment of the fair value of our U.S. property located in Fremont, California, which has been decontaminated and is being prepared for sale, to market value. Accordingly, we recorded a \$481,000 market value adjustment after we entered into an agreement with an independent third party purchaser to purchase the property for estimated net proceeds of \$5.1 million, after deducting estimated commission and selling expenses. Subsequent to the three and nine months ended September 30, 2007, we received a notice from this third party purchaser terminating the agreement to purchase the property. On October 22, 2007, we entered into a new agreement with a different independent third party purchaser to purchase the property for \$5.65 million, subject to certain contingencies. See Note 14 to our condensed consolidated financial statements. This property has been classified as assets held for sale in the amount of \$5.1 million on the condensed consolidated balance sheet as of September 30, 2007.

### **Critical Accounting Policies and Estimates**

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

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

#### ***Revenue Recognition***

We manufacture and sell high-performance compound and single element semiconductor substrates and sell certain raw materials including gallium, germanium dioxide and pBN crucibles. After we ship our products, there are no remaining obligations or customer acceptance requirements that would preclude recognition of the revenue earned on the sale. Our products are typically sold pursuant to a purchase order placed by our customers, and our terms and conditions of sale do not require customer acceptance. We recognize revenue upon shipment and transfer of title of products to our customers, which is ordinarily upon shipment from our dock, receipt at the customer's dock, or removal from consignment inventory at the customer's location, provided that we have received a signed purchase order, the price is fixed or determinable, title and risk of ownership have transferred, collection of resulting receivables is probable, and product returns are reasonably estimable. We do not provide training, installation or commissioning services.

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

In June 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force ( EITF ) regarding EITF Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Government Authorities Should be Presented in the Income Statement (That Is, Gross versus Net Presentation)* . We have historically presented, and will continue to present sales tax, value added tax, and other similar taxes on a net basis, excluding them from revenue.



### ***Allowance for Doubtful Accounts***

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

As of September 30, 2007 and December 31, 2006, our accounts receivable, net, balance was \$11.9 million and \$9.7 million, respectively, which was net of an allowance for doubtful accounts of \$0.6 million and \$0.1 million, respectively. The increase in gross accounts receivable balance was primarily due to increased sales, while the increase in allowance for doubtful accounts was mainly for our slow-paying customers in Asia. If actual uncollectible accounts differ substantially from our estimates, revisions to the estimated allowance for doubtful accounts would be required, which could have a material impact on our financial results for the period.

### ***Warranty Reserve***

We maintain a warranty reserve based upon our claims experience during the prior twelve months. Warranty costs are accrued at the time revenue is recognized. As of September 30, 2007 and December 31, 2006, accrued product warranties totaled \$819,000 and \$459,000, respectively. The increase in accrued warranties is primarily attributable to increased claims on quality experienced by some customers as well as an increase in revenues. If actual warranty costs differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material impact on our financial condition and results of operations.

### ***Inventory Valuation***

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average cost method. Our inventory consists of raw materials as well as finished goods and work-in-process that include material, labor and manufacturing overhead costs. Given the nature of our substrate products, and the materials used in the manufacturing process, the wafers and ingots comprising work-in-process may be held in inventory for up to two years and three years, respectively, as the risk of obsolescence for these materials is low. We routinely evaluate the levels of our inventory in light of current market conditions in order to identify excess and obsolete inventory, and we provide a valuation allowance for certain inventories based upon the age and quality of the product and the projections for sale of the completed products. As of September 30, 2007 and December 31, 2006, we had an inventory reserve of \$13.2 million and \$15.4 million for excess and obsolete inventory, respectively. The majority of this inventory has not been scrapped, and accordingly, may be sold in future periods. If actual demand for our products were to be substantially lower than estimated, additional inventory adjustments for excess or obsolete inventory might be required, which could have a material impact on our business, financial condition and results of operations.

### ***Impairment of Investments***

We classify our investments in debt and equity securities as available-for-sale securities as prescribed by Statement of Financial Accounting Standards ( SFAS ) No. 115, *Accounting for Certain Investments in Debt and Equity Securities* . All available-for-sale securities with a quoted



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market value below cost (or adjusted cost) are reviewed in order to determine whether the decline is other-than-temporary. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and our ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value.

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

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

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

### ***Employee Stock Options***

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

### ***Income Taxes***

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

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

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

31, 2006.

As of the date of the filing of this quarterly report, there have been no material changes to our critical accounting policies and procedures during the three months and nine months ended September 30, 2007 compared to that disclosed in our Annual Report on Form 10K for the fiscal year ended December 31, 2006 filed with the SEC on March 23, 2007 and our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2007 and June 30, 2007 filed with the SEC on May 11, 2007 and August 13, 2007, respectively.

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

	<b>Three Months Ended September 30,</b>		<b>Increase (Decrease)</b>	<b>% Change</b>
	<b>2007</b>	<b>2006</b>		
	(\$ in thousands)			
GaAs	\$ 9,909	\$ 10,561	\$ (652)	(6.2)%
InP	408	340	68	20.0%
Ge	536	387	149	38.5%
Raw materials	3,621	1,251	2,370	189.4%
Other		8	(8)	NM
Total revenue	\$ 14,474	\$ 12,547	\$ 1,927	15.4%

NM = % not meaningful

Revenue increased \$1.9 million, or 15.4%, to \$14.5 million for the three months ended September 30, 2007 from \$12.5 million for the three months ended September 30, 2006. Total GaAs substrate revenue decreased \$0.7 million, or 6.2%, to \$9.9 million for the three months ended September 30, 2007 from \$10.6 million for the three months ended September 30, 2006.

Sales of 5 inch and 6 inch diameter GaAs substrates were \$3.1 million for the three months ended September 30, 2007 compared to \$5.3 million for the three months ended September 30, 2006. The decrease was due mainly to held shipments by a major customer who was transitioning to a new device in the third quarter of 2007 and encountered an issue with our substrates due to a change in their specifications, and held orders by another major customer that had an inventory adjustment causing 6 inch orders to be lower than normal. We expect both customers to resume orders beginning the fourth quarter of 2007.

Sales of 2 inch, 3 inch and 4 inch diameter GaAs substrates were \$6.8 million for the three months ended September 30, 2007 compared to \$5.3 million for the three months ended September 30, 2006. The increase in revenue from smaller diameter substrates was due to the continued market growth of LED laser diodes and commercial epitaxy.

InP revenue increased \$68,000, or 20.0%, to \$408,000 for the three months ended September 30, 2007 from \$340,000 for the three months ended September 30, 2006. InP substrate revenue increased due to some continued demand of specialized automotive applications, and overall optical communications applications. However, we do not expect significant near term changes in the market for InP.

Ge substrate revenue increased \$149,000, or 38.5%, to \$536,000 for the three months ended September 30, 2007 from \$387,000 for the three months ended September 30, 2006. The increase in Ge substrate revenue was due to a customer in Germany who has now qualified our product, as demand for photovoltaic and opto-electronic applications increases.

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Raw materials revenue increased \$2.4 million, or 189.4%, to \$3.6 million for the three months ended September 30, 2007 from \$1.3 million for the three months ended September 30, 2006. The increase in raw materials revenue was primarily due to sales of gallium to a customer in North America as the demand for gallium increases, as well as an increase in raw materials pricing. We expect this demand for gallium to continue at this pace.

	<b>Nine Months Ended</b>			
	<b>September 30,</b>	<b>September 30,</b>	<b>Increase</b>	<b>% Change</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>	
	<b>(\$ in thousands)</b>			
GaAs	\$ 27,997	\$ 25,441	\$ 2,556	10.0%
InP	1,586	1,249	337	27.0%
Ge	1,479	592	887	149.8%
Raw materials	9,532	4,083	5,449	133.5%
Other	45	8	37	462.5%
Total revenue	\$ 40,639	\$ 31,373	\$ 9,266	29.5%

Revenue increased \$9.3 million, or 29.5%, to \$40.6 million for the nine months ended September 30, 2007 from \$31.4 million for the nine months ended September 30, 2006. Total GaAs substrate revenue increased \$2.6 million, or 10.0%, to \$28.0 million for the nine months ended September 30, 2007 from \$25.4 million for the nine months ended September 30, 2006.

Sales of 5 inch and 6 inch diameter GaAs substrates were \$11.1 million for the nine months ended September 30, 2007 compared to \$11.4 million for the nine months ended September 30, 2006. The decrease was mainly due to the impact in the three months ended March 31, 2007 when we experienced a decrease in 6 inch diameter wafer sales from the prior quarter primarily due to less than expected orders from a few handset market customers, as well as less than expected sales to certain customers that did not materialize due to the delay in BIFET qualifications of those customers. In addition, in the three months ended September 30, 2007, a major customer who was transitioning to a new device delayed shipments of our products pending this transition, and encountered an issue with our substrates due to a change in their specifications. We also experienced a delay in shipments by another major customer that had an inventory adjustment causing 6 inch orders to be lower than normal. We expect to resume orders beginning the fourth quarter of 2007.

Sales of 2 inch, 3 inch and 4 inch diameter GaAs substrates were \$16.9 million for the nine months ended September 30, 2007 compared to \$13.9 million for the nine months ended September 30, 2006. The increase in revenue from smaller diameter substrates was due to the continued market growth generally of LED laser diodes and commercial epitaxy.

InP revenue increased \$337,000, or 27.0%, to \$1.6 million for the nine months ended September 30, 2007 from \$1.2 million for the nine months ended September 30, 2006. The increase in InP revenue was primarily due to a one-time sale of \$251,000 indium scrap metal, while InP substrate revenue increased slightly from customers in the optical networking industry. However, we do not expect significant near term changes in the market for InP, and we do not expect to sustain this increased level of InP revenue.

Ge substrate revenue increased \$887,000, or 149.8%, to \$1.5 million for the nine months ended September 30, 2007 from \$592,000 for the nine months ended September 30, 2006. The increase in Ge substrate revenue was due to a customer in Germany who has now qualified our product, as demand for photovoltaic and opto-electronic applications continues to increase.

Raw materials revenue increased \$5.4 million, or 133.5%, to \$9.5 million for the nine months ended September 30, 2007 from \$4.1 million for the nine months ended September 30, 2006. The increase in raw materials revenue was primarily due to sales of gallium to new customers in Japan and Europe, and increased demand by a customer in North America as the demand for gallium increases, as well as an increase in raw materials pricing. We expect this demand for gallium to continue at this pace.

*Revenue by Geographic Region*





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	Three Months Ended		Increase	
	September 30, 2007	September 30, 2006	(Decrease)	% Change
	(\$ in thousands)			
North America *	\$ 2,820	\$ 3,033	\$ (213)	(7.0)%
<i>% of total revenue</i>	19.5%	24.2%		
Europe	2,521	2,012	509	25.3%
<i>% of total revenue</i>	17.4%	16.0%		
Japan	3,301	842	2,459	292.0%
<i>% of total revenue</i>	22.8%	6.7%		
Taiwan	2,444	2,869	(425)	(14.8)%
<i>% of total revenue</i>	16.9%	22.9%		
Asia Pacific (excluding Japan and Taiwan)	3,388	3,791	(403)	(10.6)%
<i>% of total revenue</i>	23.4%	30.2%		
Total revenue	\$ 14,474	\$ 12,547	\$ 1,927	15.4%

\* Primarily the United States

North America revenue decreased by \$0.2 million, or 7.0%, to \$2.8 million for the three months ended September 30, 2007 from \$3.0 million for the three months ended September 30, 2006. In the three months ended September 30, 2006 one new customer bought \$0.3 million 4 semi-insulating wafers for the first time, and has never purchased from us since. That decline in substrate wafer sales was partially offset by an increase in raw material sales.

Europe revenue increased by \$0.5 million, or 25.3%, to \$2.5 million for the three months ended September 30, 2007 from \$2.0 million for the three months ended September 30, 2006. This increase came primarily from increased substrate sales to customers in Germany partially offset by decreased sales to customers in France.

Japan revenue increased by \$2.5 million, or 292.0%, to \$3.3 million for the three months ended September 30, 2007 from \$0.8 million for the three months ended September 30, 2006. The increase came from three new customers for raw materials sales amounting to \$1.9 million, while substrate sales to existing customers increased by \$0.6 million.

Taiwan revenue decreased by \$0.4 million, or 14.8%, to \$2.4 million for the three months ended September 30, 2007 from \$2.9 million for the three months ended September 30, 2006. The decrease was due mainly to a major customer who was transitioning to a new device delayed shipments of our products pending this transition, and encountered an issue with our substrates due to a change in their specifications. We expect this customer to resume orders beginning the fourth quarter of 2007.

Asia Pacific (excluding Japan and Taiwan) revenue decreased by \$0.4 million, or 10.6%, to \$3.4 million for the three months ended September 30, 2007 from \$3.8 million for the three months ended September 30, 2006. The decrease was due mainly to reduced sales to our customers in Malaysia and Singapore from a fall in demand.

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	Nine Months Ended		Increase (Decrease)	% Change
	September 30, 2007	September 30, 2006		
	(\$ in thousands)			
North America *	\$ 8,918	\$ 7,704	\$ 1,214	15.8%
<i>% of total revenue</i>	21.9%	24.6%		
Europe	7,163	5,684	1,479	26.0%
<i>% of total revenue</i>	17.6%	18.1%		
Japan	8,699	2,638	6,061	229.8%
<i>% of total revenue</i>	21.4%	8.4%		
Taiwan	6,512	5,782	730	12.6%
<i>% of total revenue</i>	16.0%	18.4%		
Asia Pacific (excluding Japan and Taiwan)	9,347	9,565	(218)	(2.3)%
<i>% of total revenue</i>	23.0%	30.5%		
Total revenue	\$ 40,639	\$ 31,373	\$ 9,266	29.5%

\* Primarily the United States

North America revenue increased by \$1.2 million, or 15.8%, to \$8.9 million for the nine months ended September 30, 2007 from \$7.7 million for the nine months ended September 30, 2006. The increase was due to approximately \$0.7 million more raw material sales, a one-time sale of \$0.3 million indium scrap metal, and \$0.2 million of increased substrate sales.

Europe revenue increased by \$1.5 million, or 26.0%, to \$7.2 million for the nine months ended September 30, 2007 from \$5.7 million for the nine months ended September 30, 2006. This increase came primarily from increased substrate sales to customers in Germany and Russia, partially offset by decreased substrate sales to customers in France, and increased raw materials sales to customers in the Netherlands.

Japan revenue increased by \$6.1 million, or 229.8%, to \$8.7 million for the nine months ended September 30, 2007 from \$2.6 million for the nine months ended September 30, 2006. The increase came from five new customers for raw materials amounting to \$4.8 million, while substrate sales to existing customers increased by \$1.3 million due to higher demand.

Taiwan revenue increased by \$0.7 million, or 12.6%, to \$6.5 million for the nine months ended September 30, 2007 from \$5.8 million for the nine months ended September 30, 2006. We had \$2.2 million increased sales in small diameter wafers as demand grew, partially offset by \$1.4 million decrease in sales of large diameter wafers from a major customer who was transitioning to a new device delayed shipments of our products pending this transition, and encountered an issue with our substrates due to a change in their specifications. We expect this customer to resume orders beginning the fourth quarter of 2007.

Asia Pacific (excluding Japan and Taiwan) revenue decreased by \$0.2 million, or 2.3%, to \$9.3 million for the nine months ended September 30, 2007 from \$9.6 million for the nine months ended September 30, 2006. We had a decrease in raw material sales of \$1.0 million as demand dropped slightly in P.R. China, offset by an increase of \$0.8 million in small diameter substrate sales to customers in P.R. China.

**Gross Margin**

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	Three Months Ended		Increase (Decrease)	% Change
	September 30, 2007	September 30, 2006		
	(\$ in thousands)			
Gross profit	\$ 4,530	\$ 3,479	\$ 1,051	30.2%
Gross Margin %	31.3%	27.7%		

*Gross margin.* Gross margin increased to 31.3% of total revenue for the three months ended September 30, 2007 from 27.7% of total revenue for the three months ended September 30, 2006. Gross margin for the three months ended September 30, 2007 was positively impacted by sales of approximately \$0.6 million of gallium arsenide ( GaAs ) wafers that were previously fully reserved. Product mix also contributed to higher gross margins as we sold a greater amount of raw

materials which contributed higher gross margins. In addition, we had manufacturing equipment that has become fully depreciated since the third quarter of 2006, and the absence of depreciation expense for this equipment, partially offset by depreciation on property, plant and equipment additions, contributed approximately 1.8 percentage points to gross margin for the three months ended September 30, 2007. Finally, higher substrate gross margins were also achieved through better slicing techniques, longer length ingot growth, shorter runtimes, and higher production volumes, partially offset by higher prices of raw materials for gallium and arsenic. Gross margin for the three months ended September 30, 2006 was positively impacted by sales of approximately \$0.8 million of GaAs wafers which were previously fully reserved.

	<b>Nine Months Ended</b>			
	<b>September 30,</b>		<b>Increase</b>	
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>	<b>% Change</b>
	<b>(\$ in thousands)</b>			
Gross profit	\$ 14,967	\$ 7,748	\$ 7,219	93.2%
Gross Margin %	36.8%	24.7%		

*Gross margin.* Gross margin increased to 36.8% of total revenue for the nine months ended September 30, 2007 from 24.7% of total revenue for the nine months ended September 30, 2006. Gross margin for the nine months ended September 30, 2007 was positively impacted by sales of approximately \$1.7 million of GaAs wafers that were previously fully reserved. Product mix also contributed to higher gross margins as we sold InP scrap metal, as well as raw materials, both of which contributed higher gross margins. In addition, we had manufacturing equipment that has become fully depreciated since the third quarter of 2006, and the absence of depreciation expense for this equipment, partially offset by depreciation on property, plant and equipment additions, contributed approximately 2.5 percentage points to gross margin for the nine months ended September 30, 2007. Finally, higher substrate gross margins were also achieved through better slicing techniques, longer length ingot growth, shorter runtimes, and higher production volumes, partially offset by higher prices of raw materials for gallium and arsenic. Gross margin for the nine months ended September 30, 2006 was positively impacted by sales of approximately \$2.2 million of GaAs wafers, which were previously fully reserved, and by approximately \$53,000 as a result of a reversal of a sales return reserve established in 2004 as we favorably resolved an outstanding matter with a customer.

#### *Selling, General and Administrative Expenses*



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	Three Months Ended		Increase (Decrease)	% Change
	September 30, 2007	September 30, 2006		
	(\$ in thousands)			
Selling, general and administrative expenses	\$ 3,083	\$ 2,641	\$ 442	16.7%
<i>% of total revenue</i>	21.3%	21.0%		

Selling, general and administrative expenses increased \$0.4 million to \$3.1 million for the three months ended September 30, 2007 from \$2.6 million for the three months ended September 30, 2006. The increase was primarily \$0.2 million in general increases in employee salaries and related costs in 2007 over 2006, as well as \$0.2 million higher bad debt expenses mainly for our slow-paying customers in Asia, \$0.3 million in higher legal fees mainly because 2006 included a \$0.3 million refund from insurance, partially offset by \$0.3 million lower decontamination fees on our property in Fremont, California.

	Nine Months Ended		Increase (Decrease)	% Change
	September 30, 2007	September 30, 2006		
	(\$ in thousands)			
Selling, general and administrative expenses	\$ 10,529	\$ 9,724	\$ 805	8.3%
<i>% of total revenue</i>	25.9%	31.0%		

Selling, general and administrative expenses increased \$0.8 million to \$10.5 million for the nine months ended September 30, 2007 from \$9.7 million for the nine months ended September 30, 2006. The increase was primarily due to \$0.2 million higher bad debt expenses mainly for our slow-paying customers in Asia, a \$0.4 million bad debt recovery taken in 2006 which was provided for an Asian customer in late 2005, and \$0.2 million in higher salaries and related costs in 2007 over 2006.

**Research and Development**

	<b>Three Months Ended September 30,</b>		<b>Increase</b>	<b>% Change</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>	
	(\$ in thousands)			
Research and development	\$ 382	\$ 392	\$ (10)	(2.6)%
<i>% of total revenue</i>	2.6%	3.1%		

Research and development expenses decreased \$10,000, or 2.6% to \$382,000 for the three months ended September 30, 2007 from \$392,000 for the three months ended September 30, 2006, mainly from \$70,000 savings in salary and related costs as a result of the retirement of Dr. Morris Young, our former Chief Technology Officer effective December 31, 2006, partially offset by \$60,000 in increased new products testing expenses.

	<b>Nine Months Ended September 30,</b>		<b>Increase</b>	<b>% Change</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>	
	(\$ in thousands)			
Research and development	\$ 1,190	\$ 1,497	\$ (307)	(20.5)%
<i>% of total revenue</i>	2.9%	4.8%		

Research and development expenses decreased \$0.3 million, or 20.5% to \$1.2 million for the nine months ended September 30, 2007 from \$1.5 million for the nine months ended September 30, 2006, mainly from \$0.4 million savings in salary and related costs as a result of the retirement of Dr. Morris Young, our former Chief Technology Officer effective December 31, 2006 and the reduction in engineering headcount including severance pay, partially offset by increased new products testing expenses of \$0.1 million.

**Impairment (recovery of impairment) on assets held for sale**

	<b>Three Months Ended September 30,</b>		<b>Increase</b>	<b>% Change</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>	
	(\$ in thousands)			
Impairment on assets held for sale	\$	\$ 1,417	\$ (1,417)	NA
<i>% of total revenue</i>	NA	11.3%		

During the three months ended September 30, 2006, we incurred an impairment charge of \$1.4 million to write down our U.S. property located in Fremont, California, which had been decontaminated and was being prepared for sale. That property had been classified as Assets held for sale in the amount of \$4.7 million on the condensed consolidated balance sheet as of December 31, 2006.

	<b>Nine Months Ended September 30,</b>		<b>Increase</b>	<b>% Change</b>
	<b>2007</b>	<b>2006</b>	<b>(Decrease)</b>	
	(\$ in thousands)			
Impairment (Recovery of impairment) on assets held for sale	\$ (481)	\$ 1,417	\$ (1,898)	(133.9)%

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*% of total revenue*

(1.2)%

4.5%

During the nine months ended September 30, 2007, we benefited from a recovery of impairment on assets held for sale in connection with our adjustment of the fair value of our U.S. property located in Fremont, California, which had been decontaminated and is being prepared for sale. Accordingly, we recorded a \$481,000 market value adjustment after we entered into an agreement with an independent third party purchaser in June 2007 to purchase the property for estimated net proceeds of \$5.1 million, after deducting estimated commission and selling expenses. Subsequent to the three and nine months ended September 30, 2007, we received a notice from this third party purchaser terminating the agreement to purchase the property. On October 22, 2007, we entered into a new agreement with a different independent third party purchaser to purchase the property for \$5.65 million, subject to certain contingencies.

During the nine months ended September 30, 2006, we incurred an impairment charge of \$1.4 million to write down our U.S. property located in Fremont, California, which had been decontaminated and was being prepared for sale. That property had been classified as Assets held for sale in the amount of \$4.7 million on the condensed consolidated balance sheet as of December 31, 2006.



*Interest Income, net*



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	Three Months Ended		Increase (Decrease)	% Change
	September 30, 2007	September 30, 2006		
Interest income, net	\$ 102	\$ 103	\$ (1)	(1.0)%
<i>% of total revenue</i>	0.7%	0.8%		

Interest income, net was comparable at \$0.1 million for the three months ended September 30, 2007 and 2006.

	Nine Months Ended		Increase (Decrease)	% Change
	September 30, 2007	September 30, 2006		
Interest income, net	\$ 551	\$ 342	\$ 209	61.1%
<i>% of total revenue</i>	1.4%	1.1%		

Interest income, net increased \$0.2 million to \$0.6 million for the nine months ended September 30, 2007 from \$0.3 million for the nine months ended September 30, 2006 as a result of higher balances of our investments which came from the net proceeds of our public offering of common stock, completed in December 2006 and January 2007.

***Other Income and Expense, net***



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	Three Months Ended September 30,		Increase (Decrease)	% Change
	2007	2006		
Other income (expense), net	\$ (156)	\$ 641	\$ (797)	(124.3)%
<i>% of total revenue</i>	(1.1)%	5.1%		

Other expense was \$0.2 million for the three months ended September 30, 2007 due to the minority interests in our joint ventures. Other income was \$0.6 million for the three months ended September 30, 2006 due to a realized gain of \$0.7 million on the sale of shares of common stock of Finisar Corporation which we no longer hold, partially offset by minority interests in our joint ventures.

	Nine Months Ended September 30,		Increase (Decrease)	% Change
	2007	2006		
Other income (expense) net	\$ (439)	\$ 1,693	\$ (2,132)	(125.9)%
<i>% of total revenue</i>	(1.1)%	5.4%		

Other expense was \$0.4 million for the nine months ended September 30, 2007 due to the minority interests in our joint ventures. Other income was \$1.7 million for the nine months ended September 30, 2006 due to a realized gain of \$2.2 million on the sale of shares of common stock of Finisar Corporation which we no longer hold, partially offset by minority interests in our joint ventures.

*Provision for Income Taxes*



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	Three Months Ended September 30,		Increase (Decrease)	% Change
	2007	2006		
Provision (benefit) for income taxes	\$ 153	\$ (862)	\$ (1,015)	(117.7)%
<i>% of total revenue</i>	1.1%	(6.9)%		

We provided for income taxes of \$0.2 million for our China operations for the three months ended September 30, 2007. For the three months ended September 30, 2006, we reversed approximately \$1.0 million of income tax payable accrued for potential exposures relating to 1999 and 2000 net operating loss carryback as a benefit from income taxes in 2006, offset by a provision for income taxes of \$0.1 million, which was related to our China operations.

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	Nine Months Ended September 30,		Increase	% Change
	2007	2006	(Decrease)	
	(\$ in thousands)			
Provision (benefit) for income taxes	\$ 426	\$ (406)	\$ (832)	(204.9)%
<i>% of total revenue</i>	1.0%	(1.3)%		

We provided for income taxes of \$0.4 million for our China operations for the nine months ended September 30, 2007. For the nine months ended September 30, 2006, we reversed approximately \$1.0 million of income tax payable accrued for potential exposures relating to 1999 and 2000 net operating loss carryback as a benefit from income taxes in 2006, partially offset by a provision for income taxes of \$0.5 million, which was related to our China operations.

***Gain from Discontinued Operations***





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	Three Months Ended September 30,		Increase (Decrease)	% Change
	2007	2006		
	(\$ in thousands)			
Gain from discontinued operations	\$	\$ 4	\$ (4)	(100.0)%
<i>% of total revenue</i>		NA		0.0%

In January, 2007, we dissolved the corporation that operated our discontinued operations that related to our opto-electronics business and transferred the cash balance to our continuing operations. Accordingly, we no longer have discontinued operations. For the three months ended September 30, 2006, the \$4,000 in income was from interest income earned on cash balances held in the discontinued operations.

	Nine Months Ended September 30,		Increase (Decrease)	% Change
	2007	2006		
	(\$ in thousands)			
Gain from discontinued operations	\$	\$ 7	\$ (7)	(100.0)%
<i>% of total revenue</i>		NA		0.0%

In January 2007, we dissolved the corporation that operated our discontinued operations that related to our opto-electronics business and transferred the cash balance to our continuing operations. Accordingly, we no longer have discontinued operations. For the nine months ended September 30, 2006, the \$7,000 in income was from interest income earned on cash balances held in the discontinued operations.

### Liquidity and Capital Resources

As of September 30, 2007, our principal sources of liquidity were \$35.2 million in cash and cash equivalents and short-term investments, excluding restricted deposits. We consider cash and cash equivalents and short-term investments as liquid and available for use. Short-term investments are comprised of government bonds and high-grade commercial debt instruments.

Cash and cash equivalents and short-term investments decreased \$0.3 million to \$35.2 million as of September 30, 2007 compared with \$35.5 million as of December 31, 2006. Included in this decrease are the purchase of machinery and equipment of \$2.8 million, payments of long-term debt of \$0.5 million, and the continual funding of our operations, partially offset by the net proceeds of \$3.7 million received from the public offering of 862,500 shares of our common stock in January 2007, and a China tax refund of \$0.9 million from our PRC subsidiary.

Net cash used in operating activities of \$2.6 million for the nine months ended September 30, 2007 was primarily comprised of our net income of \$3.4 million, adjusted for non-cash items of depreciation of \$1.1 million, stock based compensation of \$0.3 million, partially offset by a recovery of impairment on assets held for sale of \$0.5 million, and offset by a net increase of \$6.9 million in assets and liabilities. The net increase in assets and liabilities resulted from a \$4.7 million increase in inventories, a \$2.2 million increase in accounts receivable, net, a \$1.1 million decrease in accounts payable, and a \$0.7 million increase in other assets and partially offset by a \$0.5 million decrease in prepaid expenses, an increase of \$0.5 million in accrued liabilities, and a \$0.3 million decrease in income taxes payable.



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Inventories increased by \$4.9 million, or 24.0%, to \$25.1 million as of September 30, 2007 compared with \$20.3 million as of December 31, 2006, as we increased inventory in raw materials, work-in-process, and finished goods to increase production in anticipation of increased forecast sales and increased costs of raw materials. The value of finished goods held as consignment inventory increased by \$0.6 million as we increased our number of consignees from four to six.

Accounts receivable, net increased by \$2.3 million, or 23.7%, to \$11.9 million as of September 30, 2007 compared to \$9.7 million as of December 31, 2006. Gross accounts receivable increased by \$2.7 million from \$9.8 million to \$12.5 million as revenue increased. The allowance for doubtful accounts increased by \$0.5 million from \$0.1 million to \$0.6 million mainly for slow-paying customers in Asia. We continue to pursue collections on slow-paying customers. Our days sales outstanding is 76 days as of September 30, 2007 compared to 68 days as of December 31, 2006.

Net cash used in investing activities of \$0.5 million for the nine months ended September 30, 2007 was primarily for the purchase of investments totaling \$22.7 million, the purchase of property, plant and equipment of \$2.8 million, partially offset by the proceeds from sale of investments of \$24.5 million and the decrease of restricted cash of \$0.5 million.

We expect to invest approximately \$2.1 million in capital projects for the remainder of 2007. We believe that our existing and planned facilities and equipment are sufficient to fulfill current and expected future orders.

Net cash provided by financing activities of \$3.8 million for the nine months ended September 30, 2007 consisted of \$3.7 million net proceeds from the issuance of 862,500 shares of common stock as a result of our January 2007 closing of our public offer of our common stock and \$0.7 million from employee stock options exercised, partially offset by payments of \$0.5 million related to long-term borrowings.

Our main Fremont, California facility is financed by long-term borrowings, which were refinanced by taxable variable rate revenue bonds in 1998. These bonds mature in 2023 and bear interest at a variable rate that was 5.23% as of September 30, 2007. The bonds are traded in the public market. Repayment of principal and interest under the bonds is supported by a letter of credit from our bank and is paid on a quarterly basis. We have the option to redeem the bonds in whole or in part during their term. As of September 30, 2007, \$6.7 million was outstanding under these bonds.

As of September 30, 2007, the credit facility maintained by us with a bank included a letter of credit supporting repayment of our revenue bonds with an outstanding amount of \$6.7 million. We have pledged and placed a like amount of investment securities with an affiliate of the bank as additional collateral for this facility.

On October 22, 2007, we entered into a new sales agreement with an independent third party to sell our main Fremont, California facility. We estimate our net proceeds will be approximately \$5.4 million after deducting sales commission and other selling expenses. We expect to close escrow in the fourth quarter of 2007. Please refer to Note 14 to the condensed consolidated financial statements for further details.

We believe that we have adequate cash and investments to meet our needs over the next 12 months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to those set forth below under Item 1A Risks Factors.

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Outstanding contractual obligations as of September 30, 2007 are summarized as follows (in thousands):

Contractual Obligations	Total	Payments due by period			
		Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
Debt	\$ 6,745	\$ 450	\$ 945	\$ 750	\$ 4,600
Operating leases	4,057	659	1,476	1,564	357
Purchase obligation	6,105	4,860	1,245		
Total	\$ 16,907	\$ 5,969	\$ 3,666	\$ 2,314	\$ 4,957

We lease certain office space, manufacturing facilities and property under long-term operating leases expiring at various dates through March 2013. Total rent payments under these operating leases were approximately \$0.5 million and \$0.8 million for the nine month periods ended September 30, 2007 and 2006, respectively.

On February 27, 2007, we entered into an agreement with Recapture Metals Limited of Ontario, Canada ( Recapture ), pursuant to which Recapture will supply our subsidiary in the People's Republic of China with one thousand kilograms per month of 99.99999% pure gallium, during the eighteen month period beginning July 1, 2007 for a total value of \$7.3 million. Under the terms of the agreement, we are required to purchase a minimum of eighteen thousand kilograms of gallium, unless the agreement is terminated prior to the expiration of the eighteen month period on December 31, 2008. As of September 30, 2007, our total remaining commitment under this agreement is approximately \$6.1 million.

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

#### Foreign Currency Exchange Rate Exposure

We operate in the United States, manufacture in the People's Republic of China ( PRC ), and the substantial majority of our sales to date have been made in U.S. dollars. Certain expenses from our PRC operations are incurred in the PRC's Renminbi. As a result, currency fluctuations between the U.S. dollar and the Renminbi could cause foreign currency transaction gains or losses that we would recognize in the period incurred. However, a 10% fluctuation in the dollar at September 30, 2007 would have an immaterial impact on our net dollar position in outstanding trade payables and receivables.

Since July 2005, when the PRC uncoupled the Renminbi from the U.S. dollar and began to permit it to float in a narrow band against a basket of foreign currencies, the Renminbi has progressively appreciated at an accelerating rate against the U.S. dollar. However, the government of the PRC has yet to allow the Renminbi to float, or to be freely traded against foreign currencies. Accordingly, it is uncertain whether, and to what extent, further adjustments will follow. Regardless of whether the PRC government allows the Renminbi-U.S. dollar exchange rate to float in the future, the Renminbi could likely continue to appreciate further relative to the U.S. dollar.

We expect our international revenues and expenses to continue to be denominated largely in U.S. dollars. We also believe that our PRC operations will likely expand in the future as our business continues to grow. As a result, we anticipate that we may experience increased exposure to the risks of fluctuating currencies and may choose to engage in currency hedging activities to reduce these risks. However, we cannot be certain that any such hedging activities will be effective, or available to us at commercially reasonable rates.

#### Interest Rate Risk

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

Instrument	Balance as of September 30, 2007	Current Interest Rate	Projected Annual Interest Income/(Expense)	Proforma 10% Interest Rate Decline Income/(Expense)	Proforma 10% Interest Rate Increase Income/(Expense)
Cash	\$ 6,800	0.50%	\$ 34	\$ 31	\$ 37
Cash equivalents	10,267	5.29	543	489	597
	24,874	4.99	1,241	1,117	1,365

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Investment in debt and equity instruments					
Taxable variable rate revenue bonds	(6,700)	5.23	(350)	(315)	(385)
		\$	1,468	\$	1,614

## Equity Risk

We maintain minority investments in two privately-held U.S. companies. We maintain a minority investment in Global Communication Semiconductors, Inc. (GCS) as a result of its acquisition of Alpha Photonics, Inc. We also maintain a minority investment in Intelligent Epitaxy Technology, Inc. (IntelliEPI) as a result of certain in-kind contracts whereby we delivered GaAs and InP wafers to IntelliEPI and IntelliEPI agreed to issue shares of its Series B Preferred Stock in return in year 2000. These investments are reviewed for other than temporary declines in value on a quarterly basis. These investments are classified as other assets in the consolidated balance sheets and are accounted for under the cost method as we do not have the ability to exercise significant influence over their operations. We monitor our investments for impairment and record reductions in carrying value when events or changes in circumstances indicate that the carrying value may not be recoverable. Reasons for other than temporary declines in value include whether the related company would have insufficient cash flow to operate for the next twelve months, significant changes in the operating performance and changes in market conditions. The minority investments totaled \$0.4 million as of December 31, 2006 and September 30, 2007.

## ITEM 4T. CONTROLS AND PROCEDURES

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

(b) No change in our internal control over financial reporting was made during the quarter ended September 30, 2007, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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

On October 15, 2004, a purported securities class action lawsuit was filed in the United States Court for the Northern District of California, City of Harper Woods Employees Retirement System v. AXT, Inc. et al., No. C 04 4362 MJJ. The Court consolidated the case with a subsequent related case and appointed a lead plaintiff. On April 5, 2005, the lead plaintiff filed a consolidated complaint, captioned as Morgan v. AXT, Inc. et al., No. C 04 4362 MJJ. The lawsuit complaint names AXT, Inc. and our chief technology officer as defendants, and is brought on behalf of a class of all purchasers of our securities from February 6, 2001 through April 27, 2004. The complaint alleges that we announced financial results during this period that were false and misleading. No specific amount of damages is claimed. On September 23, 2005, the Court granted our motion to dismiss the complaint, with leave to amend. The lead plaintiff filed an amended complaint, which we had moved to dismiss. On April 24, 2007, we reached a settlement of this litigation for which we are responsible only for the amount remaining in our insurance retention. We paid the remaining amount of the retention (approximately \$350,000) as of September 30, 2007.

On June 1, 2005, a lawsuit was filed in the Superior Court of California, County of Alameda, Zhao et al. v. American Xtal Technology, et al., No. R 605215713. The lawsuit complaint names as defendants AXT, Inc., our chief technology officer and one of our suppliers. The lawsuit was brought on behalf of two former employees and their minor child. The complaint alleged personal injury, general negligence, intentional tort, wage loss and other damages, including punitive damages, as a result of exposure of the child while in utero to high levels of gallium arsenide and methanol used in the production of gallium arsenide wafers. On April 23, 2007, we reached a settlement of this litigation, all of which is covered by our insurance carriers.

### Item 1A. Risk Factors

There are no material changes from the risk factors set forth under Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, provided, however, that the two litigation matters described under the risks disclosed under the captions *If we fail to comply with environmental and safety regulations, we may be subject to significant fines or forced to cease our operations; in addition, we could be subject to suits for personal injuries caused by hazardous materials* and *Existing or future litigation could result in significant judgments against us, or cause us to incur costly settlements.* These two settled matters comprise (i) the complaint filed against us and a current and former officer, alleging personal injury, general negligence, intentional tort, wage loss and other damages as a result of exposure of plaintiffs, who are former employees of AXT, including a minor child in utero, to high levels of gallium arsenide in gallium arsenide wafers, and methanol, and (ii) the ongoing securities litigation matter.

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

#### *Use of Proceeds*



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On December 19, 2006 and January 9, 2007, we sold 5,750,000 shares and 862,500 shares, respectively, of our common stock in a firmly underwritten public offering pursuant to a registration statement on Form S-3 (SEC file number 333-135474), which was declared effective by the SEC on August 3, 2006, and a registration statement on Form S-3MEF (SEC file number 333-139365), which was effective upon filing with the SEC on December 15, 2006. Needham & Company, LLC acted as the sole underwriter. The price per share to the public was \$4.50. We received net proceeds of \$24.1 million and \$3.7 million, for an aggregate net proceeds of \$27.8 million. The net proceeds have been and will continue to be used for corporate and joint venture capacity expansion, research and development and working capital requirements, as well as potential acquisitions of complementary products, technologies or businesses.

**Item 3. Defaults upon Senior Securities**

None

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

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

**a. Exhibits**

Exhibit Number	Description
3.1(1)	Restated Certificate of Incorporation
3.2(2)	Certificate of Designation, Preferences and Rights of Series A Preferred Stock (which is incorporated here in reference to Exhibit 2.1 to the registrant's Form 8-K dated May 28, 1999).
3.3(3)	Second Amended and Restated By Laws
4.2(3)	Rights Agreement dated April 24, 2001 by and between AXT, Inc. and ComputerShare Trust Company, Inc.
10.24(4)	Purchase and Sale Agreement dated October 22, 2007 by and between AXT, Inc. and SBC&D Co., Inc., a California Corporation, dba South Bay Development.
31.1	Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

(2) Incorporated by reference to the exhibit as of the same number as filed with the SEC in our Form 8-K on June 14, 1999.

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

(4) Incorporated by reference to the exhibit as of the same number as filed with the SEC in our Form 8-K on October 25, 2007.

**SIGNATURES**

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

AXT, INC.

Dated: November 7, 2007

By:

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

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

**EXHIBIT INDEX**

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