NEXT LEVEL COMMUNICATIONS INC
Form 10-K
April 01, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2001
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 NO. 0-27877

NEXT LEVEL COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	95-3342408
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6085 STATE FARM DRIVE
ROHNERT PARK, CA 94928
(Address of principal executive offices)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE:
(707) 584-6820

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:

TITLE OF CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Common Stock, par value $0.01	Nasdaq National Market

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the

best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

The aggregate market value of our voting and non-voting common equity held by non-affiliates is $32,045,212 as of March 20, 2002.

As of March 20, 2002, we have 85,999,133 outstanding shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENTS	FORM 10-K REFERENCES
Our Definitive Proxy Statement for our 2002 Annual Meeting of Stockholders	Part III

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PART I

ITEM 1. BUSINESS

This Annual Report on Form 10-K of Next Level Communications, Inc. includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with these safe harbor provisions. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions, including those in the section entitled "Risk Factors" in this annual report. Actual results may vary materially from these forward-looking statements as a result of these and other risks.

Words such as "expect," "anticipate," "intend," "plan," "believe," "estimate" and variations of these words and similar expressions are intended to identify forward-looking statements. We undertake no obligations to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless we are required to do so by law. In light of these risks, uncertainties and assumptions, the forward-looking events discussed below might not occur.

OVERVIEW

We design and market broadband communications equipment that enables telephone companies and other communications service providers to cost-effectively deliver a full suite of voice, high-speed data and digital video services over the existing copper telephone wire infrastructure. Service providers who deploy our equipment can either offer voice, data and video services in a single product offering or offer each service separately depending on subscriber demand and the service provider's objectives. We believe that by installing our equipment, telephone companies and other emerging communications service providers will be able to capitalize on, and compete effectively in, the emerging market for integrated voice, data and video services. Our products consist of equipment located at the telephone company's central office or exchange, in the field and at the subscriber's home or business.

We commenced operations in July 1994 and recorded our first sale in September 1997. From January 1998 until November 1999, we operated through Next Level Communications L.P., which was formed as the result of the transfer of all of the net assets, management and workforce of a wholly-owned subsidiary of General Instrument. In November 1999, the business and assets of that partnership were merged into Next Level Communications, Inc. as part of our recapitalization. In November 1999, we completed an initial public offering of our common stock, raising approximately $177.0 million in net proceeds. In January 2000, General Instrument was acquired by Motorola, Inc., making us an indirect subsidiary of Motorola. As a result of the transactions that occurred in connection with our recapitalization and subsequent borrowings, Motorola owns 64,103,724 shares of our common stock and warrants to acquire an additional 7.4 million shares of our common stock constituting approximately 61% of our outstanding common stock on a fully diluted basis as of December 31, 2001.

Our equipment is designed to provide the following key benefits:

Flexible, Integrated Products. We designed our products are designed with the flexibility to allow our customers to deliver voice, data and video services in a single packaged offering or to offer them individually. This flexibility

allows telephone companies to immediately serve the varying needs of their diverse end-user base, including residential, corporate and telecommuter customers. By offering the flexibility inherent in an integrated system, our products enable telephone companies to effectively time their network equipment expenditures and rapidly introduce new services as demand warrants.

Cost-Effective Product Deployment. Our product design reduces the cost and complexity often associated with deploying multiple services to end-users. Because telephone companies often use separate equipment for each communications service, they require multiple equipment purchases, installations, training

procedures, maintenance procedures and network management packages. In contrast, our products deliver all services from a single system. By integrating many traditionally separate functions, our products allow telephone companies to add services incrementally by simply installing new modules into our existing equipment, rather than purchasing entirely new infrastructure equipment. Additionally, our products installed in the house or office deliver video and data services from a single networked set-top box, thus eliminating the need for set-top boxes or modems for different services or separately located TVs and PCs. We believe our products provide cost savings, reduce trouble calls and ease installation compared to other equipment that often consists of separate systems, each of which corresponds to one service and which may not operate effectively together.

Complete Solution For Delivery of Voice, Data and Video. By supplying equipment for the telephone company central office, the field and the subscriber's home or office, we offer a single integrated system for the delivery of voice, data and video services. With our products, telephone companies initially deploying voice service can subsequently activate data and/or video service with a simple addition and installation of equipment at the subscriber's home or office. We believe the flexibility found in our products cannot currently be accomplished by attempting to integrate multiple systems from multiple vendors.

Reliable and Compatible Technology. Because our products provide multiple services, including voice, they are engineered to comply with rigorous industry standards for reliability and safety. We have also designed our products to operate with existing telephone company switches and billing systems, thereby minimizing the cost of using our products.

Security. We believe that our products produce greater security compared to cable systems that are based on shared network design in which data is broadcast to all users simultaneously. Security has always been important to individuals and businesses in voice transmission and is becoming increasingly important as e-commerce applications and video-on-demand services become more prevalent.

PRODUCTS

Our products include equipment located at a telephone company's central office, in the field and at a subscriber's home or business.

Broadband Digital Terminal. The Broadband Digital Terminal is the central element of our product suite, providing centralized access to both broadband and narrowband core networks and related voice, data and video services. The Broadband Digital Terminal is typically located in a telephone company's central office, or at a remote building basement or hut where it connects with central office equipment including voice and data switches and billing systems. On the subscriber side, the Broadband Digital Terminal provides high-speed connections

to remote Universal Service Access Multiplexers or Broadband Network Units that can support several thousand telephone subscribers or combinations thereof. The Broadband Digital Terminal has the capacity for broadband applications such as video-on-demand and high definition television. Also, because the Broadband Digital Terminal supports different remote terminals, changes to network layouts or transmission media, copper or fiber, do not require different Broadband Digital Terminals.

Universal Service Access Multiplexer. We designed the Universal Service Access Multiplexer to use existing copper wire to connect to a customer's home or office. This product can be connected with fiber optic cable to the Broadband Digital Terminal. Each Universal Service Access Multiplexer can support up to 32 video and/or data subscribers via Very High Bit Rate Digital Subscriber Line of Asymmetric Digital Subscriber Line technology or up to 96 voice subscribers. By using modular components, a single Universal Service Access Multiplexer enables multiple voice, data and video services. The Universal Service Access Multiplexer can be deployed in the telephone company's central office or remotely. Because the Universal Service Access Multiplexer is flexible in terms of where it can be located in the network, as well as the services it can support, its use can reduce both the costs and the complexity of deploying new high-speed data and video services.

Broadband Service Access Multiplexer. The Broadband Service Access Multiplexer is our latest remote terminal solution enabling the intelligent transport of voice, video, and data over a single twisted pair to the

home. This is the first commercially available Digital Subscriber Line service shelf that utilizes the global 998 standard for VDSL transport. The 998 standard provides an ADSL spectrally compatible spectrum plan and is designed to provide a means for multi-vendor equipment interoperability. The Broadband Service Access Multiplexer can be deployed in the telephone company's central office or remotely. The Broadband Service Access Multiplexer provides increased density of VDSL ports per shelf, substantially decreasing the cost per subscriber, and supports both Very High Bit Rate Digital Subscriber Line and Asymmetric Digital Subscriber Line cards, with 12 ports per card. The capacity is 12 line cards per shelf, totalling 144 Digital Subscriber Line ports per Broadband Service Access Multiplexer. Transport from the Broadband Digital Terminal to the Broadband Service Access Multiplexer is over a 622 megabit per second Optical Distribution Unit. The high-speed transport coupled with multicasting capability, which provides the intelligence to share the bandwidth of a single video channel over multiple homes, reduces costs of deploying high-speed as well as providing digital cable television competitive broadcast services.

Broadband Network Unit. The Broadband Network Unit is used with Fiber to the Curb installations where fiber optic cable is deployed up to a location relatively close to the customer's home or office. The Broadband Network Unit supports voice, data and video services, and can be mounted on a telephone pole, a pedestal or a wall. The Broadband Network Unit provides voice, high-speed data and video service for clusters of up to 16 video and/or data and up to 36 voice subscribers. Our Broadband Network Unit is particularly suited to situations where a new network is being built, or where existing copper wire is being upgraded by the installation of fiber optic cable as the transmission medium for residences or larger apartment buildings or offices. The advanced design and environmentally secure housing of the Broadband Network Unit helps to reduce in-field trouble calls.

N3 Residential Gateway 2000. Our N3 Residential Gateway product is a single set-top box that delivers integrated data and video services. One N3 Residential Gateway enables multiple televisions and PCs to be served from the

same copper line coming into the customer's home or office. Traditionally, the high cost of customer home or office equipment for broadband services has been a limiting factor in the deployment of broadband services to multiple televisions or personal computers. Historically, a customer would have to obtain multiple modems or set-top boxes to support services to multiple televisions or personal computers. In contrast, our N3 Residential Gateway simultaneously provides three independent high quality digital video streams that can be distributed throughout a home or office using standard coaxial cable. The N3 Residential Gateway also supports enhanced telephone services, such as an indicator on the television that a message is waiting on the customer's answering machine or service as well as on-screen caller ID. The data port in our N3 Residential Gateway supports high-speed connectivity to the Internet or remote work-at-home access.

N3 Residential Gateway 2100. The N3 Residential Gateway 2100 product is our latest single set-top box that delivers integrated data and video services. The form factor of this set-top box is both sleeker and lighter. The N3 Residential Gateway 2100 contains all of the advantages of three independent high quality digital video streams and enhanced telephone services as the N3 Residential Gateway 2000, but also contains increased memory, 16 bit graphics, home network options, applications on all streams, and lower deployment costs from integrated equipment. Additionally, this set-top box supports the global 998 standard for VDSL transport.

N3 ETHERset. Our N3 ETHERset is a data-only, desktop device that provides a powerful, low-cost solution for delivering high-speed Internet or data services to subscribers in residences, small businesses and branch offices and the like. Individual or multiple PCs can be connected to a single N3 ETHERset.

Element Management Systems. Our products can be managed remotely by our N3 View-1 Element Management System and our N3 View-2 Service Manager. The View-1 Element Management System enables service providers to manage our equipment and their other systems and products. The View-2 Service Manager enables service providers to manage delivery of voice, data and video services to their customers.

CUSTOMERS

We market and sell our products through our direct sales force to service providers. Qwest (formerly US WEST) accounted for 41%, 56% and 67% of our revenues in 2001, 2000 and 1999. Accordingly, we have

increased the percentage of our sales to the local, independent and international telephone companies. During 2001, we had 72 customers that had purchased at least $100,000 of our products.

We recorded our first sale to Qwest in September 1997 for deployment of video and data service to Qwest's customers in Phoenix, Arizona. In October 1998, Qwest selected our product to provide voice applications in six of the 14 states that Qwest serves. As a result of the merger between U S WEST and Qwest, Qwest slowed its purchases of our equipment in 2001 while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon their decision regarding the deployment of our product.

Our customers also include All West Communications, Bell Canada, Brandenburg Telephone Company, Cablevision, Centurytel Supply Group, Chibardun Telephone, Chillicothe Telephone, Citizens, Clearlake, Horizon, Horry Telephone Cooperative, Hutchinson Telephone, New ULM Telecom, Paul Bunyan Rural Telephone, South Central Rural Telephone Cooperative, Tri County Telephone, Unite Broadband

Services, Warwick Valley, Wood County and XIT Communications.

TECHNOLOGY

We believe the following key technologies have been instrumental in our ability to provide what we believe is the world's only integrated, complete solution for the delivery of integrated voice, high-speed data and digital video services over the existing telephone copper wires.

Advanced Application Specific Circuits Architecture. Applications Specific Circuits are custom-designed silicon circuits that are optimized for a specific task or set of tasks. These circuits are critical because they are performance-optimized to minimize gate counts, packaging size, power dissipation and cost. In addition, one of these circuits may be the only way to provide a new or novel function that is not available in an off-the-shelf circuit. Our engineers have substantial experience in the design of these circuits and have developed a portfolio of over 50 of these circuits, which enables flexible delivery of voice, data and video from a single system. We will continue to pursue additional service and system level Application Specific Circuits as a mechanism for protecting our intellectual property and to achieve ongoing cost reductions.

System Design and Integration Expertise. We employ a team of experienced system design and integration engineers in our research and development group. These individuals provide research, design and development resources and ensure that our products can be integrated by our customers. System integration by our customers is required on our specific access products, equipment at the consumer's home or business, and management systems, as well as the integration of our products into our customers' networks. System integration expertise is critical to the successful deployment of new advanced full service telecommunications systems and services by our customers.

Wavelength Division Multiplexing Technology. Our system uses a technology known as wavelength division multiplexing. This technology allows multiple optical signals to be carried on the same optical fiber. In particular, this technology is used to communicate two-way voice, data and video over a single optical fiber. This enables our customers to save fiber costs and increase bandwidth.

Software and Protocol Stacks. Most of the system software in our products has been developed internally using modern design principles and processes. Where appropriate, various third-party software packages have been integrated into the access system. Some examples include the real time operating system and various protocol stack software packages.

Standards-based Architecture. We support multiple industry standards to minimize interoperability issues and leverage industry hardware and software capabilities, and improve time to market. On the customer side of the network, we are working with industry standards for asynchronous digital subscriber line and very high-speed digital subscriber line standards to support various equipment at the customer's home or business. In addition, we are providing an open middleware environment for our family of Residential Gateway products that enable support for various third party interactive applications.

RESEARCH AND DEVELOPMENT

As of March 20, 2002, we have 112 full time employees and one independent contractor engaged in research and development. We believe that our future success depends on our ability:

- to adapt to the rapidly changing telecommunications environment;

- to maintain our expertise in core technologies; and

- to continue meeting and anticipating the evolving needs of telephone companies.

We continually review and evaluate technological changes affecting the telecommunications market and invest substantially in applications-based research and development. We are committed to an ongoing program of new product development that combines internal development efforts with strategic relationships and licensing or marketing arrangements relating to new products and technologies from outside sources.

We have focused our research and development expenditures for the past several years on creating a complete solution for the delivery of voice, data and video services using the existing infrastructure of telephone companies. We have also concentrated on developing the associated customer premises equipment, including our N3 Residential Gateway, and on developing our N3 View-1 Element Management Systems. In 2001, 2000 and 1999, research and development expenses were $46.9 million, $55.8 million and $48.5 million. We believe that our extensive experience in designing and implementing high-quality network components has enabled us to develop integrated systems solutions. We continually seek to constantly improve our existing products, including developing additional home and office products and higher speed interfaces for our products.

SALES AND MARKETING

We primarily market and sell our products through a direct sales force located in North America that consists of 34 people as of March 20, 2002. To date, sales activities have been focused primarily on Qwest and local, independent and international telephone markets. Because of the potential importance of our products to our customers' networks, we focus our selling efforts at many levels within each customer's organization.

We have a variety of marketing programs and initiatives to support the sale and distribution of our products. As of March 20, 2002, we have 14 full time employees engaged in marketing activities focusing on reaching technical experts within telephone companies and creating product awareness and credibility for our systems among telephone companies. A key factor to building brand awareness for our products is promoting the success of our customers deploying our products. We seek to educate telephone companies regarding the benefits of deploying broadband-ready equipment across a diverse subscriber base. We also build our brand name through continued publicity and referral efforts in both media and industry-centered activities, including editorial presence in various trade magazines, press releases, public speaking opportunities, national and regional trade show participation, advertising, Internet-based communication and promotion, media sponsorships and participation in industry standards activities.

MANUFACTURING

We seek to deliver our products on time and defect-free by capitalizing on the experience and expertise of strategic contract manufacturers. Based on their quality assurance and strengths in the volume manufacture of our products, we have established our primary contract manufacturing relationships with Sanmina-SCI Systems and Flextronics Enclosures. Using contract manufacturers allows us to reduce the costly investment in manufacturing capital.

We maintain only a limited in-house manufacturing capability for final

assembly, testing and integration of our products. Our internal manufacturing expertise is focused on product design for testability, design for manufacturability and the transfer of products from development to manufacturing. Our contract manufacturers typically assemble an account team of personnel representing all the essential functions to deliver products from prototype through volume production. This team works with our design, test and manufacturing engineers, and our quality, materials, logistics and program management teams. Our primary contract

manufacturers are certified under international quality standards. Although our contract manufacturers manage material procurement for the majority of the components that are incorporated in our products, we continue to manage the evaluation and selection of certain key components.

Our engineering team designs circuits and tests these designs using computer simulations. When the fundamental design is stable, our outsourced manufacturers make the circuits for testing. Upon completion of these tests, vendors such as Metalink, Oki Semiconductor, Broadcom, STMicroelectronics, Philips and Motorola manufacture the circuit in volume. Warranty and repair support is performed off-site by our contract manufacturers and by us at our Rohnert Park, California facility.

CUSTOMER SERVICE AND SUPPORT

We believe that successful long-term relationships with our customers require a service organization committed to customer satisfaction. As of March 20, 2002, we have 22 technical support employees at our headquarters or in the field. While not essential to the functionality of the product, we also offer a five-day training course for all new customers prior to receiving and installing a system. To date, revenues from customer service and support have been immaterial.

We provide direct support by telephone or at a customer's office or other location at any time. To monitor service activities, we maintain a customer call tracking system. We also maintain a dial-up analog modem connection or an Internet-based management interface to our equipment to assist with diagnostics.

COMPETITION

The market for providing equipment for local telecommunications networks is extremely competitive. The principal competitive factors in this market include, or are likely to include:

- product performance and price;
- features and reliability;
- technical support and service;
- relationships with phone companies and systems integrators;
- compliance with industry standards;
- compatibility with the products of other suppliers;
- sales and distribution capabilities;
- strength of brand name;

- long-term cost of ownership to communications providers; and

- general industry and economic conditions.

Many of our current and potential competitors have longer operating histories and greater name recognition and resources than we do. These competitors may undertake more extensive marketing campaigns than we do. In addition, these competitors may adopt more aggressive pricing policies than we do. Also, these competitors may devote substantially more resources to developing new products than we do. Many of our competitors have been consolidated with larger companies and now have even greater resources to compete with us.

Our significant current and potential competitors include Advanced Fibre Communications, Alcatel, Cisco Systems, Efficient Networks, Lucent Technologies, Nokia, Nortel Networks, RELTEC Corporation, BAE Systems, CNI Division, formerly GEC Marconi, Siemens and our largest stockholder, Motorola. Some of these competitors have existing relationships with our current and prospective customers, which could give them a competitive advantage over us as a preferred provider. In addition, we anticipate that other large companies, such as Matsushita Electric Industrial, which markets products under the Panasonic brand name,

Microsoft, Network Computer, Philips, Sony Corp., STMicroelectronics and Toshiba America, will likely introduce products that compete with our N3 Residential Gateway product in the future.

In addition, we are likely to face increasing competition from alternative technologies. In particular, cable operators are currently deploying products that deliver voice, high-speed data and video services over cable. Cable service providers that offer these packaged services will give subscribers the alternative of purchasing all communications services from a single service provider. If these services are implemented successfully, they will compete directly with the services offered by telephone companies using our products.

Consolidation in the telecommunications equipment industry may strengthen our competitors' position in our market. Consolidation of our competitors has occurred, and we expect it to continue to occur in the foreseeable future. For example, Alcatel acquired DSC Communications, Lucent acquired Ascend Communications, and GEC Marconi acquired RELTEC Corporation. Acquisitions such as these further strengthen our competitors' financial, technical and marketing resources and provide access to regional Bell operating company customers. As a result, these competitors are able to devote greater resources to the development, promotion, sale and support of their products. This consolidation may allow some of our competitors to penetrate new markets that we have targeted, such as the domestic local, independent and international telephone markets. If our competitors are successful in these markets, we will be harmed.

INTELLECTUAL PROPERTY

We rely on a combination of patent, copyright and trademark laws, and on trade secrets, confidentiality provisions and other contractual provisions to protect our intellectual property. These measures afford only limited protection. As of March 20, 2002, we have 25 issued patents in the United States and eight issued patents in foreign countries. We have 24 pending U.S. patent applications and 51 pending international patent applications. We market our products primarily under our own name and mark. We consider our trademarks to be valuable assets. We rely on patent, trademark, trade secret and copyright laws both to protect our proprietary technology and to protect us against claims from

others. We believe that we have direct intellectual property rights or rights under cross-licensing arrangements covering substantially all of our material technologies. Given the technological complexity of our systems and products, however, we cannot assure that claims of infringement will not be asserted against us or against our customers in connection with their use of our systems and products, nor can we assure the outcome of any such claims.

SOURCES AND AVAILABILITY OF MATERIALS

We contract for the manufacture of all of our products and have limited in-house manufacturing capabilities. We rely primarily on two large contract manufacturers: Sanmina-SCI Systems and Flextronics Enclosures. For a detailed discussion of these relationships and the risks associated with our dependence upon third-party manufacturers, see "Business -- Manufacturing" and "Risk Factors."

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers or we fail to obtain components in sufficient quantities when required, delivery of our products could be delayed. Additional sole-sourced components may be incorporated into our equipment in the future. We do not have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

ENVIRONMENTAL MATTERS

Our research and development operations are subject to certain federal, state, local and foreign environmental protection laws and regulations. These laws and regulations relate to the use, handling, storage, discharge and disposal of certain hazardous materials and wastes, the pre-treatment and discharge of process waste waters and the control of process air pollutants. We believe that we are in compliance in all material respects with applicable environmental regulations. If those laws and regulations become more stringent over time, we may not be able to comply in a timely manner, or comply at all. Compliance with new laws and

regulations could create significant compliance expenses, result in production suspension and delay, restrictions on expansion at present locations and require the acquisition of costly equipment. Non-compliance with laws and regulations could result in penalties and suspension of operations.

REGULATION OF CUSTOMERS

Although our products are not now directly subject to significant regulation by the Federal Communications Commission, (or "FCC"), or any other federal or state communications regulatory agency, our customers and their networks, into which our products are incorporated, are subject to government regulation. Accordingly, the effects of regulation on our customers may, in turn, affect our business, operating results and financial condition. FCC regulatory policies affecting either the willingness or the ability of telephone companies or cable operators to offer certain services and to purchase and install our products in their networks, or the terms on which these companies offer the services and conduct their businesses, may impede sales of our products.

Several FCC regulatory policies may affect the degree to which or way in which incumbent local exchange carriers, which we refer to as incumbent

carriers, principally the regional Bell operating companies, can or choose to make integrated voice, data and video offerings available. For example, the Telecommunications Act of 1996 requires incumbent carriers to offer their competitors cost-based access to certain parts of their networks to enable these competitors to provide telecommunications services. Current FCC rules identify the specific network elements that incumbent carriers must offer to their competitors to enable them to provide telecommunications services. The list of elements that must be unbundled, which is currently under review by the FCC, include the facilities and equipment used to provide broadband services, including high-speed data services. Over the past year, the FCC has initiated several related proceedings to evaluate the appropriate regulatory framework for incumbent carriers to provide broadband services. The Commission has tentatively concluded that it intends to develop a consistent framework for regulation of broadband services offered by cable and telephone companies. The Commission also has tentatively concluded that wireline broadband services are not subject to all the requirements that regulate the offerings of common carriers under Title II of the Communications Act of 1934. Finally, the Commission recently decided that broadband service provided by cable operators via a cable modem is not subject to regulation as a telecommunications service. This ruling, combined with the FCC's review of rules governing the incumbent carriers, indicates that change in the regulatory climate affecting incumbent carriers is possible. However, we will not know for certain the FCC's position until it issues orders in these proceedings and any legal challenges have been decided, which is not expected to occur until later this year at the earliest.

The Telecommunications Act of 1996 also requires incumbent carriers to offer for resale, at wholesale rates, any telecommunications services that incumbent carriers offer to customers. As explained above, existing regulations currently define Internet access services as "telecommunications services," and thus incumbent carriers must offer such services for resale to competitors. This requirement also is implicated by on-going FCC proceedings, but the outcome is uncertain until the FCC issues orders in these proceedings and any legal challenges have been resolved.

Legislation pending in Congress, namely "The Internet Freedom and Broadband Deployment Act," also would have the effect of changing the requirements on incumbent carriers by reducing the regulation of incumbent carriers' provision of video and high-speed data services. If enacted, this bill would make it easier for the incumbent Bell companies to offer broadband services by allowing them to provide interstate broadband service without prior FCC approval. This legislation was approved by the U.S. House of Representatives earlier this year, but again there is no way to predict whether this legislation will be adopted.

Incumbent carriers can provide video services through a structurally separate subsidiary that is not subject to the unbundling and resale requirements. Our equipment is designed to allow carriers to provide video, high-speed data, and digital voice on an integrated basis. Because of the regulatory restrictions, if incumbent carriers choose to offer video or data services through a separate affiliate, incumbent carriers may prefer vendors whose equipment does not provide for integration of service offerings. A separate affiliate may choose to purchase less sophisticated equipment because it might not be able to utilize fully our equipment's

integrated features. The FCC may change the separate subsidiary requirement, but we will not know for certain until the FCC issues an order and any legal challenges have been resolved.

In its order approving the merger of two Bell operating companies, SBC and Ameritech, the FCC permitted the merged entity to avoid its statutory resale

obligations on "advanced services" provided that such services were offered through a separate subsidiary. Recently, however, the U.S. Court of Appeals for the D.C. Circuit vacated, in part, the FCC's order and held that the FCC may not permit an incumbent carrier to avoid its statutory obligations under the Telecommunications Act of 1996 by setting up an affiliate to offer such services.

Distribution of our N3 Residential Gateway could be adversely affected by the FCC's "navigation devices" rules. Those rules require video program distributors, including those who use our system to deliver video, to allow set-top boxes and other navigation devices owned by customers or manufactured by third parties to be connected to the video program distributor's system. The rules require video program distributors to disclose technical details of their interfaces so as to permit third parties to manufacture the navigation devices and retail customers to connect them. We believe these rules are not readily applicable to our system because our N3 Residential Gateway is in many ways different from a cable set-top box, and currently there is little likelihood of an independent market for our N3 Residential Gateway separate from our entire system. However, if these rules could be applied to our N3 Residential Gateway or other parts of our system, our customers might be required to disclose proprietary technical information including patented data about our technology, to allow competing vendors to access the system.

The uncertainties caused by pending regulatory proceedings and possible appeals of FCC decisions, and by pending legislation, could cause potential customers to delay purchasing decisions. In addition, the outcomes of the various regulatory proceedings and legislation may cause potential customers not to deploy all of the services for which our products are designed or to delay the widespread introduction of one or more of these services.

BACKLOG

Our backlog primarily consists of purchase orders for products to ship within the next six months. At December 31, 2001, backlog was approximately $3.2 million. We consider backlog to be an indicator, but not the sole predictor, of future sales because our customers may cancel or defer orders without penalty. Cancellation or reduction of pending purchase orders could seriously harm our future revenues.

EMPLOYEES

As of March 20, 2002, we have a total of 238 full-time employees and 7 independent contractors. The total number of employees consists of 112 in research and development, 14 in marketing, 21 in operations, 55 in sales and sales support and 36 in administration. The total number of contractors consists of one in research and development, one in operations, three in marketing and sales support and two in administration. Our employees are not represented by any collective bargaining agreement with respect to their employment, and we have never experienced an organized work stoppage. Satisfactory relations have generally prevailed between our employees and us. Our future success is heavily dependent upon our ability to hire and retain qualified technical, marketing and management personnel. The competition for personnel is intense, particularly for engineering personnel.

ITEM 2. PROPERTIES

Our principal corporate offices, which include two main buildings, are located in Rohnert Park, California. We lease one of the buildings and own the other. We lease three sales offices, in Parsippany, New Jersey, Englewood, Colorado and Highland Ranch, Colorado. We also lease sales support offices in Phoenix, Arizona and Boulder, Colorado and Englewood, Colorado. In addition, we lease two facilities for our technology department in Parsippany, New Jersey and

San Diego, California. We also lease one administrative office in Schaumburg, Illinois. We believe our current facilities are suitable and adequate and have sufficient productive capacity to meet our current needs.

ITEM 3. LEGAL PROCEEDINGS

Securities Litigation. In July 2001, a class action complaint entitled Zichron Yakov Menachem Inc. v. Next Level Communications, Inc., et al, was filed in the United States District Court for the Southern District of New York, alleging various violations of law, including alleged violations of Sections 11, 12 and 15 of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, based on alleged excessive commissions, and agreements to engage in after-market transactions, received by underwriters in exchange for the receipt of allocations of stock in our initial public offering. Plaintiff seeks to represent a class comprised of all persons who purchased our common stock during the period from November 9, 1999 through December 6, 2000. Based upon information presently known to us, we do not believe that the ultimate resolution of these lawsuits will have a material adverse effect on our business.

On January 28, 2002, a complaint entitled Next Level Communications, Inc. v. Virtual Access plc was filed by us in the Superior Court of the State of California, County of Sonoma. The complaint relates to a demand made by Virtual Access that Next Level invest an additional $2 million in Virtual Access pursuant to various investment and settlement agreements between the two companies. The complaint by Next Level seeks declaratory relief that Next Level has no obligation to make any further payments to Virtual Access, as well as restitution and rescission. Virtual Access did not file a timely response to the lawsuit and the court entered a Notice of Default in favor of Next Level. Default judgment has not yet been sought or entered.

Other Matters. From time to time, we are a party to other actions which arise in the normal course of business. In our opinion, the ultimate disposition of the items discussed above and these other matters will not have a material adverse effect on our consolidated financial statements taken as a whole.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our stockholders during the quarter ended December 31, 2001.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDERS MATTERS

During November 1999, we completed our initial public offering in which we sold 9,775,000 shares of our common stock at a price of $20.00 per share pursuant to a Registration Statement on Form S-1 (File No. 333-85999). Our common stock is listed on The NASDAQ Stock Market's National Market under the symbol "NXTV." The following table sets forth the high and low closing prices for our common stock for the periods indicated as reported on The NASDAQ National Market.

YEAR		HIGH	LOW
2001.....	Fourth Quarter	$ 6.44	$ 2.60

	Third Quarter	$ 6.45	$ 1.40
	Second Quarter	$ 12.18	$ 3.16
	First Quarter	$ 14.69	$ 5.02
2000	Fourth Quarter	$ 71.50	$10.38
	Third Quarter	$125.56	$40.63
	Second Quarter	$128.13	$50.00
	First Quarter	$195.75	$60.75

On March 20, 2002, the last reported sale price for our common stock on the NASDAQ National Market was $1.47 per share. At March 20, 2002, the number of record holders of our common stock was 260.

We have never declared or paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We intend to retain all available funds and any future earnings for use in the operation of our business. In addition, our loan agreement with Motorola restricts our ability to pay dividends.

ITEM 6. SELECTED FINANCIAL DATA

The selected financial data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the historical consolidated financial statements and notes included in this report.

	YEAR ENDED DECEMBER 31,				
	2001	2000	1999	1998	1997
	(IN THOUSANDS, EXCEPT SHARE DATA)				
Statement of Operations Data:					
Revenues					
Equipment	$ 91,030	$ 146,314	$ 54,301	$ 39,243	$ 6,045
Software	2,215	3,777	3,296	4,587	2,266
Total revenues	93,245	150,091	57,597	43,830	8,311
Cost of revenues					
Equipment	81,021	116,090	51,265	37,372	10,954
Software	127	141	292	261	306
Inventory charges	76,816	9,000	--	5,800	--
Total cost of revenues	157,964	125,231	51,557	43,433	11,260
Gross profit (loss)	(64,719)	24,860	6,040	397	(2,949
Operating Expenses:					
Research and development	46,868	55,834	48,454	47,086	37,064
Selling, general and administrative	53,349	46,907	30,511	26,248	26,414
Asset impairments and disposals, net	8,431	--	--	--	--
Litigation	--	--	--	5,000	--
Non-cash compensation charge	--	2,384	128,284	--	--

Total operating expenses....	108,648	105,125	207,249	78,334	63,478
Operating loss.....	(173,367)	(80,265)	(201,209)	(77,937)	(66,427
Interest income (expense), net.....	(14,454)	5,575	(3,564)	(3,776)	--
Investment impairments and other income (expense), net.....	(20,785)	(148)	(299)	(18)	(2
Net loss.....	$ (208,606)	$ (74,838)	$ (205,072)	$ (81,731)	$ (66,429
Basic and diluted net loss per share (pro forma in 1999, 1998 and 1997).....	$ (2.45)	$ (0.91)	$ (2.78)	$ (1.08)	$ (0.95
Shares used to compute basic and diluted net loss per share (pro forma in 1999, 1998 and 1997).....	85,277,764	81,929,663	71,597,834	69,967,053	69,967,053

	DECEMBER 31,				
	2001	2000	1999	1998	1997
	(IN THOUSANDS)				
BALANCE SHEET DATA:					
Cash and cash equivalents.....	$ 20,580	$ 35,863	$128,752	$ 28,983	$ 377
Working capital (deficit).....	47,785	85,265	147,948	38,564	(29,571)
Total assets.....	154,035	275,716	267,811	97,771	52,689
Long-term obligations, net of current portion.....	104,428	15,000	25,199	81,275	--
Total stockholders' equity (deficit)/partners' equity (deficit).....	(8,299)	158,749	206,228	(14,769)	(3,702)

The following table sets forth unaudited statement of operations data for our eight most recent quarters in the period ended December 31, 2001 (in millions, except per share data).

	THREE MONTHS ENDED				YEAR ENDED	THR
	MARCH 31, 2001	JUNE 30, 2001	SEPTEMBER 30, 2001	DECEMBER 31, 2001	DECEMBER 31, 2001	MARC 20
Revenues.....	$ 28.7	$ 31.9	$ 20.2	$ 12.4	$ 93.2	$ 3
Total cost of goods sold, excluding inventory charge.....	22.6	25.9	17.6	15.0	81.1	2
Inventory charge.....	--	72.0	--	4.8	76.8	
Gross profit (loss)...	6.1	(66.0)	2.6	(7.4)	(64.7)	
Gross margin %.....	21.2%	-207.0%	13.0%	-59.7%	-69.4%	18
R&D.....	14.1	12.9	11.8	8.1	46.9	1

SG&A.....	14.5	14.8	12.9	11.1	53.3	1
Impairments and asset disposals.....	--	0.8	0.0	7.6	8.4	
Total operating expenses.....	28.6	28.5	24.7	26.8	108.6	2
Operating loss.....	(22.5)	(94.5)	(22.1)	(34.2)	(173.4)	(2
Interest income/ (expense) net.....	0.1	(3.2)	(5.4)	(5.9)	(14.5)	
Other income/(expense) net.....	--	(4.4)	(0.2)	(16.1)	(20.8)	
Net loss.....	$(22.4)	$(102.1)	$(27.8)	$(56.3)	$ (208.6)	$(1
Shares O/S.....	84.6	85.2	85.5	85.8	85.3	7
Net loss per share....	$(0.26)	$ (1.20)	$(0.32)	$(0.66)	$ (2.45)	$(0

The following table excludes special items from the GAAP results of operations and is presente loss and net loss per share information before the effect of special items (in millions, except p

Net loss per GAAP.....	$(22.4)	$(102.1)	$(27.8)	$(56.3)	$ (208.6)	$(1
SPECIAL ITEMS						
Non-cash interest.....	--	2.5	3.8	4.1	10.4	
Goodwill amortization.....	1.7	1.7	1.7	1.5	6.5	
Inventory and related charges.....	--	72.4	--	6.3	78.7	
Investment impairments.....	--	4.0	--	16.0	20.0	
Asset impairments and disposals.....	--	0.8	--	7.6	8.4	
Non-cash compensation charges.....	--	--	--	--	--	
Net loss excluding special items.....	$(20.7)	$ (20.7)	$(22.3)	$(20.9)	$ (84.6)	$(1
Net loss per share excluding special items.....	$(0.24)	$ (0.24)	$(0.26)	$(0.24)	$ (0.99)	$(0

	THREE MONTHS ENDED		YEAR ENDED
	SEPTEMBER 30, 2000	DECEMBER 31, 2000	DECEMBER 31, 2000
Revenues.....	$ 48.3	$ 31.2	$150.1
Total cost of goods sold, excluding inventory charge.....	36.1	23.0	116.2
Inventory charge.....	--	9.0	9.0
Gross profit (loss)...	12.1	(0.9)	24.9
Gross margin %.....	25.1%	-2.8%	16.6%
R&D.....	13.1	15.3	55.8
SG&A.....	13.7	12.7	49.3
Impairments and asset disposals.....	--	--	--
Total operating expenses.....	26.8	28.0	105.1

Operating loss.....	(14.6)	(28.8)	(80.3)
Interest income/ (expense) net.....	1.3	0.5	5.6
Other income/(expense) net.....	--	(0.1)	(0.1)
Net loss.....	$(13.4)	$(28.4)	$(74.8)
Shares O/S.....	83.5	84.2	81.9
Net loss per share....	$(0.16)	$(0.34)	$(0.91)
The following table loss and net loss per			
Net loss per GAAP.....	$(13.4)	$(28.4)	$(74.8)
SPECIAL ITEMS			
Non-cash interest.....	--	--	--
Goodwill amortization.....	1.5	1.7	3.7
Inventory and related charges.....	--	9.0	9.0
Investment impairments.....	--	--	--
Asset impairments and disposals.....	--	--	--
Non-cash compensation charges.....	--	--	2.4
Net loss excluding special items.....	$(11.9)	$(17.7)	$(59.7)
Net loss per share excluding special items.....	$(0.14)	$(0.21)	$(0.73)

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Some of the statements in the following discussion and elsewhere in this report constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with these safe harbor provisions. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential" or "continue" or the negative of such terms or other comparable terminology. These statements involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. These factors include, among other things, those listed under "Risk Factors" below and elsewhere in this report.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

OVERVIEW

We design and market broadband communications equipment that enables telephone companies and other communications service providers to cost-effectively deliver a full suite of voice, data and video services over the existing copper wire telephone infrastructure. We commenced operations in July 1994 and recorded our first sale in September 1997. From January 1998 until November 1999, we operated through Next Level Communications L.P., which was formed in connection with the transfer of all of the net assets, management and workforce of a wholly-owned subsidiary of General Instrument. In November 1999, the business and assets of that partnership were merged into Next Level Communications, Inc. as part of our recapitalization. In January 2000, General Instrument was acquired by Motorola, Inc., making us an indirect subsidiary of Motorola.

We generate our revenues primarily from sales of our equipment. A small number of customers have accounted for a large part of our revenues to date, and we expect this concentration to continue in the future. Qwest, formerly U S WEST, accounted for 41%, 56% and 67% of our total revenues in 2001, 2000 and 1999. Our agreements with our largest customers do not obligate the customers to purchase any products. In addition, our significant customer agreements generally contain fixed-price provisions. As a result, our ability to generate a profit on these contracts depends upon our ability to produce and market our products at costs lower than these fixed prices.

The timing of our revenues is difficult to predict because of the length and variability of the sales cycle for our products. Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deploying them. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. While our customers are evaluating our products and before they place an order, if at all, we may incur substantial sales and marketing expenses and expend significant management efforts.

RESULTS OF OPERATIONS

Revenues. Total revenues in 2001 decreased to $93.2 million from $150.1 million in 2000. The decrease was primarily due to a decrease in equipment sales to Qwest. An equipment revenue analysis by channel is detailed in the following chart. Our equipment revenue is analyzed using three channels: independent operating companies (IOC), major carriers which currently include Qwest and other North American regional bell operating companies (MAJOR CARRIERS) and other customers which include, among others, multiple service organizations and international customers (OTHER).

	FISCAL YEAR ENDED DECEMBER 31,	
CHANNEL	2001	2000
	(IN MILLIONS)	
IOC	$48.1	$ 56.0
MAJOR CARRIERS (PRIMARILY QWEST)	38.3	84.8
OTHER	4.6	5.5
TOTAL EQUIPMENT REVENUE	$91.0	$146.3

Sales to Qwest were significantly reduced in 2001 due to an overall reduction in capital spending by Qwest. Additionally, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. The re-evaluation by Qwest is continuing, and sales to Qwest in the future are dependent upon its decision regarding the deployment of our products. Sales to IOCs and our other customers decreased in 2001 due to a general slowdown in the telecommunications industry and the resulting reduction of our customers' capital expenditures.

We expect to continue to derive substantially all of our revenues from sales of equipment to regional bell operating companies and local, foreign and independent telephone companies for the foreseeable future. Revenue levels in future quarters will depend significantly upon Qwest's future decisions and general economic conditions, as well as whether and how quickly our existing customers roll out broadband services in their coverage areas and whether and how quickly we obtain new customers.

Cost of Revenues. Total cost of revenues increased to $158.0 million in 2001 from $125.2 million in 2000. The increase in our cost of revenues in 2001 was primarily attributable to inventory charges taken in the year totaling $76.8 million related to excess inventory, obsolescence and lower of cost or market adjustments. Included in 2001 and 2000 cost of revenues are inventory charges totaling $76.8 million and $9.0 million. Excluding the inventory charges, cost of revenues were $81.2 million and $116.2 million in 2001 and 2000. The 2001 decrease was primarily due to lower sales of equipment.

To meet forecasted demand and reduce the anticipated component supply constraints that had existed in the past, in late 2000 we increased inventory levels for certain components and entered into purchase commitments for certain components with long lead times. However, in the quarter ended June 30, 2001, our estimates of forecasted sales in 2001 and 2002 for our current generation of products declined significantly. As a result, inventory related charges were required and were calculated based upon (i) the substantial completion of the negotiation process with our contract manufacturers and their suppliers and our other vendors regarding purchase commitments and cancellations made by us, (ii) the inventory levels in excess of forecasted demand and (iii) our estimates of salvage or recovery value for each raw material or finished good on an item by item basis. We do not currently anticipate that the excess inventory included in this provision will be used based on our current demand forecast. At December 31, 2001, we updated our estimates and recorded an additional inventory charge. These write-downs were included in cost of revenues in 2001 and consisted of the following:

	(IN MILLIONS)
Excess quantities of raw materials on hand or under purchase commitments, net of salvage	$36.9
Excess quantities of finished goods on hand, net of salvage	10.8
Obsolescence	14.5
Cancellation charges on purchase commitments	5.2
Lower of cost or market write-down on current generation product platform	9.4
Total	$76.8

Significant estimates included in the calculation of the inventory write-downs above include forecasted demand for our products, sales prices for residential gateways and other finished goods and estimated salvage

or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

During 2000, we recorded a $9.0 million inventory write-down primarily related to a lower of cost or market adjustment to certain residential gateway products and other obsolescence provisions.

Excluding the inventory charges in both 2001 and 2000, our gross margin percentage decreased to 13% in 2001 from 23% in 2000. The decline in our gross margin percentage was primarily related to spreading the manufacturing overhead elements of product cost over reduced sales volumes. In the future, gross margin percentage may fluctuate due to a wide variety of factors, including customer mix, product mix, the timing and size of orders which are received, the availability of adequate supplies of key components and assemblies, our ability to introduce new products and technologies on a timely basis, the timing of new product introductions or announcements by us or our competitors, price competition and unit volume. Our overhead reductions and the improved product cost attributes of our new standards compliant product platform are intended to improve the gross margin percentage in future periods.

Research and development. Research and development expenses decreased to $46.9 million in 2001 from $55.8 million in 2000. The decrease in the research and development expenses was primarily due to cost cutting measures, including a reduction in research and development personnel, implemented in the current year.

Selling, general and administrative. Selling, general and administrative expenses increased to $53.3 million in 2001 from $46.9 million 2000. The increase was attributable to increased goodwill amortization arising from the purchase of SoftProse in July 2000 and higher recruiting and relocation expenses in the first half of the year. We reduced our workforce in October 2001 and January 2002 by approximately 15% and 33%.

Non-cash compensation charge. Substantially all of our employees in 1999 were granted contingently exercisable stock options that became options to purchase our common stock upon our recapitalization in 1999. In addition, tandem stock options were granted in January 1997 to some of our employees. As a result, non-cash compensation expense was recognized upon the completion of our initial public offering based on the difference between the exercise price of these options and the initial public offering price of our common stock. The non-cash compensation expense related to these option grants in 2000 was $2.4 million. There was no such expense in 2001, and we do not expect any such expenses to be material in the future.

Asset impairments and disposals, net. Asset impairments and disposals in 2001 consisted of (i) the write-off of goodwill related to SoftProse of $8.4 million, (ii) loss on disposal of property, plant and equipment and other assets of $2.6 million and (iii) the gain on sale of our software product line of $2.6 million (see Note 5 to the consolidated financial statements).

Interest income (expense), net. Interest expense was $14.5 million in 2001. Interest income was $5.6 million in 2000. Interest expense in 2001

included non-cash interest expense of $10.4 million related to our loan agreement with Motorola. Interest income in 2000 related primarily to interest earned on our initial public offering proceeds.

Other income (expense), net. Other expense in 2001 was $20.8 million, and was primarily related to the write-down of certain long-term investments in Virtual Access of $13.0 million, $4.0 million in Outreach Communications and $3.0 million in Expanse Networks, Inc.

COMPARISON OF 2000 TO 1999

Revenues. Total revenues in 2000 increased to $150.1 million from $57.6 million in 1999. The increase was primarily due to an increase in equipment sales. Total revenues for the period included $146.3 million of equipment sales, compared to $54.3 million in 1999. Qwest accounted for $83.4 million of equipment revenue in 2000 as compared to $38.5 million in 1999. This increase was primarily attributable to Qwest's increased deployment in the first three quarters of 2000.

Cost of Revenues. Total cost of revenues increased to $125.2 million in 2000 from $51.6 million in 1999. Included in 2000 cost of sales was a $9.0 million charge to inventory that was primarily related to a lower of

cost or market adjustment to certain residential gateway products due to decreases in our sales price per unit and other obsolescence reserves. Our gross margin percentage, including the inventory charge, increased to 17% in 2000 from 10% in 1999. Excluding the inventory charge, the gross margin percentage increased to 23% in 2000 from 10% in 1999. The increase in the gross margin percentage was primarily the result of higher unit volumes, leading to greater efficiencies, including lower fixed costs per unit.

Research and development. Research and development expenses increased to $55.8 million in 2000 from $48.5 million in 1999. The increase was primarily due to an increase in research and development personnel.

Selling, general and administrative. Selling, general and administrative expenses increased to $46.9 million in 2000 from $30.5 million in 1999. The increase was primarily attributable to the increase in the scale of our operations including additional personnel in our operations, administration, sales and marketing organizations, promotional expenses and other administrative expenses. We generated higher sales expenses through the hiring of new sales representatives in our efforts to increase the number and size of our customer accounts.

Non-cash compensation charge. Substantially all of our employees had been granted contingently exercisable stock options that became options to purchase our common stock upon our recapitalization in 1999. In addition, tandem stock options were granted in January 1997 to some of our employees. As a result, non-cash compensation expense was recognized upon the completion of our initial public offering based on the difference between the exercise price of these options and the initial public offering price of our common stock. The non-cash compensation expense related to these option grants was $2.4 million in 2000 and $128.3 million in 1999.

Interest income (expense), net. Interest income in 2000 was $5.6 million, and represents interest income earned on proceeds from our initial public offering. In 1999, interest expense was $3.6 million, and related to interest on a $75.0 million note and accrued interest thereon payable to General Instrument that General Instrument contributed to us in exchange for shares of our common stock immediately prior to our initial public offering.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $127.8 million in 2001, $103.3 million in 2000 and $56.6 million in 1999. In 2001, the use of cash in operating activities was primarily due to our net losses of $208.6 million, less non-cash charges of approximately $136.0 million, and an increase in inventory net purchases of $42.7 million and a reduction in accounts payable of $25.1 million, partially off-set by a reduction in accounts receivable of $17.0 million. During 2000, the cash used in operating activities was primarily due to net losses of $74.8 million, and an increase in inventory and receivables of $73.2 million and $20.6 million, partially off-set by an increase in liabilities of $40.1 million. In 1999, net loss of $205.1 million included $128.3 million in non-cash compensation charges.

Net cash provided by investing activities was $17.8 million in 2001. Net cash used by investing activities was $12.5 million in 2000 and $78.7 million in 1999. The 2001 amount was primarily attributable to the sale of marketable securities, partially off-set by capital expenditures made to support our engineering and testing activities as well as an additional $8.0 million investment in Virtual Access. In 2001, we also received $4.9 million for the sale of our software product line. In 2000, net cash used in investing activities also included investments in Expanse Networks, Inc., OutReach Communications L.L.C. and Virtual Access totaling approximately $15.0 million, off-set by the sale of $18.0 million in marketable securities. Net cash used in 1999 also included purchases of $45.1 million of marketable securities with the proceeds from our initial public offering.

Net cash provided by financing activities was $94.7 million in 2001, $22.9 million in 2000 and $235.0 million in 1999. The 2001 amount is primarily related to borrowings of $83.0 million from Motorola, mortgage proceeds of $20.0 million and $14.3 million in proceeds related to our Tax Sharing Agreement with Motorola. The 2001 amount was partially off-set by the repayment of a $25.0 million note. The 2000 amount was primarily related to $15.0 million in proceeds related to the Tax Sharing Agreement with Motorola and

$9.3 million related to the issuance of common stock in connection with the exercise of stock options. Net cash provided by financing activities in 1999 included $177.0 million net proceeds from our initial public offering, $34.0 million contributed by General Instrument (acquired by Motorola, Inc. in January 2000) and borrowings of $24.9 million.

Motorola Loan Commitment -- During 2001 we entered into a note agreement with Motorola for $83.0 million which matures on May 17, 2003. Interest is payable monthly and is determined on either the base rate, as defined in the agreement, plus 2% or the Eurodollar rate plus 3 1/2% (5.4% at December 31, 2001).

In connection with the note agreement we granted warrants to purchase up to 10,000,000 shares of our common stock; 7,500,000 warrants have an exercise price of $7.39 per share and 2,500,000 warrants have an exercise price of $4.29 per share. Warrants to purchase 7,000,000 shares of our common stock were exercisable at December 31, 2001. The remaining warrants become exercisable as follows:

- 1,000,000 shares become exercisable unless, prior to May 17, 2002, all borrowings under the note agreement have been repaid in full, and it has been terminated;

- 1,000,000 shares become exercisable unless, prior to November 17, 2002 all borrowings under the note agreement have been repaid in full, and it has been terminated; and

- 1,000,000 shares become exercisable unless, prior to February 17, 2003, all borrowings under the note agreement have been repaid in full, and it has been terminated.

We do not expect to repay amounts due under the agreement until its maturity date of May 17, 2003. As a result, the debt discount related to the estimated fair value of the remaining 3,000,000 warrants will be adjusted in subsequent periods, up to their respective measurement dates, to reflect changes in our stock price.

The fair value of the warrants of $37.4 million was recorded as a discount to the note payable with a corresponding increase to additional paid-in capital. The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate that ranged from 4.3% to 4.9%; volatility of 101%; and a contractual life of five years. As of December 31, 2001, no shares of common stock had been purchased under the warrants.

We are amortizing the discount under the effective interest method up to the maturity date (May 17, 2003) of the related note. During the year ended December 31, 2001 we amortized $10.4 million of the discount, which has been reflected as interest expense in our statement of operations. As of December 31, 2001, the Motorola note was recorded at $56.0 million, net of $27.0 million of unamortized discount.

The note agreement with Motorola contains various covenants, including compliance with net worth requirements, and restrictions on additional indebtedness, capital expenditures, and payment of dividends. As of December 31, 2001, we were not in compliance with the net worth financial covenant. On March 22, 2002, we and Motorola amended the note agreement to waive the debt covenant violation and established revised financial covenants for net worth.

Tax sharing and allocation agreement with Motorola -- In December 2000, we received a $15.0 million advance from Motorola related to a tax sharing and allocation agreement (the "Tax Sharing Agreement"). During 2001 we received an additional $17.3 million in January 2001, and the Tax Sharing Agreement was finalized in February 2001. The amount advanced to us of $32.3 million was based on an estimate of the present value of income tax benefits to Motorola from the inclusion of our operating losses for the period from January 6, 2000 to May 17, 2000 in Motorola's consolidated tax return. On October 10, 2001, we received a revised calculation of the estimated present value of income tax benefits to Motorola based upon actual net losses that were included in Motorola's 2000 tax return. The revised amount was $29.3 million. Under the original agreement, we were required to repay the $3.0 million difference by October 15, 2001. On October 15, 2001, the Loan Agreement between us and Motorola was amended to include such $3.0 million (see above). To the extent Motorola does not achieve the expected tax benefits by September 30, 2006, we must repay any difference.

In the event of a debt or equity security offering or a sale of assets in excess of $25.0 million, the first $25.0 million of proceeds may be retained by us; the next $25.0 million (between $25.0 million and $50.0 million) of such proceeds will be allocated at least one-third to repay our obligations under the Tax Sharing Agreement, and the balance may be retained by us; the next $25.0 million of such proceeds (between $50.0 million and $75.0 million) will be allocated at least one-half to repay our obligations under the Tax Sharing

Agreement and the balance may be retained by us; amounts of such proceeds in excess of $75.0 million must be used 100% first to repay our obligations under the Tax Sharing Agreement (to the extent of such obligations) and then to repay and reduce the amount owed under the note agreement.

Mortgage Financing -- On October 30, 2001, we received $20.0 million under a mortgage loan for a company-owned office building. The loan is amortized over a 12-year period with a ten-year term and bears interest at an annual fixed rate of 7.51%. The entire unpaid principal balance, plus accrued interest thereon is due and payable on November 1, 2011.

The mortgage was guaranteed by Motorola. In consideration for the guarantee, we issued to Motorola warrants to purchase up to 400,000 shares of common stock with an exercise price of $3.82 per share. Accordingly, the warrants were recorded at the fair value of $0.7 million, with a discount to the mortgage loan note payable and a corresponding increase to additional paid-in capital. The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate that ranged from 4.3% to 4.9%; volatility of 101%; and a contractual life of five years.

Vendor Note Payable -- At December 31, 2001, we had a $24.3 million note payable to a vendor. The note bears interest at 10% per year. Accrued interest at December 31, 2001 was $1.5 million. On March 28, 2002, the Vendor Note Payable was amended. The revised principal and interest payment terms are as follows: $5.0 million on March 29, 2002, $13.0 million on May 18, 2002 and the balance of $9.5 million on March 31, 2003. Such amended due dates have been considered in the table below.

Contractual Obligations -- The following table depicts our contractual obligations as of December 31, 2001:

	PAYMENTS DUE BY PERIOD						
	2002	2003	2004	2005	2006	THEREAFTER	TOTAL
	(IN MILLIONS)						
Vendor Note Payable	$15.6	$ 8.7	--	--	--	--	$ 24.
Motorola Debt							
Note Payable	--	83.0	--	--	--	--	83.
Tax Sharing Liability	--	--	--	--	29.3	--	29.
Mortgage Debt	1.1	1.2	$1.3	$ 1.4	1.5	$13.5	20.
Off-balance sheet Commitments							
Vendor purchase commitments	19.1	--	--	--	--	--	19.
Operating leases	1.5	1.3	1.0	0.9	0.7	--	5.
Total Contractual Obligations	$37.3	$94.2	$2.3	$ 2.3	$31.5	$13.5	$181.

2001 RESULTS AND MANAGEMENT'S PLANS FOR 2002

In 2001, net loss was $208.6 million and net cash used in operating activities was $127.8 million. As of December 31, 2001, our accumulated deficit was $488.5 million. Our ability to generate operating income and positive operating cash flows is dependent on our ability to increase sales, convert our inventory and accounts receivable to cash, negotiate favorable terms with our vendors, effectively manage our operating costs and to continue to raise sufficient operating capital.

Since late 2000, we have been significantly dependent on Motorola for financial resources. Advances from Motorola totaled $15.0 million in 2000 and loans and advances totaled $97.3 million in 2001. In addition, on February 20, 2002, we issued $30.0 million of redeemable convertible preferred stock ("preferred stock") to

Motorola comprised of 6,912,442 shares at a purchase price of $4.34 per share. Each share of preferred stock is convertible, at the option of the holder, into two shares of our common stock, or 13,824,884 shares in total. The preferred stock is redeemable, at the option of the holder, at an initial redemption price of $5.21 per share, on or after February 19, 2007. Dividends are cumulative at a rate of 7.5%, payable in cash or additional shares of preferred stock, at our option. Liquidation value is $10.85 per share. In conjunction with this financing, we issued to Motorola warrants to purchase 3,456,221 shares of common stock at an exercise price of $2.17 per share and warrants to purchase 3,456,221 shares of common stock at an exercise price of $2.60 per share. The warrants have a term of five years.

During 2001, in addition to the Motorola financing described above, we instituted the following measures to improve liquidity:

- Closed our operation in Vietnam eliminating 84 employees in April, 2001;
- reduced our workforce by approximately 36 employees in April, 2001;
- received $20.0 million in October 2001 through the mortgage of our largest office building;
- sold our software product line in October 2001 and received $4.9 million in net proceeds;
- reduced our workforce by approximately 60 employees, or 15% in October 2001;
- reduced our commitments to purchase raw materials from vendors from approximately $78.0 million in the second quarter of 2001 to approximately $19.1 million as of December 31, 2001, primarily due to inventory purchases, along with vendor negotiations; and
- extended payments terms for $24.3 million of vendor payables (see Note 10 to the consolidated financial statements).

In 2002, in addition to the issuance of $30.0 million of preferred stock to Motorola:

- we reduced our workforce by approximately 120 employees or 33% in January 2002; and
- on March 29, 2002, Motorola agreed to make available to us an additional $35.0 million in financing (see Note 16 to the consolidated financial statements).

At March 29, 2002, we had cash and cash equivalents of $26.0 million. Management believes that the cash on hand and amounts available under the March 29, 2002 $35.0 million financing with Motorola will be sufficient to enable us to meet our financial obligations and sustain our operations through at least December 31, 2002.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Our preparation of these consolidated financial statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from such estimates under different assumptions or conditions. The following summarizes our critical accounting policies and significant estimates used in preparing our consolidated financial statements:

Revenue -- We recognize revenue when contractual obligations have been satisfied, title and risk of loss have been transferred to the customer and collection of the resulting receivable is reasonably assured. Generally, we recognize revenue from equipment sales upon shipment. In cases where title and risk of loss pass upon delivery, we recognize revenue from equipment sales upon receipt by the customer. We accrue a provision for estimated sales returns as a reduction of revenue at the time of revenue recognition.

Inventory impairment and loss on purchase commitments -- During 2001, we recorded a write-down of inventory excess and obsolete quantities and lower of cost or market adjustments related to our current generation product platform and related communications equipment totaling $76.8 million. Inventory related charges were calculated based upon (i) the substantial completion of the negotiation process with our contract manufacturers and their suppliers and our other vendors regarding purchase commitments and cancellations made by us, (ii) the inventory levels in excess of forecasted demand and (iii) our estimates of salvage or recovery value for each raw material or finished good on an item by item basis. Significant estimates included in the calculation of the inventory write-downs above include forecasted demand for our products, sales prices for residential gateways and other finished goods and estimated salvage or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

Impairment of long-term assets -- We periodically evaluate the recoverability of our long-term assets, and recognize an impairment loss when changes in circumstance indicate that the carrying amount of that asset may not be recoverable. When the sum of the undiscounted future net cash flows to result from the use of the asset and its eventual disposition is less than the carrying amount, an impairment loss would be recorded to reduce the carrying amount to fair value. During 2001, we recorded impairment losses of $31.0 million. Included within our impairment losses are write-downs of certain long term investments, acquired goodwill and certain other long-term assets. Significant estimates included in the calculation of the impairment loss are estimates of the future operating cash flows and the ultimate sales price of the underlying assets, if any.

Accrued Warranty Reserves -- We accrue the estimated cost of product warranties at the time revenues are recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our contract manufacturers, our warranty obligation is affected by actual warranty costs including, material usage and service delivery costs incurred in correcting a product failure. If actual product failure rates,

material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required.

Employee stock-based compensation -- We account for employee stock-based compensation under Accounting Principles Board Opinion No. 25. If we were to account for this compensation under Statement of Financial Accounting Standards No. 123, results would have changed as described in Note 12 to our consolidated financial statements.

NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations" and Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets." SFAS 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. We adopted SFAS 142 as of January 1, 2002, as required. Upon the adoption of SFAS 142, we will no longer amortize goodwill of $0.2 million at December 31, 2001. We do not expect that the adoption of SFAS No. 142 will have a significant effect on our consolidated financial statements.

In October 2001, the Financial Accounting Standards Board issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB No. 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," and addresses financial accounting and reporting for the impairment of disposal of long-lived assets. We adopted SFAS 144 on January 1, 2002. We do not expect that the adoption of SFAS 144 will have a material impact on our consolidated financial statements.

RISK FACTORS

You should carefully consider the risk factors set forth below.

WE HAVE INCURRED NET LOSSES AND NEGATIVE CASH FLOW FOR OUR ENTIRE HISTORY, WE EXPECT TO INCUR FUTURE LOSSES AND NEGATIVE CASH FLOW, AND WE HAVE BEEN FINANCIALLY DEPENDENT ON MOTOROLA.

We incurred net losses of $208.6 million in 2001. Our ability to achieve positive operating cashflow and ultimate profitability will depend on the successful design, development, testing, introduction, marketing and broad commercial distribution of our broadband equipment products. Since late 2000, we have been significantly dependent on Motorola for financial resources. Loans from Motorola totaled $15.0 million in 2000 and $97.3 million in 2001. We also issued $30.0 million in redeemable convertible preferred stock to Motorola in February 2002, and entered into a $35.0 million financing agreement with Motorola in March, 2002.

We expect to incur significant product development, sales and marketing, and administrative expenses. In addition, we depend in part on cost reductions to improve gross profit margins because the fixed-price nature of most of our long-term customer agreements prevents us from increasing prices. As a result,

we will need to generate significant revenues and improve gross profit margins to achieve and maintain profitability. We may not be successful in reducing our costs or in selling our products in sufficient volumes to realize cost benefits from our manufacturers. We cannot be certain that we can achieve sufficient revenues or gross profit margin improvements to generate profitability.

OUR CUSTOMER BASE OF TELEPHONE COMPANIES IS EXTREMELY CONCENTRATED AND THE LOSS OF OR REDUCTION IN BUSINESS FROM EVEN ONE OF OUR CUSTOMERS, PARTICULARLY QWEST, COULD CAUSE OUR SALES TO FALL SIGNIFICANTLY.

A small number of customers have accounted for a large part of our revenues to date. We expect this concentration to continue in the future. If we lose one of our significant customers, our revenues could be significantly reduced. Qwest accounted for 41%, 56% and 67% of total revenues in 2001, 2000 and 1999. Our agreements with our customers are cancelable by these customers on short notice, without penalty, do not obligate the customers to purchase any products and are not exclusive. As a result of the merger between U S WEST and Qwest, Qwest slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon their decision regarding the deployment of our product. Any continued significant reduction in purchases of our equipment by Qwest could have a material adverse effect on us.

A SIGNIFICANT MARKET FOR OUR PRODUCTS MAY NOT DEVELOP IF TELEPHONE COMPANIES DO NOT SUCCESSFULLY DEPLOY BROADBAND SERVICES SUCH AS HIGH-SPEED DATA AND VIDEO; RECENT RELUCTANCE OF TELEPHONE COMPANIES TO MAKE SIGNIFICANT CAPITAL EXPENDITURES MAY HEIGHTEN THIS ISSUE.

Telephone companies have recently begun offering high-speed data services, and most telephone companies have not offered video services at all. Unless telephone companies make the strategic decision to enter the market for providing broadband services, a significant market for our products may not develop. Sales of our products largely depend on the increased use and widespread adoption of broadband services and the ability of our customers to market and sell broadband services, including video services, to their customers. Certain critical issues concerning use of broadband services are unresolved and will likely affect their use. These issues include security, reliability, speed and volume, cost, government regulation and the ability to operate with existing and new equipment. In addition, telephone companies have recently been reluctant to make significant capital expenditures.

Even if telephone companies decide to deploy broadband services, this deployment may not be successful. Our customers have delayed deployments in the past and may delay deployments in the future. Factors that could cause telephone companies not to deploy, to delay deployment of, or to fail to deploy successfully the services for which our products are designed include the following:

- industry consolidation;

- regulatory uncertainties and delays affecting telephone companies;

- varying quality of telephone companies' network infrastructure and cost of infrastructure upgrades and maintenance;

- inexperience of telephone companies in obtaining access to video programming content from third-party providers;

- inexperience of telephone companies in providing broadband services and the lack of sufficient technical expertise and personnel to install

products and implement services effectively;

- uncertain subscriber demand for broadband services; and

- inability of telephone companies to predict return on their investment in broadband capable infrastructure and equipment.

Unless our products are successfully deployed and marketed by telephone companies, we will not be able to achieve our business objectives and increase our revenues.

OUR LIMITED OPERATING HISTORY MAKES IT DIFFICULT FOR YOU TO EVALUATE OUR BUSINESS AND PROSPECTS.

We recorded our first sale in September 1997. As a result, we have only a limited operating history upon which you may evaluate our business and prospects. You should consider our prospects in light of the heightened risks and unexpected expenses and difficulties frequently encountered by companies in an early stage of development. These risks, expenses and difficulties, which are described further below, apply particularly to us because the market for equipment for delivering voice, data and video services is new and rapidly evolving. Due to our limited operating history, it will be difficult for you to evaluate whether we will successfully address these risks.

WE EXPECT OUR QUARTERLY REVENUES AND OPERATING RESULTS TO FLUCTUATE, AND THESE FLUCTUATIONS MAY MAKE OUR STOCK PRICE VOLATILE.

Our quarterly revenues and operating results have fluctuated in the past and are likely to fluctuate significantly in the future. As a result, we believe that quarter-to-quarter comparisons of our operating results may not be meaningful. Fluctuations in our quarterly revenues or operating results may cause volatility in the price of our stock. It is likely that in some future quarter our operating results may be below the expectations of public market analysts and investors, which may cause the price of our stock to fall. Factors likely to cause variations in our quarterly revenues and operating results include:

- delays or cancellations of any orders by Qwest, which accounted for approximately 41% of our revenues in 2001, or by any other customer accounting for a significant portion of our revenues;

- variations in the timing, mix and size of orders and shipments of our products throughout a quarter or year;

- new product introductions by us or by our competitors;

- the timing of upgrades of telephone companies' infrastructure;

- variations in capital spending budgets of telephone companies; and

- increased expenses, whether related to sales and marketing, product development or administration.

The amount and timing of our operating expenses generally will vary from quarter to quarter depending on the level of actual and anticipated business activity. Because most of our operating expenses are fixed in the short term, we may not be able to quickly reduce spending if our revenues are lower than we had projected and our results of operations could be harmed.

CONSOLIDATION AMONG TELEPHONE COMPANIES MAY REDUCE OUR SALES.

Consolidation in the telecommunications industry may cause delays in the

purchase of our products and cause a reexamination of strategic and purchasing decisions by our customers. In addition, we may lose

relationships with key personnel within a customer's organization due to budget cuts, layoffs, or other disruptions following a consolidation. For example, our sales to NYNEX, previously one of our largest clients, have decreased significantly as a result of a shift in focus resulting from its merger with Bell Atlantic. In addition, as a result of the merger between U S WEST and Qwest, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding deployment of VDSL across its network.

BECAUSE OUR SALES CYCLE IS LENGTHY AND VARIABLE, THE TIMING OF OUR REVENUE IS DIFFICULT TO PREDICT, AND WE MAY INCUR SALES AND MARKETING EXPENSES WITH NO GUARANTEE OF A FUTURE SALE.

Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deployment. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. Before a customer places an order, we may incur substantial sales and marketing expenses and expend significant management efforts. In addition, product purchases are frequently subject to unexpected administrative, processing and other delays on the part of our customers. This is particularly true for customers for whom our products represent a very small percentage of their overall purchasing activities. As a result, sales forecasted to be made to a specific customer for a particular quarter may not be realized in that quarter; and this could result in lower than expected revenues.

WE INCURRED SIGNIFICANT WRITE-DOWNS OF OUR INVENTORY IN THE YEAR ENDED DECEMBER 31, 2001 BASED ON ESTIMATES WHICH MAY VARY FROM ACTUAL RESULTS; THEREFORE, ADDITIONAL INVENTORY WRITE-DOWNS MAY BE NECESSARY IN FUTURE PERIODS.

In the quarter ended June 30, 2001, we recorded an inventory write-down (including purchase commitments) related to our current generation product platform and related communications equipment totaling $72.0 million. In the quarter ended December 31, 2001, we recorded an additional inventory write-down of $4.8 million. To meet forecasted demand and reduce the anticipated component supply constraints that had existed in the past, we had increased inventory levels for certain components and had entered into purchase commitments for certain components with long lead times. In the quarter ended June 30, 2001, our estimates of forecasted sales in 2001 and 2002, for our current generation of products declined significantly. As a result, the inventory charges were calculated based on:

- the substantial completion of the negotiation process with our contract manufacturers and their suppliers and our other vendors regarding purchase commitments and cancellations made by us;

- the inventory levels in excess of forecasted demand through June 30, 2003; and

- our estimates of salvage or recovery value for each raw material of finished good on an item by item basis.

We do not currently anticipate that the excess inventory included in this provision will be used after June 30, 2003 based on our current demand forecast. Significant estimates included in the calculation of the inventory write-downs include forecasted demand for our products, sales prices for residential

gateways and other finished goods and estimated salvage or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

GOVERNMENT REGULATION OF OUR CUSTOMERS AND RELATED UNCERTAINTY COULD CAUSE OUR CUSTOMERS TO DELAY THE PURCHASE OF OUR PRODUCTS.

The Telecommunications Act requires telephone companies, such as the regional Bell operating companies, to offer their competitors cost-based access to some elements of their networks, including facilities and equipment used to provide high-speed data and video services. These telephone companies may not wish to make expenditures for infrastructure and equipment required to provide broadband services if they will be forced to allow competitors access to this infrastructure and equipment. The Federal Communications Commission announced that, except in limited circumstances, it will not require incumbent carriers to offer

their competitors access to the facilities and equipment used to provide high-speed data services. Nevertheless, other regulatory and judicial proceedings relating to telephone companies' obligations to provide elements of their network to competitors are pending. The FCC also requires incumbent carriers to permit competitive carriers to collocate their equipment with the local switching equipment of the incumbents. The FCC's collocation rules recently have been vacated in part and continue to be subject to regulatory and judicial proceedings. Recently, the FCC issued a ruling that classified cable modem service as an interstate information service that is subject to FCC jurisdiction but not subject to common carrier regulation. As a result, such services are not currently regulated by the FCC and should not be subject to separate state and local regulation. This ruling may improve the competitive position of cable providers who compete with our customers who provide wireline-based broadband services. There is currently a pending rulemaking proceeding in which the FCC proposes to classify broadband Internet access services provided by wireline-based telephone companies as interstate information services. We cannot predict when or how this rulemaking will be decided. The uncertainties caused by these regulatory proceedings may cause these telephone companies to delay purchasing decisions at least until the proceedings and any related judicial appeals are completed. The outcomes of these regulatory proceedings, as well as other FCC regulation, may cause these telephone companies not to deploy services for which our products are designed or to further delay deployment. Additionally, telephone companies' deployment of broadband services may be slowed down or stopped because of the need for telephone companies to obtain permits from city, state or federal authorities to implement infrastructure.

OUR CUSTOMERS AND POTENTIAL CUSTOMERS WILL NOT PURCHASE OUR PRODUCTS IF THEY DO NOT HAVE THE INFRASTRUCTURE NECESSARY TO USE OUR PRODUCTS.

The copper wire infrastructures over which telephone companies may deliver voice, data and video services using our products vary in quality and reliability. As a result, some of these telephone companies may not be able to deliver a full set of voice, data and video services to their customers, despite their intention to do so, and this could harm our sales. Even after installation of our products, we remain highly dependent on telephone companies to continue to maintain their infrastructure so that our products will operate at a consistently high performance level. Infrastructure upgrades and maintenance may be costly, and telephone companies may not have the necessary financial resources. This may be particularly true for our smaller customers and potential customers such as independent telephone companies and domestic local telephone

companies. If our current and potential customers' infrastructure is inadequate, we may not be able to generate anticipated revenues from them.

IF COMPETING TECHNOLOGIES THAT OFFER ALTERNATIVE SOLUTIONS TO OUR PRODUCTS ACHIEVE WIDESPREAD ACCEPTANCE, THE DEMAND FOR OUR PRODUCTS MAY NOT DEVELOP.

Technologies that compete with our products include other telecommunications-related wireline technologies, cable-based technologies, fixed wireless technologies and satellite technologies. If these alternative technologies are chosen by our existing and potential customers, our business, financial condition and results of operations could be harmed. In particular, cable operators are currently deploying products that will be capable of delivering voice, high-speed data and video services over cable, including products from General Instrument, our principal stockholder, and Motorola, its parent. Our technology may not be able to compete effectively against these technologies on price, performance or reliability.

Our customers or potential customers that also offer cable-based services may choose to purchase cable-based technologies. Cable service providers that offer not only data and video but also telephony over cable systems will give subscribers the alternative of purchasing all communications services from a single communications service provider, allowing the potential for more favorable pricing and a single point of contact for bill payment and customer service. If these services are implemented successfully over cable connections, they will compete directly with the services offered by telephone companies using our products. In addition, several telephone companies have commenced the marketing of video services over direct broadcast satellite while continuing to provide voice and data services over their existing copper wire

infrastructure. If any of these services are accepted by consumers, the demand for our products may not develop and our ability to generate revenues will be harmed.

WE FACE INTENSE COMPETITION IN PROVIDING EQUIPMENT FOR TELECOMMUNICATIONS NETWORKS FROM LARGER AND MORE WELL-ESTABLISHED COMPANIES, AND WE MAY NOT BE ABLE TO COMPETE EFFECTIVELY WITH THESE COMPANIES.

Many of our current and potential competitors have longer operating histories, greater name recognition and significantly greater financial, technical, marketing and distribution resources than we do. These competitors may undertake more extensive marketing campaigns, adopt more aggressive pricing policies and devote substantially more resources to developing new products than we are able to, which could result in the loss of current customers and impair our ability to attract potential customers.

Our significant current competitors include Advanced Fibre Communications, Alcatel, Cisco Systems, Efficient Networks, Ericsson, Lucent Technologies, Nokia, Nortel Networks, RELTEC (acquired by BAE Systems, CNI Division, formerly GEC Marconi), Scientific Atlanta, Siemens and our largest stockholder, General Instrument/Motorola, as well as emerging companies that are developing new technologies. Some of these competitors have existing relationships with our current and prospective customers. In addition, we anticipate that other large companies, such as Matsushita Electric Industrial which markets products under the Panasonic brand name, Microsoft, Network Computer, Philips, Sony, STMicroelectronics and Toshiba America will likely introduce products that compete with our N(3) Residential Gateway product in the future. Our customer base may be attracted by the name and resources of these large, well-known companies and may prefer to purchase products from them instead of us.

CONSOLIDATION OF OUR COMPETITORS MAY CAUSE US TO LOSE CUSTOMERS AND NEGATIVELY AFFECT OUR SALES.

Consolidation in the telecommunications equipment industry may strengthen our competitors' positions in our market, cause us to lose customers and hurt our sales. For example, as a result of the merger between U S WEST and Qwest, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. In addition, Alcatel acquired DSC Communications, Lucent acquired Ascend Communications and BAE Systems, CNI Division, formerly GEC Marconi, acquired RELTEC. Acquisitions such as these may strengthen our competitors' financial, technical and marketing resources and provide them access to regional Bell operating companies and other potential customers. Consolidation may also allow some of our competitors to penetrate new markets that we have targeted, such as domestic local, independent and international telephone companies. This consolidation may negatively affect our ability to increase revenues.

IF WE DO NOT RESPOND QUICKLY TO CHANGING CUSTOMER NEEDS AND FREQUENT NEW PRODUCT INTRODUCTIONS BY OUR COMPETITORS, OUR PRODUCTS MAY BECOME OBSOLETE.

Our position in existing markets or potential markets could be eroded rapidly by product advances. The life cycles of our products are difficult to estimate. Our growth and future financial performance will depend in part upon our ability to enhance existing products and develop and introduce new products that keep pace with:

- the increasing use of the Internet;

- the growth in remote access by telecommuters;

- the increasingly diverse distribution sources for high quality digital video; and

- other industry and technological trends.

We expect that our product development efforts will continue to require substantial investments. We may not have sufficient resources to make the necessary investments. If we fail to timely and cost-effectively develop new products that respond to new technologies and customer needs, the demand for our products may fall and we could lose revenues.

OUR EXECUTIVE OFFICERS AND CERTAIN KEY PERSONNEL ARE CRITICAL TO OUR BUSINESS AND THE LOSS OF THEIR SERVICES COULD DISRUPT OUR OPERATIONS AND OUR CUSTOMER RELATIONSHIPS.

Except for J. Michael Norris, our President and Chief Executive Officer, none of our executive officers or key employees is bound by an employment agreement. Many of these employees have a significant number of options to purchase our common stock. Many of these options are currently vested and some of our key employees may leave us once they have exercised their options. In addition, our engineering and product development teams are critical in developing our products and have developed important relationships with our regional Bell operating company customers and their technical staffs. The loss of any of these key personnel could harm our operations and customer relationships.

OUR LIMITED ABILITY TO PROTECT OUR INTELLECTUAL PROPERTY MAY AFFECT OUR ABILITY TO COMPETE, AND WE COULD LOSE CUSTOMERS.

We rely on a combination of patent, copyright and trademark laws, and on trade secrets and confidentiality provisions and other contractual provisions to protect our intellectual property. There is no guarantee that these safeguards will protect our intellectual property and other valuable confidential information. If our methods of protecting our intellectual property in the United States or abroad are not adequate, our competitors may copy our technology or independently develop similar technologies and we could lose customers. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. If we fail to adequately protect our intellectual property, it would be easier for our competitors to sell competing products, which could harm our business.

THIRD-PARTY CLAIMS REGARDING INTELLECTUAL PROPERTY MATTERS COULD CAUSE US TO STOP SELLING OUR PRODUCTS, LICENSE ADDITIONAL TECHNOLOGY OR PAY MONETARY DAMAGES.

From time to time, third parties, including our competitors and customers, have asserted patent, copyright and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in our market grows and the functionality of products overlaps, and our products may currently infringe on one or more United States or international patents. The results of any litigation are inherently uncertain. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required:

- to pay substantial damages, including paying treble damages if we are held to have willfully infringed;

- to halt the manufacture, use and sale of infringing products;

- to expend significant resources to develop non-infringing technology; and/or

- to obtain licenses to the infringing technology.

Licenses may not be available from any third party that asserts intellectual property claims against us, on commercially reasonable terms, or at all. In addition, litigation frequently involves substantial expenditures and can require significant management attention, even if we ultimately prevail. In addition, we indemnify our customers for patent infringement claims, and we may be required to obtain licenses on their behalf, which could subject us to significant additional costs.

WE DEPEND ON THIRD-PARTY MANUFACTURERS AND ANY DISRUPTION IN THEIR MANUFACTURE OF OUR PRODUCTS WOULD HARM OUR OPERATING RESULTS.

We contract for the manufacture of all of our products and have limited in-house manufacturing capabilities. We rely primarily on two large contract manufacturers: Sanmina-SCI Systems and Flextronics Enclosures. The efficient operation of our business will depend, in large part, on our ability to have Sanmina-SCI Systems, Flextronics Enclosures and other companies manufacture our products in a timely manner, cost-effectively and in sufficient volumes while maintaining consistent quality. As our business grows, Sanmina-SCI Systems, Flextronics Enclosures and other contracted manufacturing companies may not have

the capacity to keep up with the increased demand. Any manufacturing disruption could impair our ability to fulfill orders and could cause us to lose customers.

WE HAVE NO LONG-TERM CONTRACTS WITH OUR MANUFACTURERS, AND WE MAY NOT BE ABLE TO DELIVER OUR PRODUCTS ON TIME IF ANY OF THESE MANUFACTURERS STOP MAKING OUR PRODUCTS.

We have no long-term contracts or arrangements with any of our contract manufacturers that guarantee product availability, the continuation of particular payment terms or the extension of credit limits. If our manufacturers are unable or unwilling to continue manufacturing our products in required volumes, we will have to identify acceptable alternative manufacturers, which could take in excess of three months. It is possible that a source may not be available to us when needed or be in a position to satisfy our production requirements at acceptable prices and on a timely basis. If we cannot find alternative sources for the manufacture of our products, we will not be able to meet existing demand. As a result, we may lose existing customers, and our ability to gain new customers may be significantly constrained.

OUR INABILITY TO PRODUCE SUFFICIENT QUANTITIES OF OUR PRODUCTS BECAUSE OF OUR DEPENDENCE ON COMPONENTS FROM KEY SOLE SUPPLIERS COULD RESULT IN DELAYS IN THE DELIVERY OF OUR PRODUCTS AND COULD HARM OUR REVENUES.

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers or we fail to obtain components in sufficient quantities when required, delivery of our products could be delayed resulting in decreased revenues. Additional sole-sourced components may be incorporated into our equipment in the future. We do not have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

THE OCCURRENCE OF ANY DEFECTS, ERRORS OR FAILURES IN OUR PRODUCTS COULD RESULT IN DELAYS IN INSTALLATION, PRODUCT RETURNS AND OTHER LOSSES TO US OR TO OUR CUSTOMERS OR END USERS.

Our products are complex and may contain undetected defects, errors or failures. These problems have occurred in our products in the past and additional problems may occur in our products in the future and could result in the loss of or delay in market acceptance of our products. In addition, we have limited experience with commercial deployment and we expect additional defects, errors and failures as our business expands from trials to commercial deployment at certain customers. We will have limited experience with the problems that could arise with any new products that we introduce. Further, our customer agreements generally include a longer warranty for defects than our manufacturing agreements. These defects could result in a loss of sales and additional costs and liabilities to us as well as damage to our reputation and the loss of our customers.

WE DO NOT HAVE SIGNIFICANT EXPERIENCE IN INTERNATIONAL MARKETS AND MAY HAVE UNEXPECTED COSTS AND DIFFICULTIES IN DEVELOPING INTERNATIONAL REVENUES.

We plan to extend the marketing and sales of our products internationally. International operations are generally subject to inherent risks and challenges that could harm our operating results, including:

- unexpected changes in telecommunications regulatory requirements;
- limited number of telephone companies operating internationally;
- expenses associated with developing and customizing our products for foreign countries;

- tariffs, quotas and other import restrictions on telecommunications equipment;

- longer sales cycles for our products; and

- compliance with international standards that differ from domestic standards.

To the extent that we generate international sales in the future, any negative effects on our international business could harm our business, operating results and financial condition. In particular, fluctuating exchange rates may contribute to fluctuations in our results of operations.

MOTOROLA MAY EXERCISE SIGNIFICANT INFLUE