

Shutterstock, Inc.  
Form 10-Q  
May 10, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

**For the quarterly period ended March 31, 2013**

or

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

**For the transition period from                    to**

**Commission File Number: 001-35669**

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**SHUTTERSTOCK, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**80-0812659**  
(I.R.S. Employer  
Identification No.)

**Jonathan Oringer**

**Chief Executive Officer**

**Shutterstock, Inc.**

**60 Broad Street, 30th Floor**

**New York, NY 10004**

(Address of principal executive offices, including zip code)

**(646) 419-4452**

(Registrant's telephone number, including area code)

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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 file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

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

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Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

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

Class	Outstanding at May 8, 2013
Common Stock, \$0.01 par value per share	33,523,654

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**SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements. These forward-looking statements can be identified by the use of forward-looking terminology such as believe, may, estimate, continue, anticipate, intend, expect, predict, potential, project, guidance, target, forecast

We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends affecting the financial condition of our business. Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time those statements are made and/or management's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in or suggested by the forward-looking statements as a result of certain factors, as more fully described in Part II, Item 1A (Risk Factors) of this Quarterly Report on Form 10-Q and in the reports and documents filed from time to time by us with the Securities and Exchange Commission (the "SEC").

Forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q. You should not put undue reliance on any forward-looking statements. We assume no obligation to update forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except to the extent required by applicable laws. If we update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements.

**WHERE YOU CAN FIND MORE INFORMATION**

Shutterstock's corporate website is located at [www.shutterstock.com](http://www.shutterstock.com). Shutterstock makes available free of charge, on our corporate website, our annual, quarterly and current reports, and any amendments to those reports, as soon as reasonably practicable after electronically filing such reports with, or furnishing to, the SEC. Information contained on Shutterstock's corporate website is not part of this report or any other report filed with the SEC.

Prior to its initial public offering, Shutterstock operated as a New York limited liability company under the name Shutterstock Images LLC (the "LLC"). On October 5, 2012, Shutterstock reorganized by way of a merger of the LLC with and into Shutterstock, Inc., a newly-formed Delaware corporation, with Shutterstock, Inc. surviving in the merger. Since October 5, 2012, Shutterstock has operated as a Delaware corporation.

Unless the context otherwise indicates, references in this report to the terms Shutterstock, the Company, we, our and us refer to Shutterstock, Inc. and its subsidiaries including, for the period on and prior to October 5, 2012, Shutterstock Images LLC.

Table of Contents**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****Shutterstock, Inc.****Consolidated Balance Sheets****(In thousands, except per share data)**

	<b>March 31, 2013 (unaudited)</b>	<b>December 31, 2012</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 107,013	\$ 102,096
Credit card receivables	2,218	1,373
Accounts receivable, net	2,618	1,738
Prepaid expenses and other current assets	2,095	2,008
Deferred tax assets	20,801	18,760
Total current assets	134,745	125,975
Property and equipment, net	5,660	5,255
Intangible assets, net	984	1,040
Goodwill	1,423	1,423
Deferred tax assets	12,890	13,239
Restricted cash	2,008	182
Total assets	\$ 157,710	\$ 147,114
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,792	\$ 2,606
Accrued expenses	14,370	15,606
Contributor royalties payable	7,986	6,984
Income taxes payable	4,626	
Deferred revenue	43,336	37,934
Term loan facility		6,000
Other liabilities	181	161
Total current liabilities	73,291	69,291
Other non-current liabilities	871	889
Total liabilities	74,162	70,180
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, \$0.01 par value; 200,000 shares authorized; 33,517 and 33,513 shares outstanding as of March 31, 2013 and December 31, 2012, respectively	335	335
Additional paid-in capital	49,331	48,282
Retained earnings	33,882	28,317
Total stockholders' equity	83,548	76,934
Total liabilities and stockholders' equity	\$ 157,710	\$ 147,114

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

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## Shutterstock, Inc.

## Consolidated Statements of Operations

(In thousands, except for share and per share data)

(unaudited)

	Three Months Ended March 31,	
	2013	2012
Revenue	\$ 51,117	\$ 37,574
Operating expenses:		
Cost of revenue	19,821	14,389
Sales and marketing	11,978	12,240
Product development	4,555	3,419
General and administrative	4,780	3,732
Total operating expenses	41,134	33,780
Income from operations	9,983	3,794
Other (expense) / income, net	(12)	3
Income before income taxes	9,971	3,797
Provision for income taxes	4,406	86
Net income	\$ 5,565	\$ 3,711
Less:		
Preferred interest distributed		2,100
Undistributed earnings (loss) to participating stockholder/members	19	(1,172)
Net income available to common stockholders/members	\$ 5,546	\$ 2,783
Net income (loss) per basic share available to common stockholders/members:		
Distributed	\$	\$ 0.30
Undistributed	0.17	(0.17)
Basic	\$ 0.17	\$ 0.13
Net income (loss) per diluted share available to common stockholders/members:		
Distributed	\$	\$ 0.30
Undistributed	0.16	(0.17)
Diluted	\$ 0.16	\$ 0.13
Weighted average shares outstanding:		
Basic	33,398,797	20,849,242
Diluted	33,851,843	20,849,242

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



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## Shutterstock, Inc.

## Consolidated Statements of Cash Flows

(In thousands)

(unaudited)

	Three Months Ended March 31,	
	2013	2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 5,565	\$ 3,711
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	779	528
Deferred taxes	(1,692)	(97)
Non-cash equity-based compensation	1,016	664
Bad debt reserve	84	50
Chargeback reserve	20	
Amortization of deferred financing fees	125	
Changes in operating assets and liabilities:		
Credit card receivable	(845)	(621)
Accounts receivable	(964)	(295)
Prepaid expenses and other current and non-current assets	(259)	(870)
Accounts payable and other liabilities	(1,069)	1,884
Contributors payable	1,002	1,086
Income taxes payable	4,626	
Deferred revenue	5,402	3,775
Net cash provided by operating activities	\$ 13,790	\$ 9,815
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(1,127)	(1,313)
Acquisition of patents		(193)
Security deposit (payment)/receipt	(1,779)	38
Net cash used in investing activities	\$ (2,906)	\$ (1,468)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from exercise of stock options	53	
Payment of term loan	(6,000)	
Payment of offering fees	(20)	
Members distributions		(8,400)
Net cash used in financing activities	\$ (5,967)	\$ (8,400)
Net increase (decrease) in cash and cash equivalents	4,917	(53)
Cash and cash equivalents Beginning	102,096	14,097
Cash and cash equivalents Ending	\$ 107,013	\$ 14,044
<b>Supplemental Disclosure of Cash Information:</b>		
Cash paid for:		
Income taxes	\$ 1,264	\$ 300
Interest	\$ 34	\$

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



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**Shutterstock, Inc.**

**Notes to Unaudited Consolidated Financial Statements**

**(In Thousands, Except Share and Per Share Data)**

**(1) Summary of Operations and Significant Accounting Policies**

*Summary of Operations*

Shutterstock, Inc. (the Company or Shutterstock) operates an industry-leading global marketplace for commercial digital imagery. Commercial digital imagery consists of licensed photographs, illustrations and videos that companies use in their visual communications, such as websites, digital and print marketing materials, corporate communications, books, publications and video content. The Company licenses commercial digital imagery to its customers. Contributors upload their digital imagery to the Company's website in exchange for a royalty payment based on customer download activity. The Company maintains its primary office location in New York City.

*Principles of Consolidation*

The consolidated financial statements reflect the operations of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

*Unaudited Interim Financial Statements*

The interim consolidated balance sheet as of March 31, 2013 and the consolidated statements of operations and cash flows for the three months ended March 31, 2013 and 2012 are unaudited. The unaudited interim financial statements have been prepared on a basis consistent with the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to state fairly the Company's financial position as of March 31, 2013 and its results of consolidated operations and cash flows for the three months ended March 31, 2013 and 2012. The financial data and the other financial information disclosed in these notes to the financial statements related to these periods are also unaudited. The results of operations for the three months ended March 31, 2013 are not necessarily indicative of the results to be expected for the year ending December 31, 2013 or for any other future annual or interim period.

There have been no changes in the significant accounting policies from those that were disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed on March 1, 2013. These financial statements should also be read in conjunction with the

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audited Consolidated Financial Statements and Notes thereto for the year ended December 31, 2012. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been omitted pursuant to such rules and regulations. The consolidated balance sheet as of December 31, 2012 included herein was derived from the audited financial statements as of that date, but does not include all disclosures required by GAAP.

### *Reorganization*

In May 2012, in connection with the filing of a registration statement for the Company's initial public offering (the "IPO"), Shutterstock Images LLC, a New York limited liability company (the "LLC") formed Shutterstock, Inc., a Delaware corporation, as a wholly-owned subsidiary of the LLC. On October 5, 2012, the LLC reorganized, by way of a merger of the LLC with and into Shutterstock, Inc. with Shutterstock, Inc. surviving in the merger (the "Reorganization"). In connection with this Reorganization, the preferred and common membership interests in the LLC, including any interests that vested upon the Reorganization, were exchanged for shares of Shutterstock, Inc. common stock and the outstanding value appreciation rights of the LLC were exchanged for options to purchase shares of common stock of Shutterstock, Inc.

### *Use of Estimates*

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company's management to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses during the period. The Company evaluates its significant estimates on an ongoing basis, including, but not limited to allowance for doubtful accounts, goodwill, intangibles, non-cash equity-based compensation, income tax provision and for certain non-income tax accruals. The Company bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

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***Revenue Recognition***

All revenue, net of refunds, is generated from the license of digital content through subscription or usage based plans. The Company's four plans are: subscription plans, On Demand plans, Pay As You Go, and credit pack plans. The Company recognizes revenue when the following basic criteria are met: there is persuasive evidence of an arrangement, performance or delivery of services has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. The Company considers persuasive evidence of an arrangement to be an electronic order form, or a signed contract, which contains the fixed pricing terms. Performance or delivery is considered to have occurred upon either the ratable passage of time over the contract period, a usage basis or upon the expiration of a contract period for which there are unused downloads or credits. Collectability is reasonably assured since most of the Company's customers purchase products by making electronic payments at the time of a transaction with a credit card. The Company establishes a chargeback allowance based on factors surrounding historical credit card chargeback trends and other information. As of March 31, 2013 and December 31, 2012, the Company has recorded a chargeback allowance of \$90 and \$70, respectively, which is included in other liabilities. Collectability is assessed for customers who pay on credit based on a credit evaluation for new customers and transaction history with existing customers. Any cash received in advance of revenue recognition is recorded as deferred revenue.

Subscription plans range in length from thirty days to one year. Subscription plan revenues are recognized on a straight-line basis using a daily convention method over the plan term. On Demand plans are for a one-year term and permit the customer to download up to a fixed amount of digital content. On-demand revenues are recognized at the time the customer downloads the digital content on a per unit basis. Revenue related to unused digital content, if any, is recognized in full at the end of the plan term. Pay As You Go plans provide for individual image download. The Company recognizes revenue as the customer downloads images. Credit-pack plans are generally for a one-year term and enable the customer to purchase a fixed number of credits which can then be utilized to pay for downloaded digital content. The number of credits utilized for each download depends on the digital content size and format. Credit-pack revenues are recognized based on customer usage on a per credit basis as digital content is downloaded. Revenue related to unused credits, if any, is recognized in full at the end of the plan term. Most plans automatically renew at the end of the plan term unless the customer elects not to renew. The Company recognizes revenue from its four types of plans on a gross basis in accordance with the authoritative guidance on principal-agent considerations as the Company is the primary obligor in the arrangement, has latitude in establishing the product's price, performs a detailed review of the digital content before accepting it to its collection to ensure it is of high quality before it may be purchased by our customers, can reject contributor's images in its sole discretion, and has credit risk.

Customers typically pay in advance (or upon commencement of the term) via credit card, wire or check. Fees paid or invoiced in advance are deferred and recognized as described above. Customers that do not pay in advance are invoiced and are required to make payment under standard credit terms. The Company does not generally offer refunds or the right of return to customers. There are situations in which a customer may receive a refund which is determined on a case-by-case basis.

The Company also licenses digital content to customers through third party resellers. The Company contracts with third party resellers around the world to access markets where the Company does not have a significant presence. Third party resellers sell the Company's products directly to end-user customers and remit a fixed amount to the Company based on the type of plan sold. The terms of the reseller program indicate that the third party reseller is the primary obligor to the end-user customer and bears the risks and rewards as principal in the transaction. In assessing whether the Company's revenue should be reported on a gross or net basis with respect to our reseller program, the Company follows the authoritative guidance in ASC 605-45 *Principal Agent Considerations*. The Company recognizes revenue on a net basis in accordance with the type of plan sold, consistent with the plan descriptions above. The Company generally does not offer refunds or the right of return to resellers.

***Equity-Based Compensation***

Between June 7, 2007 and October 5, 2012, the Company was organized as a limited liability company. Beginning in 2011, the Company granted equity rights similar to options under its Value Appreciation Rights Plan ( VAR Plan ) in the form of value appreciation rights (the VAR Plan awards ). Each VAR Plan award had an exercise price, a vesting period and an expiration date, in addition to other terms and conditions similar to typical equity option grant terms and conditions. The VAR Plan awards were subject to a time-based vesting requirement and a condition that a change of control occur in order to trigger a payment with respect to the VAR Plan awards. In connection with the Reorganization, all of the VAR Plan awards were exchanged for options to purchase an aggregate of 1,661,719 shares of common stock of Shutterstock, Inc. with only a time-based vesting requirement, which were granted pursuant to the Company s 2012 Omnibus Equity Incentive Plan (the 2012 Plan ).

The Company measures and recognizes non-cash equity-based compensation expense for all equity-based payment awards made to employees based on estimated fair values. The value portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period. For awards with a change of control condition, an evaluation is made at the grant date and future periods as to the likelihood of the condition being met. Compensation expense is adjusted in future periods for subsequent changes in the expected outcome of the change of control conditions until the vesting date. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options and other equity-based awards granted pursuant to the 2012 Plan, stock purchased pursuant to the Employee Stock Purchase Plan ( 2012 ESPP ) and the VAR Plan awards, which are discussed further in Note 10, Equity-Based Compensation.

The determination of the grant date fair value using an option-pricing model requires judgment as well as assumptions regarding a number of complex and subjective variables. These variables include the Company s fair value of the common ownership interest pre-IPO, the Company s closing market price at the grant date post-IPO, the expected unit price volatility over the expected term of the awards, awards exercise and cancellation behaviors, risk-free interest rates, and expected dividends, which are estimated as follows:

- **Fair Value of Common Membership Unit.** Prior to completion of the IPO, the Company s fair value of common ownership interest was estimated internally and approved by the Board of Managers ( BOM ) because the Company was not publicly traded. The Company s intention upon granting VAR Plan awards was for the granted award to have an exercisable price per unit that was not less than the per unit fair value of the Company s common equity on the date of grant. The valuations of the Company s common equity unit were prepared in accordance with the American Institute of Certified Public Accountants Statement on Standards for Valuation Services 1: *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*. The assumptions used in the valuation model were based on future expectations combined with the Company s judgment. In the absence of a public trading market, the Company exercised significant judgment and considered numerous objective and subjective factors to determine the fair value of the common equity unit as of the date of each VAR Plan award grant. Some, but not all of these factors included operating and financial performance, current business conditions and projections, the hiring of key personnel, the Company s history and introduction of new functionality and services, the Company s stage of development, the likelihood of achieving a liquidity event for the common ownership interests, any adjustment necessary to recognize a lack of marketability for our common ownership interests, the market performance of comparable publicly traded companies, and U.S. and global capital market conditions. The Company also obtained independent third party valuations on a periodic basis. After October 11, 2012, the date the Company s common stock began trading on the NYSE, the grant date fair value for stock-based awards is based on the closing price of the Company s common stock on the NYSE on the date of grant and fair value for all other purposes related to stock-based awards shall be the closing price of the Company s common stock on the NYSE on the relevant date.

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- **Expected Term.** The expected term was estimated using the simplified method allowed under Securities and Exchange Commission ( SEC ) guidance.
- **Volatility.** As the Company did not have a trading history for its common ownership interest pre-IPO and does not have a significant trading history for its common stock post-IPO, the expected price volatility for the common ownership interests and common stock was estimated by taking the average historic price volatility for industry peers based on daily price observations over a period equivalent to the expected term of the VAR Plan awards and stock options granted post-IPO. Industry peers consist of several public companies similar in size, stage of life cycle and financial leverage. The Company did not rely on implied volatilities of traded options in the industry peers common stock because the volume of activity was relatively low. The Company intends to continue to consistently apply this process using the same or similar public companies until a sufficient amount of historical information regarding the volatility of the Company s own common stock becomes available, or unless circumstances change such that the identified companies are no longer similar to the Company, in which case, more suitable companies whose share prices are publicly available would be utilized in the calculation.
- **Risk-free Interest Rate.** The risk-free interest rate is based on the yields of U.S. Treasury securities with maturities similar to the expected term of each award group.
- **Dividend Yield.** The Company has historically paid cash dividends or distributions to its members. Post-IPO, the Company does not intend to pay cash dividends or distributions in the foreseeable future. As a result, the Company uses an expected dividend yield of zero.

If any of the assumptions used in the Black-Scholes model changes significantly, the fair value for future awards may differ materially compared with the awards granted previously. The awards granted pursuant to the 2012 Plan, the 2012 ESPP and VAR Plan are subject to a time-based vesting requirement. The majority of stock option awards granted under the 2012 Plan vest over four years. The 2012 ESPP provides for purchase periods approximately every six months and a participant must be employed on the purchase date to participate in the 2012 ESPP. The VAR Plan awards had a condition that a change of control (as defined in the VAR Plan) must occur for a payment to trigger with respect to the VAR Plan awards. In connection with the Company s Reorganization, all of the VAR Plan awards were exchanged for options to purchase shares of common stock of Shutterstock, Inc. which do not include a change of control condition. As of March 31, 2012, no equity-based compensation expense, related to the VAR Plan awards, had been recognized because the qualifying events had not occurred. As a result of the completion of the IPO, the Company began recording share-based compensation expense using the accelerated attribution method, net of forfeitures, based on the grant date fair value of the VAR Plan awards that were exchanged for options to purchase shares of common stock of Shutterstock, Inc. as part of the Company s Reorganization.

authorize the issuance of blank check convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;

establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

require that directors only be removed from office for cause and only upon a supermajority stockholder vote;

provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;

prevent stockholders from calling special meetings; and

prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

**Our management will have broad discretion over the use of the proceeds we receive in this offering and might not apply the proceeds in ways that increase the value of your investment.**

Our management will have broad discretion to use the net proceeds from this offering, and you will be relying on the judgment of our management regarding the application of these proceeds. Our management might not apply the net proceeds of this offering in ways that increase the value of your investment. We expect to use the net proceeds from this offering to possibly repay our credit facilities, and for general corporate purposes, including working capital and capital expenditures, which may in the future include investments in, or acquisitions of, complementary businesses, services or technologies. We have not allocated these net proceeds for any specific purposes. Our management might not be able to yield a significant return, if any, on any investment of these net proceeds. You will not have the opportunity to influence our decisions on how the net proceeds from this offering are used.



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**FORWARD-LOOKING STATEMENTS**

This prospectus includes forward-looking statements that relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. All statements contained in this prospectus other than statements of historical facts, including statements regarding our future operating results and financial position, our business strategy and plans and our objectives for future operations, are forward-looking statements. The words anticipate, architected, believe, continue, could, designed, enable, estimate, expect, intend, likely, may, plan, target, will, or would and similar expressions are intended to identify forward-looking statements.

Forward-looking statements made herein include, but are not limited to, statements about:

anticipated trends and challenges in our business and the markets in which we operate;

our ability to address market needs or develop new or enhanced products to meet those needs;

expected adoption of our DTN System by our potential customers;

our ability to compete in our industry;

our ability to successfully manufacture our PICs and our DTN System;

our ability to grow our revenue and improve our gross margins;

our ability to protect our confidential information and intellectual property rights;

our ability to manage our growth and anticipated expansion into new markets;

the expected future impact of our deferred revenue and deferred inventory costs;

our ability to establish VSOE;

our need to obtain additional funding and our ability to obtain funding in the future on acceptable terms; and

our expectations regarding the use of proceeds from this offering.

All forward-looking statements involve risks, assumptions and uncertainties. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, operating results, business strategy, short-term and long-term business operations and objectives, and financial needs.

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The occurrence of the events described, and the achievement of the expected results, depend on many events, some or all of which are not predictable or within our control. Actual results may differ materially from expected results. See the section titled **Risk Factors** and elsewhere in this prospectus for a more complete discussion of these risks, assumptions and uncertainties and for other risks and uncertainties. These risks, assumptions and uncertainties are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could harm our results. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this prospectus might not occur. We undertake no obligation, and specifically decline any obligation, to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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**USE OF PROCEEDS**

We estimate that our net proceeds from the sale of the common stock that we are offering will be approximately \$165.2 million, at an initial public offering price of \$13.00 per share, and after deducting the underwriting discount and estimated offering expenses payable by us. If the underwriters' over-allotment option to purchase additional shares in this offering is exercised in full we estimate that our net proceeds will be approximately \$190.5 million.

We intend to use the net proceeds to us from this offering for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. However, we do not have agreements or commitments for any acquisitions at this time.

In addition, we may choose to repay our credit facilities, including:

up to \$5.4 million outstanding as of March 31, 2007 under our credit facility with Silicon Valley Bank and Gold Hill Ventures Lending 03, L.P. dated December 29, 2004 that has a maturity date of June 1, 2008 and had a weighted-average interest rate of 16.7% in 2006;

up to \$9.5 million outstanding as of March 31, 2007 under our credit facility with Silicon Valley Bank dated December 29, 2004 that has a maturity date of September 27, 2007 and had a weighted-average interest rate of 10.1% in 2006; and

up to \$14.1 million outstanding as of March 31, 2007 under our credit facility with United Commercial Bank dated June 21, 2005 that has a maturity date of October 31, 2009 and had an interest rate of 8.3% in 2006.

However, we do not have agreements or commitments for any specific repayments related to these credit facilities at this time.

The amount and timing of our expenditures will depend on several factors, including progress in our research and development efforts and the amount of cash used throughout our organization. Pending use of proceeds from this offering, we intend to invest the proceeds in a variety of capital preservation investments, including short- and intermediate-term interest bearing obligations, investment-grade instruments, certificates of deposit or direct or guaranteed obligations of the U.S. government.

**DIVIDEND POLICY**

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings to support the operation of and to finance the growth and development of our business. We do not anticipate paying any cash dividends in the foreseeable future. Any future determination to declare cash dividends will be made at the discretion of our board of directors, subject to compliance with certain covenants under our credit facilities, which restrict or limit our ability to pay dividends, and will depend on our financial condition, operating results, capital requirements, general business conditions and other factors that our board of directors may deem relevant.

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The following table presents our cash, cash equivalents and short-term investments and capitalization as of March 31, 2007:

on an actual basis;

on a pro forma basis after giving effect to (i) the conversion of all outstanding shares of convertible preferred stock into common stock immediately prior to the closing of the offering and (ii) the reclassification of the preferred stock warrant liability to common stock immediately prior to the closing of this offering; and

on a pro forma as adjusted basis reflecting (i) the conversion of all outstanding shares of convertible preferred stock into common stock immediately prior to the closing of this offering, (ii) the reclassification of the convertible preferred stock warrant liabilities to common stock and additional paid-in-capital and (iii) the receipt of the estimated net proceeds from the sale of 14,000,000 shares of common stock offered by us at an initial public offering price of \$13.00 per share, and after deducting the underwriting discount and estimated offering expenses and the filing of our amended and restated certificate of incorporation immediately prior to the closing of this offering.

You should read this table in conjunction with the sections titled **Selected Consolidated Financial Data** and **Management's Discussion and Analysis of Financial Condition and Results of Operations** and our consolidated financial statements and related notes included elsewhere in this prospectus.

	<b>As of March 31, 2007</b>		
	<b>Actual</b>	<b>Pro Forma (Unaudited) (In thousands)</b>	<b>Pro Forma As Adjusted</b>
Cash, cash equivalents and short-term investments	\$ 39,662	\$ 39,662	\$ 204,822
Preferred stock warrant liability	\$ 7,909	\$	\$
Current and long-term debt	33,896	33,896	33,896
Convertible preferred stock, \$0.001 par value: 62,000 authorized and issuable in series, 58,806 shares issued and outstanding, actual; no shares authorized, no shares issued and outstanding, pro forma; no shares authorized, no shares issued and outstanding, pro forma as adjusted	320,550		
Stockholders' equity (deficit):			
Convertible preferred stock, \$0.001 par value: no shares authorized, issued and outstanding, actual; no shares authorized, no shares issued and outstanding, pro forma; 25,000 shares authorized, no shares issued and outstanding, pro forma as adjusted			
Common stock, \$0.001 par value: 79,500 shares authorized, 9,710 shares issued and outstanding actual; 79,500 shares authorized, 69,137 shares issued and outstanding pro forma; 500,000 shares authorized, 83,137 shares issued and outstanding pro forma as adjusted	10	69	83
Additional paid-in capital	9,624	338,024	503,170
Accumulated other comprehensive loss	(143)	(143)	(143)
Accumulated deficit	(333,901)	(333,901)	(333,901)
Total stockholders' equity (deficit)	(324,410)	4,049	169,209
Total capitalization	\$ 37,945	\$ 37,945	\$ 203,105



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This table excludes the following shares:

8,220,738 shares of common stock issuable upon exercise of stock options outstanding as of March 31, 2007 at a weighted average exercise price of \$2.09 per share;

1,332,680 shares of common stock issuable upon the exercise of warrants outstanding as of March 31, 2007 at a weighted average exercise price of \$5.23 per share; and

16,468,938 shares of common stock reserved for future issuance under our stock-based compensation plans, consisting of 1,056,438 shares of common stock reserved for issuance under our 2000 Stock Plan, of which 158,371 shares were granted on April 24, 2007, 13,600,000 shares of common stock reserved for issuance under our 2007 Equity Incentive Plan, of which 3,076,779 shares were approved for granting by our compensation committee on May 7, 2007 and are effective as the date of this prospectus and 1,812,500 shares of common stock reserved for issuance under our 2007 Employee Stock Purchase Plan. The 2007 Equity Incentive Plan and the 2007 Employee Stock Purchase Plan became effective on the date of this prospectus, June 6, 2007.

This table includes the following shares:

1,848,299 shares of restricted common stock issued upon the early exercise of stock options at a weighted average exercise price of \$1.65 per share that are classified as outstanding for financial reporting purposes, except in the calculation of earnings per share.

See the section titled "Management - Equity Benefit Plans" for a description of our equity plans.

**Table of Contents****DILUTION**

Our pro forma net tangible book value as of March 31, 2007 was \$4.0 million, or approximately \$0.06 per share. Net tangible book value per share represents the amount of stockholders' equity divided by 69,136,638 shares of common stock outstanding after giving effect to the conversion of all outstanding shares of convertible preferred stock into shares of common stock upon the closing of this offering.

Net tangible book value dilution per share to new investors represents the difference between the amount per share paid by purchasers of shares of common stock in this offering and the net tangible book value per share of common stock immediately after the closing of this offering. After giving effect to our sale of 14,000,000 shares of common stock in this offering at an initial public offering price of \$13.00 per share, and after deducting the underwriting discount and estimated offering expenses, our net tangible book value as of March 31, 2007 would have been \$169.2 million, or \$2.04 per share. This represents an immediate increase in net tangible book value of \$1.98 per share to existing stockholders and an immediate dilution in net tangible book value of \$10.96 per share to purchasers of common stock in the offering, as illustrated in the following table:

Initial public offering price per share	\$ 13.00
Pro forma net tangible book value per share as of March 31, 2007	\$ 0.06
Increase in pro forma as adjusted net tangible book value per share attributable to new investors	1.98
Pro forma as adjusted net tangible book value per share after the offering	2.04
Dilution per share to new investors	\$ 10.96

If the underwriters exercise their option to purchase additional shares of our common stock in full in this offering, the pro forma as adjusted net tangible book value per share after the offering would be \$2.28 per share, the increase in pro forma as adjusted net tangible book value per share to existing stockholders would be \$2.22 per share and the dilution to new investors purchasing shares in this offering would be \$10.72 per share.

If all of our outstanding stock options and warrants were exercised and the underwriters do not exercise their option to purchase additional shares of our common stock in full in this offering, the pro forma as adjusted net tangible book value per share after the offering would be \$2.09 per share, the increase in pro forma net tangible book value per share to existing stockholders would be \$2.03 per share and the dilution to new investors purchasing shares in this offering would be \$10.91 per share.

If all of our outstanding stock options and warrants were exercised and the underwriters exercise their option to purchase additional shares of our common stock in full in this offering, the pro forma as adjusted net tangible book value per share after the offering would be \$2.31 per share, the increase in pro forma net tangible book value per share to existing stockholders would be \$2.25 per share and the dilution to new investors purchasing shares in this offering would be \$10.69 per share.

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The following table presents on a pro forma basis as of March 31, 2007, after giving effect to the conversion of all outstanding shares of convertible preferred stock into common stock immediately prior to the closing of this offering, the differences between the existing stockholders and the purchasers of shares in the offering with respect to the number of shares purchased from us, the total consideration paid and the average price paid per share:

	Shares Purchased		Total Consideration		Average Price Per
	Number (in thousands, except percentages and per share data)	Percent	Amount	Percent	Share
Existing stockholders	69,137	83.2%	\$ 334,533	68.5%	\$ 4.84
New stockholders	14,000	16.8	182,000	31.5	13.00
<b>Totals</b>	<b>83,137</b>	<b>100.0%</b>	<b>\$ 516,533</b>	<b>100.0%</b>	<b>\$ 6.21</b>

As of March 31, 2007, there were options outstanding to purchase a total of 8,220,738 shares of common stock at a weighted average exercise price of \$2.09 per share. As of March 31, 2007 there were warrants outstanding to purchase 1,332,680 shares of common stock with a weighted average exercise price of \$5.23 per share. The above discussion and table assumes no exercise of stock options or warrants outstanding as of March 31, 2007. If all of these options and warrants were exercised, our existing stockholders, including the holders of these options and warrants, would own 84.9% of the total number of shares of our common stock outstanding upon the closing of this offering and our new investors would own 15.1% of the total number of shares of our common stock upon the closing of this offering.

As of March 31, 2007, there were 1,848,299 shares of restricted common stock issued upon the early exercise of stock options at a weighted average exercise price of \$1.65 per share that are classified as outstanding for financial reporting purposes, except in the calculation of net loss per common share. For a description of our equity plans, please see the section titled Management Equity Benefit Plans.



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**SELECTED CONSOLIDATED FINANCIAL DATA**

You should read the following selected consolidated historical financial data below in conjunction with the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements, related notes and other financial information included elsewhere in this prospectus. The selected financial data in this section is not intended to replace the financial statements and is qualified in its entirety by the consolidated financial statements and related notes thereto included elsewhere in this prospectus.

We derived the statements of operations and cash flow data for the years ended December 31, 2004, 2005 and 2006 and the balance sheet data as of December 31, 2005 and 2006 from our audited consolidated financial statements and related notes, which are included elsewhere in this prospectus. We derived the statements of operations and cash flow data for the years ended December 31, 2002 and 2003 and the balance sheet data as of December 31, 2002, 2003 and 2004 from our audited consolidated financial statements and related notes which are not included in this prospectus. The statement of operations and cash flow data for the three months ended March 31, 2006 and 2007 and the balance sheet data as of March 31, 2007 are derived from our unaudited consolidated financial statements that are included in this prospectus. In the opinion of management, the unaudited consolidated financial statements have been prepared on the same basis as our audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the information set forth therein. The results for any interim period are not necessarily indicative of the results that may be expected for a full year. Additionally, our historical results are not necessarily indicative of the results that should be expected in the future.

The pro forma basic and diluted net loss per common share data in the statement of operations data for the year ended December 31, 2006 and three months ended March 31, 2006 and 2007 reflect the conversion of all of our outstanding shares of convertible preferred stock into 59,427,606 shares of common stock immediately prior to the closing of this offering.

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	Three Months Ended						
	2002	Years Ended December 31,			2006	March 31,	
		2003	2004	2005		2006	2007
	(In thousands, except per share data)						
<b>Statements of Operations Data:</b>							
Revenue:							
Ratable product and related support and services	\$	\$	\$	\$ 4,127	\$ 52,978	\$ 2,653	\$ 45,947
Product			599		5,258		3,245
<b>Total revenue</b>			599	4,127	58,236	2,653	49,192
Cost of revenue:							
Cost of ratable product and related support and services				17,759	48,072	5,485	34,843
Lower of cost or market adjustment			1,587	9,696	21,693	4,325	1,067
Cost of product			5,653		1,660		1,363
<b>Total cost of revenue</b>			7,240	27,455	71,425	9,810	37,273
<b>Gross profit (loss)</b>			(6,641)	(23,328)	(13,189)	(7,157)	11,919
Operating expenses:							
Sales and marketing	895	1,680	8,294	11,053	20,682	2,701	7,636
Research and development	26,759	41,951	46,306	24,986	38,967	6,446	16,058
General and administrative	4,938	4,587	2,888	4,328	12,650	1,378	5,557
Amortization of intangible assets					56		37
<b>Total operating expenses</b>	32,592	48,218	57,488	40,367	72,355	10,525	29,288
<b>Loss from operations</b>	(32,592)	(48,218)	(64,129)	(63,695)	(85,544)	(17,682)	(17,369)
<b>Other income (expense), net</b>	(1,470)	(2,013)	(2,351)	(2,256)	(4,319)	(496)	(2,415)
<b>Loss before provision for income taxes and cumulative effect of change in accounting principle</b>	(34,062)	(50,231)	(66,480)	(65,951)	(89,863)	(18,178)	(19,784)
<b>Provision for income taxes</b>				12	72	15	29
<b>Loss before cumulative effect of change in accounting principle</b>	(34,062)	(50,231)	(66,480)	(65,963)	(89,935)	(18,193)	(19,813)
<b>Cumulative effect of change in accounting principle</b>				(1,137)			
<b>Net loss</b>	\$ (34,062)	\$ (50,231)	\$ (66,480)	\$ (64,826)	\$ (89,935)	\$ (18,193)	\$ (19,813)
<b>Net loss per common share, basic and diluted</b>	\$ (21.27)	\$ (19.61)	\$ (17.94)	\$ (14.08)	\$ (14.90)	\$ (3.63)	\$ (2.62)
<b>Weighted average number of shares used in computing basic and diluted net loss per common share</b>	1,602	2,561	3,705	4,605	6,036	5,010	7,560

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Pro forma net loss per common share, basic and diluted (unaudited)	\$ (1.49)	\$ (0.36)	\$ (0.30)
Weighted average number of shares used in computing pro forma basic and diluted net loss per common share (unaudited)	60,389	50,762	66,988

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	2002	2003	As of December 31,		2006	As of
			2004	2005		March 31,
						2007
						(Unaudited)
	(In thousands)					
<b>Balance Sheet Data:</b>						
Cash, cash equivalents and short-term investments	\$ 49,997	\$ 54,244	\$ 40,017	\$ 37,112	\$ 29,572	\$ 39,662
Working capital	40,956	43,976	37,665	29,579	2,218	(12,869)
Total assets	69,849	75,441	69,514	100,912	230,466	227,870
Current and long-term debt	16,638	10,256	6,359	23,773	28,382	33,896
Convertible preferred stock	91,870	151,865	207,315	247,147	320,550	320,550
Common and additional paid-in-capital	1,628	2,095	2,979	3,529	7,920	9,634
Stockholders deficit	(41,725)	(91,200)	(156,471)	(220,710)	(306,321)	(324,410)

	2002	2003	Years Ended December 31,		2006	Three Months Ended
			2004	2005		March 31,
						2007
						(Unaudited)
	(In thousands)					
<b>Cash Flow Data:</b>						
Cash provided by (used in) operating activities	\$ (31,527)	\$ (43,727)	\$ (62,222)	\$ (56,449)	\$ (67,775)	\$ 6,963
Cash provided by (used in) investing activities	(59,001)	(4,892)	9,283	29,451	(18,069)	(4,025)
Cash provided by financing activities	38,611	53,573	51,608	58,059	78,780	7,138

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

*The following discussion and analysis of the financial condition and results of our operations should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this prospectus. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included elsewhere in this prospectus.*

**Overview**

We were founded in December 2000. Our objective is to change the economics, operating simplicity, flexibility, reliability and scalability of optical communications networks. At the core of our Digital Optical Network architecture is what we believe to be the world's only commercially-deployed, large-scale PIC. Our PICs transmit and receive 100 Gbps of optical capacity and incorporate the functionality of over 60 discrete optical components into a pair of indium phosphide chips. We have used our PIC technology to design a new digital optical communications system called the DTN System, which is architected to improve significantly communications service providers' economics and service offerings as compared to traditional systems.

We began commercial shipment of our DTN System in November 2004. As of March 31, 2007, we had sold our DTN System for deployment in the optical networks of 28 customers worldwide. Our goal is to be a leading provider of optical communications systems to communications service providers. Our revenue growth will depend on the continued acceptance of our DTN System, growth of communications traffic and the proliferation of next-generation bandwidth-intensive services, which are expected to drive the need for increased levels of bandwidth. Our ability to increase revenue and achieve profitability will be directly affected by the level of acceptance of our products in the long-haul and metro markets and by our ability cost-effectively to develop and sell innovative products that leverage our technology advantage.

Since our inception, we have incurred significant losses, and as of March 31, 2007 we had an accumulated deficit of \$333.9 million. We have not achieved profitability on a quarterly or annual basis, and we expect to continue to incur substantial losses. Our ability to become profitable will be affected by any additional expenses that we incur to expand our manufacturing capacity, sales, marketing, development and general and administrative capabilities in order to grow our business. The largest component of our expenses is personnel costs. Personnel costs consist of salaries, benefits and incentive compensation for our employees, including commissions for sales personnel and stock-based compensation for all employees. We expect that after this offering we will incur additional accounting and legal costs related to compliance with securities laws and other regulations. These costs include, but are not limited to, costs associated with compliance with the Sarbanes-Oxley Act of approximately \$2.5 million and investor relations and additional insurance costs of approximately \$1.5 million.

We primarily sell our products through our direct sales force, with a small proportion sold indirectly through resellers. We derived 85% and 98% of our revenue from direct sales to customers in 2005 and 2006, respectively, and 97% and 98% in the three months ended March 31, 2006 and 2007, respectively. We expect to continue generating a significant majority of our revenue from direct sales in the future.

We are headquartered in Sunnyvale, California, with employees located throughout the United States, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States, and internationally to provide additional geographic sales and technical support coverage.

**Table of Contents****Overview of Consolidated Financial Data***Revenue*

We derive our revenue from sales of our products, support and services. Our revenue is comprised of two components: (1) ratable product and related support and services revenue, or ratable revenue, and (2) product revenue. Our DTN System is integrated with software that is more than incidental to the functionality of our equipment. We refer to the integration of our DTN System with our software and related support and services as a bundled product. Revenue related to these bundled products, which is ratable revenue, is the portion of our total revenue that we recognize pursuant to Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, or SOP 97-2. Product revenue consists of sales of products that are sold without related services and, therefore, is not recognized ratably in accordance with SOP 97-2.

The following table illustrates our revenue for the specified periods:

Revenue (In thousands)	Three Months Ended 2005				Year Ended Dec. 31,	Three Months Ended 2006				Year Ended Dec. 31,	Three Months Ended 2007
	Mar. 31	Jun. 30	Sept. 30	Dec. 31	2005	Mar. 31	Jun. 30	Sept. 30	Dec. 31	2006	Mar. 31
	(Unaudited)					(Unaudited)					(Unaudited)
Ratable revenue	\$ 421	\$ 603	\$ 1,126	\$ 1,977	\$ 4,127	\$ 2,653	\$ 4,054	\$ 6,118	\$ 40,153	\$ 52,978	\$ 45,947
Product revenue								1,578	3,680	5,258	3,245
Total revenue	\$ 421	\$ 603	\$ 1,126	\$ 1,977	\$ 4,127	\$ 2,653	\$ 4,054	\$ 7,696	\$ 43,833	\$ 58,236	\$ 49,192

*Ratable Revenue.* Substantially all of our sales arrangements consist of product sales bundled with training and product support. Product support services consist of software warranty, updates and unspecified upgrades and product support. To date, we have not established vendor specific objective evidence, or VSOE, of fair value for training and software warranty or product support services. All revenue for these bundled products is deferred and recognized ratably over the longest undelivered service period. In order to establish VSOE, we must have a history of selling our training and product support services separately at a consistent price. Once we have a sufficiently consistent transactional history to establish VSOE for training, software warranty and product support services, we will be able to recognize revenue up front for new customer orders once all of the following have occurred: (1) we have entered into a legally binding arrangement with a customer; (2) delivery and acceptance have occurred, which is when product title and risk of loss has transferred to the customer; (3) customer payment is deemed fixed or determinable; and (4) collectibility is reasonably assured. Revenue for then existing customer orders will continue to be recognized over the applicable revenue recognition period.

Historically, our sales arrangements have included rights to software warranty services for a period of one to five years. This warranty obligation typically represented the longest undelivered service period and resulted in straight-line recognition of revenue over the warranty period. This average period was 3.7 years in the third quarter of 2006. In the fourth quarter of 2006, we amended three of our significant sales contracts to shorten our contractual software warranty period to between 90 days and one year, which we believe is more typical in our industry. We may amend other existing contracts to shorten the software warranty period and expect the software warranty period in future contracts generally to be within this range. This contractual change in the software warranty period resulted in the reduction in the revenue recognition period of these contracts and in each case shortened the period to one year. These contractual changes also shortened the average recognition period for ratable revenue to 1.3 years in both the fourth quarter of 2006 and the first quarter of 2007. We expect that our average recognition period for ratable revenue will fluctuate based on the terms of existing and future customer contracts and our customer mix until we establish VSOE.

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In the fourth quarter of 2006, we amended three of our significant customer contracts to shorten the software warranty period and eliminate annual training credits. As part of the contractual amendments, we (1) provided certain one-time credits, (2) agreed to make available for purchase certain minimum quantities of equipment and (3) agreed to an extension of the contract for an additional period for the limited purpose of buying additional Digital Line Modules, or DLMs, Tributary Adapter Modules, or TAMs, and Tributary Optical Modules, or TOMs.

The ratable revenue that is recognized in each quarter includes a ratable portion recognized from deferred revenue of prior invoiced shipments of bundled products together with a ratable portion of each new invoiced shipment of bundled products in that quarter. Invoiced shipments of bundled products represent sales of our DTN System and services delivered and accepted by the customer for which payment will be made in accordance with normal payment terms, but for which VSOE has not been established. Shipments of bundled products are invoiced when all products ordered on a purchase order have been shipped and the relevant customer acceptance criteria have been satisfied. Customer acceptance periods averaged 18.8 days in the fourth quarter of 2006 and 17.8 days in the first quarter of 2007. Invoiced shipments of bundled products are amortized and recognized as revenue over the longest undelivered service period in each customer contract.

*Product Revenue.* A small portion of our sales arrangements do not require significant customization and the software content is considered incidental to the product. Such product revenue is recognized upon shipment in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition*, or SAB 104.

*Deferred Revenue*

Only a small amount of our invoiced shipments of bundled products within a quarter are recognized as revenue in such quarter and the majority is recorded as deferred revenue. Deferred revenue increases each quarter by the amount of invoiced shipments of bundled products in that quarter and decreases by the amount of ratable revenue recognized from invoiced shipments of bundled products.

The following table illustrates the changes in deferred revenue for the specified periods:

Deferred Revenue (In thousands)	Three Months Ended 2005 (Unaudited)				Year Ended Dec. 31, 2005	Three Months Ended 2006 (Unaudited)				Year Ended Dec. 31, 2006	Three Months Ended 2007 Mar. 31 (Unaudited)
	Mar. 31	Jun. 30	Sept. 30	Dec. 31		Mar. 31	Jun. 30	Sept. 30	Dec. 31		
Beginning balance	\$	\$ 2,577	\$ 4,020	\$ 17,020	\$	\$ 23,200	\$ 34,349	\$ 49,977	\$ 84,284	\$ 23,200	\$ 110,953
Invoiced shipments of bundled products	2,998	2,046	14,126	8,157	27,327	13,802	19,682	40,425	66,822	140,731	63,414
Ratable revenue	(421)	(603)	(1,126)	(1,977)	(4,127)	(2,653)	(4,054)	(6,118)	(40,153)	(52,978)	(45,947)
Ending balance	\$ 2,577	\$ 4,020	\$ 17,020	\$ 23,200	\$ 23,200	\$ 34,349	\$ 49,977	\$ 84,284	\$ 110,953	\$ 110,953	\$ 128,420

In 2005, we recorded \$27.3 million of invoiced shipments of bundled products, recognized \$4.1 million of revenue and added \$23.2 million to the deferred revenue balance. In 2006, we recorded \$140.7 million of invoiced shipments of bundled products, recognized \$53.0 million of revenue and added \$87.8 million to the deferred revenue balance. In the three months ended March 31, 2007, we recorded \$63.4 million of invoiced shipments of bundled products, recognized \$45.9 million of revenue and added \$17.5 million to the deferred revenue balance.

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When a contract amendment shortens the service obligation period for a customer, all invoiced shipments of bundled products that have not previously been fully recognized for such customer are amortized over this shorter period resulting in increased recognition of revenue beginning on the amendment date. Of the \$53.0 million of ratable revenue recognized in 2006, \$40.2 million was recognized in the fourth quarter reflecting a combination of increased invoiced shipments of bundled products and the shortening of the contractual service obligation period described above.

*Cost of Revenue*

Our cost of revenue is comprised of two components: cost of ratable revenue and cost of product revenue.

The following table illustrates our cost of revenue for the specified periods:

Cost of Revenue (In thousands)	Three Months Ended 2005 (Unaudited)				Year Ended Dec. 31, 2005	Three Months Ended 2006 (Unaudited)				Year Ended Dec. 31, 2006	Three Months Ended 2007 Mar. 31 (Unaudited)
	Mar. 31	Jun. 30	Sept. 30	Dec. 31		Mar. 31	Jun. 30	Sept. 30	Dec. 31		
Cost of ratable revenue	\$ 2,276	\$ 7,032	\$ 5,092	\$ 3,359	\$ 17,759	\$ 5,485	\$ 4,488	\$ 7,967	\$ 30,132	\$ 48,072	\$ 34,843
Lower of cost or market adjustment	104	1,438	3,604	4,550	9,696	4,325	3,657	4,172	9,539	21,693	1,067
Cost of product revenue								311	1,349	1,660	1,363
Total cost of revenue	\$ 2,380	\$ 8,470	\$ 8,696	\$ 7,909	\$ 27,455	\$ 9,810	\$ 8,145	\$ 12,450	\$ 41,020	\$ 71,425	\$ 37,273

*Cost of Ratable Revenue.* Cost of ratable revenue consists primarily of the costs of manufacturing our network equipment, including personnel costs, stock-based compensation, raw materials, overhead and period costs. Period costs consist primarily of shipping fees, logistics costs, manufacturing ramp-up costs, expenses for inventory obsolescence and warranty obligations.

Certain manufacturing costs are recognized in the period in which they are incurred or can be estimated, including period costs and losses associated with products which are sold or anticipated to be sold at a loss. The initial deployment of our DTN System at a customer involves the installation of common equipment, including a chassis, optical line amplifiers and related equipment. This common equipment is typically sold at low or negative gross margins. When we sell equipment at a loss, the losses are recognized in the period in which they are incurred or reasonably estimatable. We refer to this loss as a lower of cost or market adjustment, or LCM adjustment. In the years ended December 31, 2005 and 2006 and in the three months ended March 31, 2007, our LCM adjustment was \$9.7 million, \$21.7 million and \$1.1 million, respectively, and was recorded as part of cost of ratable revenue. In addition, we recorded inventory write-downs for excess and obsolete inventory in 2004, 2005 and 2006 of \$2.2 million, \$(0.7) million and \$1.7 million, respectively, and in the three months ended March 31, 2007 of \$1.4 million. The remainder of our cost of ratable revenue is recorded as deferred costs of invoiced shipments of bundled products and is recognized in the same period as the corresponding revenue.

*Cost of Product Revenue.* Cost of product revenue consists primarily of the costs of manufacturing network components, such as personnel costs, raw materials and application of overhead.



**Table of Contents***Deferred Inventory Cost*

Deferred inventory cost increases by the cost of invoiced shipments of bundled products in a period and decreases as cost of ratable revenue is amortized in that period.

The following table illustrates the increases in our deferred inventory cost for the specified periods:

	Three Months Ended 2005				Year Ended	Three Months Ended 2006				Year Ended	Three Months Ended
	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Dec. 31,	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Dec. 31,	Mar. 31
<b>Deferred Inventory Cost (In thousands)</b>	<b>(Unaudited)</b>				<b>2005</b>	<b>(Unaudited)</b>				<b>2006</b>	<b>(Unaudited)</b>
Beginning balance	\$	\$ 2,090	\$ 3,527	\$ 11,637	\$	\$ 16,687	\$ 26,548	\$ 35,038	\$ 55,612	\$ 16,687	\$ 67,253
Deferred cost of invoiced shipments of bundled products	2,365	1,872	8,954	6,428	19,619	11,880	11,298	24,442	38,986	86,606	33,164
Amortization to cost of ratable revenue	(275)	(435)	(844)	(1,378)	(2,932)	(2,019)	(2,808)	(3,868)	(27,345)	(36,040)	(26,959)
Ending balance	\$ 2,090	\$ 3,527	\$ 11,637	\$ 16,687	\$ 16,687	\$ 26,548	\$ 35,038	\$ 55,612	\$ 67,253	\$ 67,253	\$ 73,458

*Gross Margin*

Gross margins have been and will continue to be affected by a variety of factors, including the product mix, average selling prices of our products, the sale of additional support and services, new product introductions and enhancements, the cost of our hardware and software products, the amount of revenue that is recognized ratably, the period over which our revenue is recognized ratably and the amount of common equipment sold at a loss causing an LCM adjustment.

To satisfy our customer's requirement of transmitting optical signals, our customer must purchase a combination of common equipment and some limited number of DLMs, TAMs and TOMs. If a customer wishes to add capacity to our DTN System after their initial deployment to satisfy their additional demands, they may purchase additional DLMs, TAMs and TOMs. When a customer wishes to expand the reach of the DTN System or deploy another DTN System on a route on which the customer has reached the maximum capacity for its existing DTN System they may purchase a combination of additional common equipment and additional DLMs, TAMs and TOMs. Pricing for optical communications systems, such as our DTN System, is very competitive and we must often respond to these competitive pressures by decreasing the initial purchase price of our product. As a result of these competitive pressures and in order to gain new customers, our common equipment is typically sold at low margins or at a loss. Our DLMs, TAMs or TOMs are typically sold at higher gross margins. These higher margin sales positively impact overall gross margin over the ratable revenue recognition period.

The following table illustrates our gross margin for the specified periods:

	Three Months Ended 2005				Year Ended	Three Months Ended 2006				Year Ended	Three Months Ended
	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Dec. 31,	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Dec. 31,	Mar. 31
<b>Gross Margin (In thousands)</b>	<b>(Unaudited)</b>				<b>2005</b>	<b>(Unaudited)</b>				<b>2006</b>	<b>(Unaudited)</b>
Total revenue	\$ 421	\$ 603	\$ 1,126	\$ 1,977	\$ 4,127	\$ 2,653	\$ 4,054	\$ 7,696	\$ 43,833	\$ 58,236	\$ 49,192
Cost of revenue	2,380	8,470	8,696	7,909	27,455	9,810	8,145	12,450	41,020	71,425	37,273

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Gross profit											
(loss)	\$ (1,959)	\$ (7,867)	\$ (7,570)	\$ (5,932)	\$ (23,328)	\$ (7,157)	\$ (4,091)	\$ (4,754)	\$ 2,813	\$ (13,189)	\$ 11,919
Gross margin	-465%	-1,305%	-672%	-300%	-565%	-270%	-101%	-62%	6%	-23%	24%

During the three months ended March 31, 2007, we generated gross profit of \$11.9 million. This improved gross profit reflects the impact of the recognition of \$14.8 million of deferred gross margin

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related to invoiced shipments in prior periods. In addition, although we continued to sell common equipment at low or negative margins, we experienced a reduction in LCM adjustments in the period, primarily due to lower costs because of product design changes related to our common equipment that resulted in a transition to a number of lower cost components. In addition, we achieved other reductions in a number of our component costs during the period. These improvements were offset by an increase in our warranty expense due to an increase in the number of expected future returns related to a component quality issue on one specific product that ceased shipping in June 2006. We also increased the expected cost of replacing defective units due to a reduction in the expected volume of repaired units available to satisfy customer warranty claims.

We experienced negative gross profit of \$23.3 million in 2005 and \$13.2 million in 2006. These losses primarily reflect the impact of selling common equipment at low or negative margins, causing LCM adjustments of \$9.7 million and \$21.6 million in 2005 and 2006, respectively. In addition, these losses reflected high ramp up manufacturing costs and excess and obsolete inventory costs. The impact on our gross margins of these costs was greater because most of the corresponding revenue was deferred and will be recognized ratably.

The contractual prices paid for our DTN System vary by customer. In addition, the quantity of DTN Systems purchased by each of our customers varies from quarter-to-quarter depending on our customers' needs for optical transport equipment. To the extent that a customer with lower contractual prices purchases significant quantities of our DTN System that comprise a significant portion of the DTN Systems we sell within a quarter, our gross margin for such quarter and, to a lesser extent, the next three quarters if we continue to recognize revenue ratably over approximately a 1 year period, would be lower. In addition, substituting a new customer with a higher requirement for common equipment could result in an increased inventory write-down in a given quarter, which can have a significant impact on our gross margin in that quarter.

We expect our gross margins to continue to improve in the future as deferred revenue is recognized and as average selling prices and product mix improve due to new and existing customers purchasing higher margin network components to increase the capacity of their installed DTN Systems. As of December 31, 2006, deferred revenue was \$111.0 million and deferred inventory cost was \$67.3 million. As of March 31, 2007, deferred revenue was \$128.4 million and deferred inventory cost was \$73.5 million.

The table below, which only represents a portion of our results for the projected periods presented and may not be indicative of our future results, shows the expected future impact of the recognition of these deferred amounts on our Consolidated Statement of Operations (unaudited):

	Deferred Balance as of	For The Three Months				For The Nine	
		Ended 2007				Months Ended	
		March 31, 2007	Jun. 30	Sept. 30	Dec. 31	December 31, 2007	Future Periods
Revenue	\$ 128,420	\$ 46,877	\$ 39,290	\$ 24,795	\$ 110,962	\$ 17,458	
Cost of Inventory	73,458	28,065	22,967	13,818	64,850	8,608	
Gross Profit	\$ 54,962	\$ 18,812	\$ 16,323	\$ 10,977	\$ 46,112	\$ 8,850	
Operating Expenses							

Operating expenses consist of sales and marketing, research and development and general and administrative expenses, and are recognized as incurred. Personnel-related costs are the most significant component of each of these expense categories. We expect personnel costs to continue to increase as we hire new employees to support our anticipated growth. We expect that each of the

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categories of operating expenses below will increase in absolute dollars, but will decline as a percentage of total revenue over time.

Research and development expenses are the largest component of our operating expenses and primarily include salary and related benefit costs, including stock-based compensation expense, and facilities costs. We expense research and development expenses as incurred. We are devoting substantial resources to the continued development of additional functionality for existing products and the development of new products. We intend to continue to invest significantly in our research and development efforts because we believe that they are essential to maintaining our competitive position.

Sales and marketing expenses primarily include salary and related benefit costs, including stock-based compensation expense, sales commissions, marketing and facilities costs. We expect sales and marketing expenses to increase as we hire additional personnel both in the United States and internationally to support our expected revenue growth.

General and administrative expenses consist primarily of salary and related benefit costs, including stock-based compensation expense and facilities related to our executive, finance, human resource, information technology and legal organizations, and fees for professional services. Professional services principally consist of outside legal, audit and information technology consulting costs. We expect to incur significant additional expenses as a result of operating as a public company, including costs to comply with the Sarbanes-Oxley Act and the rules and regulations applicable to companies listed on the NASDAQ Global Market.

*Other Income (expense), net*

Other income (expense), net includes interest expense on short- and long-term debt, interest income on our cash balances, and losses or gains on conversion of foreign currency transactions into U.S. dollars. In 2005 and 2006, other income (expense), net, also included an adjustment to record our convertible preferred stock warrants at fair value as required by Staff Position 150-5, *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*, or FSP 150-5, as described below. In the three months ended March 31, 2007, other income (expense), net also included a gain of \$0.9 million related to the sale of assets acquired during the period under an asset purchase agreement as described in Note 4 of Notes to Consolidated Financial Statements.

**Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with GAAP in the United States. These accounting principles require us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates and assumptions made by management include revenue recognition, inventory valuation and the determination of the fair value of stock awards issued. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, our consolidated financial statements will be affected.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

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### *Revenue Recognition*

Our DTN System is generally integrated with software that is more than incidental to the functionality of such product. Accordingly, we account for revenue in accordance with SOP 97-2. We recognize product revenue when all of the following have occurred: (1) we have entered into a legally binding arrangement with a customer; (2) delivery and acceptance have occurred, which is when product title and risk of loss has transferred to the customer; (3) customer payment is deemed fixed or determinable; and (4) collectibility is reasonably assured. Revenue is recognized net of cash discounts.

Substantially all of our product sales have been sold in combination with training and product support services, which consist of software warranty and updates, and product support.

Software updates provide customers with rights to unspecified software product upgrades and to maintenance releases and patches released during the term of the support period. Product support includes internet access to technical content, telephone and internet access to technical support personnel. Training services include the right to a specified number of training classes over the term of the arrangement. Revenue for training and support services is recognized on a straight-line basis over the service contract term, which ranges from one to five years.

VSOE of fair value for training and product support services is determined by reference to the price a customer is required to pay when training and product support services are sold separately. To date, we have not established VSOE of fair value for training and product support services. Assuming all other revenue recognition criteria have been met and the only undelivered element is training or product support services, revenue is deferred and recognized ratably over the longest undelivered service period. The undelivered service periods range from one to five years. Revenue related to these arrangements is included in ratable revenue in our statements of operations.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss passes to customers. In instances where acceptance of the product is specified by the customer, revenue is deferred until all acceptance criteria have been met. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 90 days from invoice. In the event payment terms are provided that differ from our standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is deferred until the fees become fixed or determinable, which we believe is when they are legally due and payable. We assess the ability to collect from our customers based primarily on the creditworthiness of the customer and past payment history of the customer.

Revenue for products that does not require significant customization and with regard to which any software is considered incidental, is recognized under SAB 104. Under SAB 104, revenue is recognized provided that persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable and collectibility is reasonably assured. Revenue related to these arrangements is included in product revenue in our statements of operations.

Shipping charges billed to customers are included in product revenue and in ratable revenue. The related shipping costs are included in cost of product sales and cost of ratable revenue in our statements of operations.

### *Stock-Based Compensation*

Prior to January 1, 2006, we accounted for employee stock options using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued*

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to *Employees*, or APB No. 25, and Financial Accounting Standards Board Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25*. The intrinsic value represents the difference between the per share market price of the stock on the date of grant and the per share exercise price of the respective stock option. We generally grant stock options to employees for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. Under APB No. 25, no compensation expense is recorded for employee stock options granted at an exercise price equal to the market price of the underlying stock on the date of grant.

During the period from January 1, 2006 through the date of this prospectus, we granted stock options with exercise prices as follows:

<b>Stock Award Grant Dates</b>	<b>Number of Options Granted</b>	<b>Exercise Price Per Share</b>	<b>Valuation Prior to Grant Date</b>	<b>SFAS 123(R) Black-Scholes Option Fair Value</b>
February 27, 2006	118,322	\$ 1.32	\$ 1.04	\$0.80 - \$0.92
April 5, 2006	128,311	1.32	1.04	0.80 - 0.92
August 8, 2006	3,229,735	2.00	2.00	1.16 - 1.36
August 29, 2006	193,750	2.00	2.00	1.16 - 1.36
September 7, 2006	999,766	2.00	2.00	1.16 - 1.36
January 3, 2007	224,999	4.04	4.04	2.12
January 4, 2007	683,287	4.04	4.04	2.52 - 2.53
February 7, 2007	75,000	7.68	7.68	4.04
February 12, 2007	103,075	7.68	7.68	4.79
April 24, 2007	158,371	10.72	10.72	6.68

We have increased the estimated fair value of our common stock from January 1, 2006 through the date of the filing of this registration statement based on, among other factors, contemporaneous valuations. If the Internal Revenue Service determines that certain of our stock options were granted at below the fair value of our common stock on the date of grant, the recipients of those stock option grants could be subject to an additional deferred compensation tax under Internal Revenue Code Section 409A and we could be liable for withholding obligations.

In the absence of a public trading market, our board of directors relied in part upon contemporaneous valuations presented by management, which utilized the enterprise value allocation method, in order to help the board determine the value of our common stock. As part of this enterprise value allocation method, the value of our common stock was measured on a per share basis utilizing a probability weighted scenario analysis. The common stock per share value was based on the probability weighted average of two possible future liquidity scenarios: (1) a scenario where an IPO is not completed, or a no IPO liquidity scenario, and (2) a scenario where an IPO is completed, or an IPO liquidity scenario.

In the no IPO liquidity scenario, the common stock per share value is based on the Black-Scholes option-pricing model and represents the current nominal value of the common stock plus its option value for potential future increases in our value until a liquidity event. The methodology used allocated the estimated aggregate value to each security. A value was first assigned to each series of convertible preferred stock and then the remaining equity securities were analyzed and the remaining enterprise value was apportioned to the remaining equity securities. The rights, preferences and privileges of each security were considered, including the liquidation and conversion rights, and the manner in which the value of each security affects the other securities.

In the no IPO liquidity scenario, a large proportion of our enterprise value is apportioned to our convertible preferred stock because the aggregate liquidation preference is approximately \$325.2

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million and each series of our convertible preferred stock participates with the common stock up to certain capped amounts after the payment of the aggregate liquidation preference.

In the IPO liquidity scenario, options and warrants are valued based solely on the Black-Scholes option-pricing model. The aggregate value related to options and warrants are subtracted from the aggregate equity value for purposes of determining the convertible preferred stock and common stock values on an as-if converted, per share basis. After accounting for the value of the options and warrants, the remaining enterprise value is apportioned equally among the shares of common stock and each series of convertible preferred stock, which causes our common stock to have a higher relative value per share than under the no IPO liquidity scenario.

Our board of directors also considered a number of factors, in addition to the valuations, to determine the estimated fair value of our common stock at each grant date, including:

the shares of common stock underlying the options were and are illiquid securities in a private company that were not readily tradable at the time of grant and that there could be no assurance of such shares ever being readily tradable;

the prices at which convertible preferred stock was issued and sold to outside investors in arm's-length transactions, and the rights, preferences and privileges of the convertible preferred stock relative to the common stock;

important developments relating to achievement of our business objectives, including new product launches, customer wins and growth in our revenue and invoiced shipments;

our stage of development and business strategy;

the status of our efforts to build our management team;

the status of our efforts to increase revenue and invoiced shipments while reducing losses, as well as our financial results;

the likelihood of achieving a liquidity event for the shares of our common stock, such as an initial public offering or sale of the company, given prevailing market conditions and achievement of our business objectives;

the state of the new issue market for similarly-situated technology companies; and

the market prices of publicly-held technology companies with similar business models.

Our board of directors also considered the provisions of our Series A through G convertible preferred stock in determining the estimated fair value of our common stock at the time of each option grant, including the aggregate liquidation preference of the Series A through G convertible preferred stock of \$325.2 million and the fact that in a sale of Infinera the Series A through G convertible preferred stock would participate with the common stock up to certain caps after the payment of the aggregate liquidation preference. As we approach our initial public offering, the per share value of our common stock moves closer to our enterprise value per share because the likelihood of a sale of Infinera where our convertible preferred stock receives a larger proportion of our enterprise value decreases.





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The anticipated timing of a potential liquidity event, the estimated volatility, the discount rate, the discount for lack of marketability and the probability that we are able to complete an initial public offering of our common stock were the key assumptions used in the determination of the common stock value per share. These assumptions are as set forth below for each of our valuation dates since December 31, 2005:

	Dec. 31, 2005	June 30, 2006	Nov. 30, 2006	Jan. 15, 2007	Mar. 25, 2007
Common Stock Value Per Share	\$ 1.04 <sup>(1)</sup>	\$ 2.00	\$ 4.04	\$ 7.68	\$ 10.72
Time to Liquidity (in years)	N/A	1.4	1.0	0.5	0.25
Volatility	N/A	65%	60%	55%	55%
DCF Discount Rate	18-20%	30%	25%	20%	16%
Marketability Discount Rate	30%	25%	15%	5%	0%
Probability of an IPO	N/A	15%	25%	75%	90%

(1) For options granted in February and April 2006, our board of directors determined the fair value of our common stock to be \$1.32 per share. As can be seen in the table above, the increase in the valuation of our common stock from December 2005 to January 2007 can be attributed to declines in the anticipated time to liquidity, the volatility rate, the discount rate and the marketability discount rate and an increase in the probability that we are able to complete an initial public offering of our common stock. The most significant driver of the increase in the fair value of our common stock from the stock option grants we made on January 3 and 4, 2007 to the grants we made on April 24, 2007 was the increase in the probability that we are able to complete an initial public offering of our common stock. The probability of an IPO increased significantly as our 2006 financial statement audit neared completion and as we filed our initial registration statement and subsequent amendments on Form S-1 in 2007.

During 2006, we granted options to employees to purchase a total of 4,669,884 shares of common stock at exercise prices ranging from \$1.32 to \$2.00 per share. In 2007, excluding the equity grants subsequent to April 24, 2007 discussed in the section titled Certain Relationships and Related Party Transactions Equity Grants Since March 31, 2007, we have granted 1,244,732 shares of common stock at exercise prices ranging from \$4.04 to \$10.72.

Based upon an initial public offering price of \$13.00 per share, the aggregate intrinsic value of outstanding options vested and expected to vest as of March 31, 2007 was \$87.2 million, of which \$29.5 million related to vested options and \$57.7 million related to options expected to vest.

	As of March 31, 2007 (in thousands)	Weighted Average Price	IPO Price (Unaudited)	Excess of IPO Price	Aggregate Intrinsic Value (in thousands)
Vested	2,614	\$ 1.70	\$ 13.00	\$ 11.30	\$ 29,539
Expected to vest	5,379	2.27	13.00	10.73	57,717
Total vested & expected to vest	7,993	\$ 2.09	13.00	10.91	\$ 87,256
Not expected to vest	228				
	8,221				

On January 1, 2006, we adopted the provisions of the Financial Accounting Standards Board, or FASB, SFAS 123(R), *Share-Based Payments*, or SFAS 123(R). Under SFAS 123(R), stock-based compensation costs for employees is measured at the grant date, based on the estimated fair value of the award at that date, and is recognized as expense over the employee's requisite service period,



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which is generally over the vesting period, on a straight-line basis. We adopted the provisions of SFAS 123(R) using the prospective transition method. Under this transition method, non-vested option awards outstanding at January 1, 2006, continue to be accounted for under the minimum value method as stipulated by SFAS 123(R). All awards granted, modified or settled after the date of adoption are accounted for using the measurement, recognition and attribution provisions of SFAS 123(R).

We make a number of estimates and assumptions related to SFAS 123(R). The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as an adjustment in the period estimates are revised. Actual results may differ substantially from these estimates. In valuing share-based awards under SFAS 123(R), significant judgment is required in determining the expected volatility of our common stock and the expected term individuals will hold their share-based awards prior to exercising. Expected volatility of the stock is based on our peer group in the industry in which we do business because we do not have sufficient historical volatility data for our own stock. The expected term of options granted represents the period of time that options granted are expected to be outstanding and was calculated based on historical information. In the future, as we gain historical data for volatility in our own stock and more data on the actual term employees hold our options, expected volatility and expected term may change which could substantially change the grant-date fair value of future awards of stock options and ultimately the expense we record.

The following table summarizes the effects of stock-based compensation related to employees, non-recourse notes and non-employees for 2004, 2005, 2006, and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended	
	2004	2005	2006	2006 March 31, (Unaudited)	2007
Cost of revenue	\$	\$	\$ 151	\$ 14	\$ 88
Sales and marketing		36	198	12	87
Research and development	180	99	411	27	822
General and administrative	34	7	335	19	216
<b>Total stock-based compensation effects in loss before taxes</b>	<b>\$ 214</b>	<b>\$ 142</b>	<b>\$ 1,095</b>	<b>\$ 72</b>	<b>\$ 1,213</b>

For 2006, the total compensation cost related to stock-based awards granted under SFAS 123(R) to employees and directors but not yet amortized was approximately \$5.2 million, net of estimated forfeitures of \$0.4 million. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 1.1 years. Amortization for 2006 was approximately \$0.9 million, net of estimated forfeitures.

For the three months ended March 31, 2007, the total compensation cost related to stock-based awards granted under SFAS 123(R) to employees and directors but not yet amortized was approximately \$7.4 million, net of estimated forfeitures of \$0.6 million. Amortization for the three months ended March 31, 2007 was approximately \$0.5 million, net of estimated forfeitures.

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The fair value of each option grant is estimated on the date of grant using the following weighted-average assumptions used for grants in 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
Dividend					
Volatility	0%	0%	72% - 83%	77% - 83%	62% - 71%
Risk-free interest rate	3.00%	4.05%	4.57% - 5.08%	4.81% - 4.82%	4.50% - 4.51%
Weighted-average expected life	4 years	4 years	4.2 - 5.4 years	4.2 - 5.4 years	4.3 - 5.1 years
Weighted-average fair value of common stock	\$ 0.15	\$ 0.15	\$0.81 - \$1.35	\$ 0.80 - \$0.92	\$ 2.12 - \$4.80

We account for stock options granted to non-employees in accordance with Emerging Issues Task Force (EITF) No. 96-18,

*Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, Goods or Services*, or EITF No. 96-18, and related interpretations. We grant stock options to certain consultants and advisory board members for a fixed number of shares with an exercise price equal to the fair value of our common stock at the date of grant.

Under EITF No. 96-18, compensation expense on non-employee stock options is calculated using the Black-Scholes option-pricing model and is recorded using the straight-line method over the vesting period, which approximates the service period.

*Freestanding Preferred Stock Warrants*

On June 29, 2005, the FASB issued FSP 150-5. This Staff Position affirms that such warrants are subject to the requirements in Statement 150, regardless of the timing of the redemption feature or the redemption price. Therefore, under Statement 150, the freestanding warrants that are related to our convertible preferred stock and common stock are liabilities that should be recorded at fair value. We previously accounted for freestanding warrants for the purchase of our convertible preferred stock and common stock under EITF Issue No. 96-18.

Effective July 1, 2005, we adopted FSP 150-5 and reclassified the fair value of the warrants from equity to liability and recorded a cumulative effect charge of approximately \$1.1 million income. In addition, we recorded additional charges of approximately \$0.2 million to reflect the increase in fair value between July 1, 2005 and December 31, 2005. In 2006, we recorded approximately \$2.4 million of charges in other loss, to reflect the increase in fair value between January 1, 2006 and December 31, 2006. In the three months ended March 31, 2007, we recorded approximately \$2.5 million of charges in other loss to reflect the increase in fair value between January 1, 2007 and March 31, 2007. The calculation of fair value requires the input of highly subjective assumptions and a change in our assumptions could materially affect the fair value estimates.

We will continue to adjust the liabilities for changes in fair value until the earlier of the exercise of the warrants or the completion of a liquidation event, including the completion of this initial public offering, at which time the liabilities will be reclassified to stockholders equity (deficit).

We estimated the fair value of these warrants using the Black-Scholes model for change of control scenario and the Lattice model for a successful initial public offering scenario. We then used a probability weighted average of per-share values under the different scenarios to determine the fair value of these warrants at the respective balance sheet dates.

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Both models require the input of highly subjective assumptions and a change in our assumptions could materially affect the fair value estimates.

The following table presents the pro forma effect of the adoption of FSP 150-5 on our results of operations for 2004 and 2005, if applied retroactively, assuming FSP 150-5 had been adopted in those years:

	December 31,	
	2004	2005
	(In thousands, except per share data)	
Net loss, as reported	\$ (66,480)	\$ (64,826)
Add: Cumulative effect of change in accounting principle included in net loss		1,137
Change in fair value of warrants	1,029	(229)
Pro forma net loss	\$ (65,451)	\$ (66,192)
Pro forma loss per common share, basic and diluted	\$ (17.67)	\$ (14.37)
Shares used in computing basic and diluted net loss per common share	3,705	4,605

*Inventories*

Inventories consist of hardware, work-in-process and related component parts and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated average selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing for our products and technological obsolescence of our products.

Inventory that is obsolete or in excess of our forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand. We recorded total inventory write-downs for LCM adjustments in 2004, 2005, and 2006 of \$1.6 million, \$9.7 million, and \$21.7 million, respectively, and in the three months ended March 31, 2006 and 2007 of \$4.3 million and \$1.1 million, respectively. These adjustments related to our inventory and firm purchase commitments with suppliers and included the impact of expected losses on common equipment. In addition, we recorded inventory write-downs for excess and obsolete inventory in 2004, 2005 and 2006 of \$2.2 million, \$(0.7) million and \$1.7 million, respectively, and in the three months ended March 31, 2006 and 2007 of \$1.1 million and \$1.4 million, respectively. These write-downs for excess and obsolete inventory were reflected as cost of product and cost of ratable product and related support and services.

In valuing our deferred inventory costs, we considered the valuation of inventory using the guidance of Accounting Research Bulletin 43, *Restatement and Revision of Accounting Research Bulletins*, or ARB 43. In particular, we considered ARB 43, Chapter 4, Statement 5 and whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. We concluded that, in the instances where the utility of the products delivered or expected to be delivered were less than cost, it was appropriate to value the deferred inventory costs and inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. We have, therefore, recorded inventory write-downs as necessary in each period in order to reflect common equipment inventory at the lower of cost or market. In addition, we considered the guidance provided in ARB 43, Chapter 4, Statement 10 relating to losses on firm purchase commitments related

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to inventory items. Given that the expected selling price of common equipment in the future remains below cost, we have also recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

**Results of Operations***Revenue*

The following table presents our revenue by type, geography and sales channel for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended	
	2004	2005	2006	March 31, 2006 (Unaudited)	2007
	(In thousands)				
Total revenue	\$ 599	\$ 4,127	\$ 58,236	\$ 2,653	\$ 49,192
Total revenue by type					
Ratable product and related support and services	\$	\$ 4,127	\$ 52,978	\$ 2,653	\$ 45,947
Product	599		5,258		3,245
% Revenue by type					
Ratable product and related support and services	0%	100%	91%	0%	93%
Product	100%	0%	9%	100%	7%
Total revenue by geography					
Domestic	\$	\$ 2,660	\$ 49,901	\$ 2,081	\$ 39,945
International	599	1,467	8,335	572	9,247
% Revenue by geography					
Domestic	0%	64%	86%	78%	81%
International	100%	36%	14%	22%	19%
Total revenue by sales channel					
Direct	\$	\$ 3,488	\$ 57,304	\$ 2,564	\$ 48,356
Indirect	599	639	932	89	836
% Revenue by sales channel					
Direct	0%	85%	98%	97%	98%
Indirect	100%	15%	2%	3%	2%

*Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2007.* Total ratable revenue increased from \$2.7 million in the three months ended March 31, 2006 to \$45.9 million in the corresponding period in 2007. The increase reflected an increase in invoiced shipments of bundled products from \$13.8 million in the three months ended March 31, 2006 to \$63.4 million in the corresponding period in 2007. The increase in invoiced shipments of bundled products was due to increased purchases of our DTN System by existing customers and the addition of new customers. We added 19 new customers between March 31, 2006 and March 31, 2007 for a total of 28 customers as of March 31, 2007. In addition, in the first quarter of 2006, we recognized \$2.0 million of deferred revenue from prior periods and \$0.7 million from invoiced shipments of bundled products in the period. In the first quarter of 2007, we recognized \$38.1 million of ratable revenue from prior periods and \$7.8 million from current period invoiced shipments of bundled products.

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In the three months ended March 31, 2007, we recorded \$3.2 million of product revenue, consisting of \$2.8 million related to the sale of 10 Gbps cards not for use in our DTN System and \$0.4 million related to a product sale to a customer that did not require support services. We do not expect to generate significant revenue from product sales without related support services in the future.

*2005 Compared to 2006.* Total ratable revenue increased from \$4.1 million in 2005 to \$53.0 million in 2006. This increase reflected an increase in invoiced shipments of bundled products from \$27.3 million in 2005 to \$140.7 million in 2006 and the shortening of the ratable revenue recognition period from an average period of 3.7 years in the third quarter of 2006 to 1.3 years in the fourth quarter of 2006. The increase in invoiced shipments of bundled products was due to increased purchases of our DTN System by existing customers and the addition of customers in the United States and Europe.

Although our international revenue grew on an absolute basis from 2005 to 2006, international revenue as a percentage of total revenue declined by 61% from 2005 to 2006 primarily due to a significant increase in revenue from an existing U.S. customer and the addition of a number of new U.S. customers during 2006.

In 2006, we recorded \$5.3 million of product revenue related to the sale of 10 Gbps cards not for use in our DTN System. We do not expect to generate significant revenues from the sale of these products in the foreseeable future.

*2004 Compared to 2005.* Total revenue increased from \$0.6 million in 2004 to \$4.1 million in 2005. This increase was primarily due to the fact that we signed a master purchase agreement with Level 3 in April 2005 and commenced shipments of our DTN System to Level 3 shortly thereafter. In addition, we signed a number of contracts with other customers in the United States and Europe. Revenue in 2004 consisted of one product sale of evaluation equipment to a customer in Asia Pacific. The product was sold without warranty or support services and revenue was recognized upon shipment.

*Cost of Revenue and Gross Margin*

The following table presents our revenue, cost of revenue by revenue source, gross profit (loss) and gross margin for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended	
	2004	2005	2006	March 31, 2006	2007
	(In thousands)				
Total revenue	\$ 599	\$ 4,127	\$ 58,236	\$ 2,653	\$ 49,192
Cost of ratable product and related support and services		17,759	48,072	5,485	34,843
Lower of cost or market adjustment	1,587	9,696	21,693	4,325	1,067
Cost of product	5,653		1,660		1,363
Gross profit (loss)	\$ (6,641)	\$ (23,328)	\$ (13,189)	\$ (7,157)	\$ 11,919
Gross margin	N/M% <sup>(1)</sup>	-565%	-23%	-270%	24%

(1) N/M = Not Meaningful.

*Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2007.* Gross margins improved from the three months ended March 31, 2006 to the corresponding period in 2007 due primarily to the impact of the recognition of \$14.8 million of deferred gross margin related to invoiced shipments in prior periods. In addition, although we continued to sell common equipment at low

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or negative margins, we experienced a reduction of \$3.3 million in LCM adjustments in the current period compared to the first quarter of 2006, primarily due to changes in the bill of materials on a number of common equipment components and a continued decline in component pricing. These improvements were offset by an increase to our warranty expense of \$2.5 million due to an increase in the number of expected future returns related to a component quality issue on one specific product that ceased shipping in June 2006. We also increased the expected cost of replacing defective units due to a reduction in the expected volume of repaired units available to satisfy customer warranty claims.

*2005 Compared to 2006.* Gross margins improved from 2005 to 2006 due to increased ratable revenue, increased ASPs and improved product mix as customers purchased higher margin products to increase their network capacity. In addition, in 2006 we experienced reduced per unit manufacturing costs primarily due to improved yields and increased production volume, offset by an increase in LCM adjustments of \$12.0 million and charges for excess and obsolete inventory of \$2.3 million. Gross margins in 2005 were impacted primarily by negative manufacturing variances, comprised of lower yields and lower fixed cost absorption, due to low volume production. To the extent our production volume increases, we expect continued improvement in manufacturing and materials costs per unit.

*2004 Compared to 2005.* Cost of product revenue in 2004 is comprised of the cost of one evaluation equipment sale, excess and obsolete inventory, inventory reserves and manufacturing costs associated with the ramp up of production. Cost of ratable revenue in 2005 consisted of the amortization of deferred inventory costs and period costs including inventory reserves, LCM adjustments and increased costs related to the roll-out of our service organization. During 2005, we sold inventory that was previously reserved that resulted in a \$1.3 million reduction in cost of revenue, gross loss, loss from operations and net loss for 2005.

*Research and Development Expenses*

The following table presents our research and development expenses in absolute dollars and as a percent of total revenue for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
	(In thousands)				
Research and development expenses	\$ 46,306	\$ 24,986	\$ 38,967	\$ 6,446	\$ 16,058
Percent of total revenue <sup>(1)</sup>	N/M%	605%	67%	243%	33%

(1) Research and development expenses as a percent of total revenue is not a meaningful trend indicator because our revenue recognition policy requires the deferral of revenues over future periods.

*Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2007.* Research and development expenses increased from the three months ended March 31, 2006 to the corresponding period in 2007 due primarily to \$4.1 million of expense incurred in the three months ended March 31, 2007 related to software development services that we purchase from a third party to enable a supplier's products to operate in a regional bell operating company infrastructure. In addition, the increase resulted from a \$2.2 million increase in personnel-related costs due to two asset acquisitions completed in the second half of 2006 and a \$0.8 million increase in stock-based compensation expense.

*2005 Compared to 2006.* Research and development expenses increased from 2005 to 2006 due primarily to increased personnel-related costs of \$7.3 million. In addition, during 2006 we wrote off \$4.5 million of in-process research and development expenses related to an asset acquisition we completed in 2006 because technological feasibility had not been established and no alternative future uses existed.



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*2004 Compared to 2005.* Research and development expenses decreased from 2004 to 2005 because we commenced shipment of products in 2005 and all production related costs were allocated to cost of sales. In addition, spending on prototypes and scrap decreased by \$9.0 million from 2004 to 2005.

*Sales and Marketing Expenses*

The following table presents our sales and marketing expenses in absolute dollars and as a percent of total revenue for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
	(In thousands)				
Sales and marketing expenses	\$ 8,294	\$ 11,053	\$ 20,682	\$ 2,701	\$ 7,636
Percent of total revenue <sup>(1)</sup>	N/M%	268%	36%	102%	16%

(1) Sales and marketing expenses as a percent of total revenue is not a meaningful trend indicator because our revenue recognition policy requires the deferral of revenues over future periods.

*Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2007.* Sales and marketing expenses increased from the three months ended March 31, 2006 to the corresponding period in 2007 due primarily to an increase of \$2.7 million in headcount related expenses, including salaries and commission and \$1.0 million of expenses related to demonstration units used in potential customer lab trials.

*2005 Compared to 2006.* Sales and marketing expenses increased from 2005 to 2006 due primarily to an increase in commission expense of \$7.5 million, reflecting significant increases in revenue and invoiced shipments and increased personnel-related costs in 2006. Other compensation expenses increased by \$1.8 million in 2006 due to an increase in the number of sales and marketing employees. Our headcount growth reflected the expansion of our sales team in the United States and internationally.

*2004 Compared to 2005.* Sales and marketing expenses increased from 2004 to 2005 due primarily to increased personnel-related costs of \$2.0 million. In addition, equipment expenses decreased due to fewer pre-sale evaluation units.

*General and Administrative Expenses*

The following table presents our general and administrative expenses in absolute dollars and as a percent of total revenue for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
	(In thousands)				
General and administrative expenses	\$ 2,888	\$ 4,328	\$ 12,650	\$ 1,378	\$ 5,557
Percent of total revenue <sup>(1)</sup>	482%	105%	22%	52%	11%

(1) General and administrative expenses as a percent of total revenue is not a meaningful trend indicator because our revenue recognition policy requires the deferral of revenues over future periods.

*Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2007.* General and administrative expenses increased from the three months ended March 31, 2006 to the corresponding period in 2007 due primarily to increased personnel costs of \$2.0 million and \$1.3 million of legal and accounting expenses related to our preparation to become a public company.



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*2005 Compared to 2006.* General and administrative expenses increased from 2005 to 2006 due primarily to increased legal and accounting fees related to our preparations to become a public company of \$3.2 million, increased professional services and information technology consulting fees of \$3.0 million and increased personnel-related costs of \$2.1 million.

*2004 Compared to 2005.* General and administrative expenses increased from 2004 to 2005 due primarily to an increase in personnel-related costs of \$1.0 million and professional services fees of \$0.7 million.

*Other Income (Expense), Net*

The following table presents our interest income, interest expense and other loss, net for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
	(In thousands)				
Interest income	\$ 1,166	\$ 686	\$ 2,100	\$ 226	\$ 185
Interest expense	(1,949)	(2,768)	(4,852)	(990)	(1,063)
Other gain (loss), net	(1,568)	(174)	(1,567)	268	(1,537)
Total other income (expense), net	\$ (2,351)	\$ (2,256)	\$ (4,319)	\$ (496)	\$ (2,415)

*Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2007.* The increase in interest expense was due to increased borrowings required to support our continued growth. Other loss, net primarily consisted of a \$2.5 million charge related to the revaluation of preferred stock warrant liabilities at fair market value, partially offset by a \$0.9 million gain related to the sale of assets acquired during the period under an asset purchase agreement as described in Note 4 of Notes to Consolidated Financial Statements.

*2005 Compared to 2006.* Interest income increased from 2005 to 2006 due to higher invested balances resulting from funds raised in our Series G convertible preferred stock financing. The increase in interest expense from 2005 to 2006 was due to increased borrowings required to support our continued growth. Other loss, net increased from 2005 to 2006 primarily due to charges related to the revaluation of preferred stock warrant liabilities at fair market value of \$2.1 million, offset by a \$0.5 million gain from foreign currency exchange translation.

*2004 Compared to 2005.* Interest expense increased from 2004 to 2005 due to the utilization of new credit facilities to support our continued growth. Interest income decreased due to lower invested balances as we continued to utilize cash. In 2004, other loss, net included a \$1.5 million charge related to redemption of certain of our Series D convertible preferred stock. In 2005, other loss, net primarily consisted of \$0.2 million charge related to the revaluation of preferred stock warrant liabilities at fair market value.

*Provision for Income Taxes*

Since inception, we have incurred operating losses and, accordingly, have not recorded a provision for income taxes for any of the periods presented other than foreign provisions for income tax. As of December 31, 2006, we had net operating loss carry-forwards for federal and state income tax purposes of \$205.7 million and \$193.6 million, respectively. As of March 31, 2007, we had net operating loss carry-forwards for federal and state income tax purposes of \$211.3 million and \$199.1 million, respectively. As of December 31, 2006 and March 31, 2007, we also had federal research and

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development tax credit carry-forwards of approximately \$5.6 million and \$6.0 million, respectively, and state research and development tax credit carry-forwards of approximately \$3.7 million and \$4.0 million, respectively. Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance. If not utilized, the federal and state net operating loss and tax credit carry-forwards will begin to expire in 2021 and 2013 for federal and state tax purposes, respectively. Utilization of these net operating losses and credit carry-forwards may be subject to an annual limitation due to provisions of the Internal Revenue Code of 1986, as amended, or the Internal Revenue Code, that are applicable if we have experienced an ownership change in the past, or if an ownership change occurs in the future, for example, as a result of this offering aggregated with certain other sales of our stock before or after this offering.

We adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), at the beginning of 2007. At the adoption date of January 1, 2007, the cumulative unrecognized tax benefit was \$6.4 million which was netted against deferred tax assets with a full valuation allowance or other fully reserved amounts, and if recognized there would be no effect on the Company's effective tax rate. Upon adoption of FIN 48, we recognized no adjustment in the liability for unrecognized income tax benefits.

At March 31, 2007, the cumulative unrecognized tax benefit was \$6.9 million that was substantially netted against deferred tax assets with a full valuation allowance. Included in the \$6.9 million of cumulative unrecognized tax benefit, approximately \$10,000 impacted our effective tax rate in the current quarter. At March 31, 2007, we had no liability for unrecognized tax benefits nor any accrued interest and penalties related to uncertain tax positions. Tax returns for all years after 2002 are subject to future examination by the major taxing jurisdictions to which we are subject.

We are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2003 through 2006. Infinera Corporation and our subsidiaries' state income tax returns are open to audit under the statute of limitations for the years ended December 31, 2002 through 2006.

For FIN 48 purposes, we recognize interest and penalties related to uncertain tax positions as part of its provision for federal, state and foreign income taxes.

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

The following table sets forth our unaudited quarterly consolidated statements of operations data for each of the nine quarters ended March 31, 2007. The data has been prepared on the same basis as the audited consolidated financial statements and related notes included in this prospectus and you should read the following table in conjunction with such financial statements. The table includes all necessary adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of this data. The results of historical periods are not necessarily indicative of the results of operations for a full year or any future period.

	For the Three Months Ended (Unaudited)								
	2005				2006				2007
	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31
	(In thousands, except per share data)								
<b>Revenue:</b>									
Ratable product and related support and services	\$ 421	\$ 603	\$ 1,126	\$ 1,977	\$ 2,653	\$ 4,054	\$ 6,118	\$ 40,153	\$ 45,947
Product							1,578	3,680	3,245
Total revenue	421	603	1,126	1,977	2,653	4,054	7,696	43,833	49,192
<b>Cost of revenue:</b>									
Cost of ratable product and related support and services	2,276	7,032	5,092	3,359	5,485	4,488	7,967	30,132	34,843
Lower of cost or market adjustment	104	1,438	3,604	4,550	4,325	3,657	4,172	9,539	1,067
Cost of product							311	1,349	1,363
Total cost of revenue	2,380	8,470	8,696	7,909	9,810	8,145	12,450	41,020	37,273
Gross margin (loss)	(1,959)	(7,867)	(7,570)	(5,932)	(7,157)	(4,091)	(4,754)	2,813	11,919
Operating expenses	10,265	9,393	9,682	11,027	10,524	13,720	22,928	25,183	29,288
Loss from operations	(12,224)	(17,260)	(17,252)	(16,959)	(17,681)	(17,811)	(27,682)	(22,370)	(17,369)
Other income (expense), net	141	413	611	1,091	496	370	892	2,561	(2,415)
Loss before provision for income taxes and cumulative effect of change in accounting principle	(12,365)	(17,673)	(17,863)	(18,050)	(18,177)	(18,181)	(28,574)	(24,931)	(19,784)
Provision for income taxes				12	15	15	23	19	29
Loss before cumulative effect of change in accounting principle	(12,365)	(17,673)	(17,863)	(18,062)	(18,192)	(18,196)	(28,597)	(24,950)	(19,813)
Cumulative effect of change in accounting principle			(1,137)						
Net loss	\$ (12,365)	\$ (17,673)	\$ (16,726)	\$ (18,062)	\$ (18,192)	\$ (18,196)	\$ (28,597)	\$ (24,950)	\$ (19,813)
	\$ (2.84)	\$ (3.90)	\$ (3.59)	\$ (3.71)	\$ (3.63)	\$ (3.23)	\$ (4.42)	\$ (3.55)	\$ (2.62)

Net loss per common  
share, basic and diluted

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Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance.

Commencing with the first shipment of our DTN System in the fourth quarter of 2004, revenue has increased sequentially in each of the quarters presented due to increases in the number of products sold to new and existing customers and the shortening of our ratable revenue recognition period to 1.3 years in the fourth quarter of 2006. In the fourth quarter of 2006, we amended several of our significant sales contracts to shorten our contractual software warranty period. This shortening of the ratable revenue recognition period was responsible for \$28.2 million of the \$36.1 million increase in revenue and \$20.0 million of the \$28.6 million increase in cost of revenue from the third quarter of 2006 to the fourth quarter of 2006. The remainder of the increase in revenue of \$7.9 million and cost of revenue of \$8.6 million reflects the impact of increased levels of invoiced shipments throughout 2006.

Revenue increased by \$5.4 million in the first quarter of 2007 reflecting the amortization of deferred revenue from prior periods of \$38.1 million and of invoiced shipments of bundled products from the current period of \$7.8 million. Although revenue increased by \$5.4 million in the first quarter of 2007, cost of revenue decreased by \$3.7 million primarily due to a reduction in LCM adjustments from \$9.5 million in the fourth quarter of 2006 to \$1.1 million in the first quarter of 2007.

Operating expenses fluctuated from quarter-to-quarter and increased significantly in the third quarter of 2006 due to increased research and development expenses related to two asset acquisitions completed in 2006. In addition, sales commission expense increased in the second half of 2006 due to significant increases in our invoiced shipments. We also invested heavily in finance, information systems and legal resources in 2006 as we prepared to become a public company. Operating expenses increased by \$4.1 million in the first quarter of 2007 primarily due to software development services that we purchase from a third party and additional general and administrative expenses.

In the third quarter of 2005, we adopted FSP 150-5, which requires us to classify the warrants to purchase our convertible preferred stock and common stock as liabilities and to adjust the warrant instruments to fair value at each reporting period. We recorded a \$1.1 million cumulative effect for adoption as of July 1, 2005, reflecting the fair value of the warrants as of that date, and \$(29,000), \$(0.2) million, \$0.1 million, \$(0.4) million, \$(0.7) million and \$(1.4) million of additional expense that was recorded in other income (expense), net in the quarters ended September 30, 2005, December 31, 2005, March 31, 2006, June 30, 2006, September 30, 2006 and December 31, 2006, respectively, to reflect the increase in the fair value of the warrants. Additional expense of \$2.5 million was incurred in the first quarter of 2007, reflecting a further increase in the fair value of the warrants.

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

	As of December 31,			As of March 31,	
	2004	2005	2006	2006 (Unaudited)	2007 (Unaudited)
	(In thousands)				
Working capital	\$ 37,665	\$ 29,579	\$ 2,218	\$ 18,819	\$ (12,869)
Cash and cash equivalents	5,031	36,013	28,884	30,102	38,970
	For the Years Ended December 31,			For the Three Months	
	2004	2005	2006	2006 (Unaudited)	2007 (Unaudited)
	(In thousands)				
Cash provided by (used in) operating activities	\$ (62,222)	\$ (56,449)	\$ (67,775)	\$ (21,625)	\$ 6,963
Cash provided by (used in) investing activities	9,283	29,451	(18,069)	70	(4,025)
Cash provided by financing activities	51,608	58,059	78,780	15,652	7,138

Cash and cash equivalents consist of highly liquid investments in time deposits held at major banks, commercial paper, U.S. government agency discount notes, money market mutual funds and other money market securities with original maturities of 90 days or less. Since inception, we have financed our operations primarily through private sales of equity and from borrowings under credit facilities and more recently from cash collections on the sales of our DTN System.

*Operating Activities*

We experienced positive cash flows from operations of \$7.0 million in the first quarter of 2007. We generated a net loss for the period of \$19.8 million, and we had non-cash charges of \$5.1 million consisting primarily of depreciation of \$2.1 million and warrant expense of \$2.5 million. In addition, the loss reflects the continued non-cash deferral of positive gross margin from invoiced shipments of bundled products of \$11.3 million. This deferral of gross margin is one of the key drivers of the decrease of working capital in the period to a negative \$12.9 million. We expect this trend to continue as we continue to increase invoiced shipments of bundled products, which may cause our working capital balance to continue to be negative. In addition, we experienced improved collections activities in the period offset by reductions in accounts payable terms. We also continued to invest in the development of our DTN System and in the expansion of our sales and marketing presence in the United States and internationally. We experienced negative cash flows from operations of \$21.6 million in the first quarter of 2006. This reflected a net loss of \$18.2 million with a non-cash deferral of gross margin on invoiced shipments of bundled products of \$1.3 million. Other non-cash charges included \$1.6 million of depreciation. Inventory and accounts receivables continued to increase in the period as we continued to ramp the business driving higher working capital requirements.

We experienced negative cash flows from operating activities of \$67.8 million in 2006. We generated a net loss for the period of \$89.9 million, and we had non-cash charges of \$15.8 million consisting primarily of \$7.0 million of depreciation, \$4.5 million in-process research and development related to our acquisition of certain assets of Little Optics, Inc., \$2.4 million related to revaluation of convertible preferred stock and common stock warrant liabilities and \$1.1 million of stock-based compensation expense related to employees. The net loss also reflects the non-cash deferral of \$87.8 million of deferred revenue and \$50.6 million of deferred inventory cost to the balance sheet in the period. We funded increased working capital requirements of \$27.4 million due to significant growth of the business. The decrease in working capital of \$27.4 million from 2005 to 2006 was primarily due to an increase in short-term deferred revenue of \$94.4 million compared to the increase in short-term deferred



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inventory costs of \$57.8 million, reflecting the deferral of positive gross margin from invoiced shipments of bundled products. We expect this trend to continue as we continue to increase invoiced shipments of bundled products, which may cause our working capital balance to be negative. Our continued investment in the development of our DTN System and the expansion of our sales and marketing presence in the United States and internationally also negatively impacted our cash flow from operations.

Cash used in operating activities amounted to \$56.4 million in 2005, primarily due to the generation of a net loss of \$64.8 million. Results from operations in 2005 were negatively impacted by lower sales volumes, unfavorable manufacturing variances and the need to record charges for excess and obsolescent inventory. Deferred revenue increased by \$22.8 million compared to an increase in deferred cost of inventory of \$16.7 million. We commenced product shipments in November 2004 and inventory levels increased in 2005 by \$16.5 million to support customer requirements. This increase was offset by increases in accounts payable of \$7.8 million.

Cash used in operating activities in 2004 was \$62.2 million, primarily due to the generation of a loss of \$66.5 million in the period. The loss primarily reflected a significant investment in research and development of \$46.3 million, increased sales and marketing expenses of \$8.3 million and an increase in manufacturing costs in preparation for full product release in 2005. We were a development stage company for most of 2004 and the majority of our cash used in operating activities in 2004, \$46.3 million reflected investment in research and development to develop our DTN System.

*Investing Activities*

Cash used in investing activities was \$4.0 million in the first quarter of 2007, consisting of \$5.2 million for the purchase of property, plant and equipment, partially offset by \$1.1 million of proceeds from the subsequent sale of some of the purchased assets. Cash generated from investing activities in the first quarter of 2006 was \$70,000 and consisted of \$1.1 million of proceeds from the sale of acquired assets and \$1.1 million of proceeds from the sale of short-term investments partially offset by \$2.1 million for the purchase of property, plant and equipment.

Cash used in investing activities was \$18.1 million in 2006, \$15.3 million for the purchase of property and equipment related to the expansion of our manufacturing operations and \$4.7 million related to our acquisition of certain assets of Little Optics Inc., a research and development company, partially offset by the sale of surplus assets acquired as part of a previous acquisition that generated \$1.5 million.

We generated net cash from investing activities in 2005 of \$29.5 million. \$34.0 million was generated from the net sale of short-term investments, offset by \$4.0 million from purchases of property and equipment and \$0.7 million from the acquisition of certain assets from Big Bear Networks, Inc.

In 2004, net cash provided by investing activities was \$9.3 million, primarily due to net proceeds of \$13.0 million from the sale of short-term investments, offset by purchases of property and equipment of \$3.3 million.

*Financing Activities*

Our financing activities provided cash of \$7.1 million in the first quarter of 2007. The primary source of these funds was an increase in borrowings of \$7.1 million under an existing variable rate term facility. In addition, we received \$1.6 million from employee stock options exercised in the period offset by loan repayments of \$1.6 million. Cash from financing activities amounted to \$15.7 million in the first quarter of 2006. The primary sources of these funds were the issuance of convertible preferred stock of \$8.4 million and a net increase in bank borrowings of \$6.9 million.

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Our financing activities provided cash of \$78.8 million in 2006. The primary source of these funds was the issuance of Series G convertible preferred stock. In 2006, we sold an aggregate of 14.1 million shares of our Series G convertible preferred stock for a net amount of \$74.1 million to various investors. The purchase price for these shares of Series G convertible preferred stock was \$5.40 per share, with the exception of a board member's purchase of 67,934 shares in October 2006 at \$7.36 per share. We also received \$4.4 million from employee stock options exercised during 2006.

Our financing activities provided cash of \$58.1 million in 2005. \$42.6 million was raised from the issuance of convertible preferred stock. In addition, we borrowed a net amount of \$14.4 million under new and existing credit facilities.

Our financing activities provided cash of \$51.6 million in 2004. \$55.1 million was generated from the issuance of convertible preferred stock, proceeds from loans amounted to \$7.1 million and we raised \$0.7 million from the sale of common stock, offset by \$11.4 million for principal payments on our outstanding loan obligations.

*Credit Facilities*

We entered into a borrowing arrangement in December 2004 with our primary financial institution, Silicon Valley Bank, which provides for two related facilities, an operating line of credit and a revolving line of credit. The operating line of credit allows us to borrow against our accounts receivables. The revolving line of credit allows for borrowing subject to our maintaining certain minimum cash balances. These facilities are secured by our assets, including our intellectual property. Total available credit under the arrangement is \$25.0 million, and the weighted average interest rate on this facility for 2006 was 10.1%. Borrowings under these two facilities amounted to \$9.5 million of debt and \$3.2 million of outstanding stand-by letters of credit as of December 31, 2006 and March 31, 2007.

In June 2005, we put in place a variable rate term facility with United Commercial Bank. Total borrowings under this facility may not exceed \$15.0 million and are secured by certain of our equipment and other assets, including our intellectual property. The interest rate on this variable rate facility is set at the bank's prime rate. The principal balance outstanding under this facility was \$7.8 million and \$14.1 million at December 31, 2006 and March 31, 2007, respectively. At December 31, 2006, the weighted average interest rate for the year was 8.3%. Amounts under this facility are paid in equal monthly installments from the date the funds are drawn to October 2009.

We also have a growth capital loan agreement with two co-lender financial institutions, Silicon Valley Bank and Gold Hill Ventures Lending 03, L.P., that we entered into in December 2004 under which we had \$5.4 million outstanding as of December 31, 2006 and March 31, 2007. This loan is secured by our assets, including our intellectual property, and had a weighted average interest rate of 16.7% for 2006. Amounts under this facility are due in equal monthly installments from the date the funds are drawn to June 1, 2008 at which point we must make a final payment of \$0.8 million.

The loan agreements described above require us to maintain compliance with certain operating covenants. At December 31, 2006 and March 31, 2007, we had access to an additional \$19.5 million and \$12.3 million, respectively, of incremental funds under our existing credit facilities. In the next twelve months, capital expenditures are expected to be approximately \$15 million, primarily for product development and manufacturing expansion and upgrades. We believe that our existing cash and cash equivalents, combined with our existing credit facilities and the net proceeds from this offering will be sufficient to meet our anticipated cash needs for at least the next twelve months. However, we may require additional capital from equity or debt financings in the future to fund our operations, respond to competitive pressures or for strategic opportunities in the event that we continue to incur significant losses or otherwise. We may not be able to secure timely additional financing on favorable terms, or at

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all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of us, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock, including shares of common stock sold in this offering.

**Contractual Obligations**

The following is a summary of our contractual obligations as of December 31, 2006:

	Years Ended December 31,					2011 and beyond
	Total	2007	2008 (In thousands)	2009	2010	
Principal payments on credit facility	\$ 28,382	\$ 20,025	\$ 5,393	\$ 2,649	\$	\$ 315
Purchase obligations(1)	39,176	39,176				
Interest payments on credit facility(2)	2,411	1,809	432	131	19	20
Operating leases	14,987	3,119	2,940	2,929	2,650	3,349
<b>Total contractual obligations</b>	<b>\$ 84,956</b>	<b>\$ 64,129</b>	<b>\$ 8,765</b>	<b>\$ 5,709</b>	<b>\$ 2,669</b>	<b>\$ 3,684</b>

(1) We have service agreements with our major production suppliers under which we are committed to purchase certain parts.

(2) Represents estimated interest payments on our debt using an effective rate of 8.5% at December 31, 2006.

**Off-Balance Sheet Arrangements**

During 2004, 2005, 2006 and the three months ended March 31, 2007, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

**Recent Accounting Pronouncements**

See Note 19 of Notes to Consolidated Financial Statements for recent accounting pronouncements that could have an effect on us.

**Quantitative and Qualitative Disclosures about Market Risk***Foreign Currency Risk*

Certain of our sales contracts are priced in Euros and, therefore a portion of our revenue is subject to foreign currency risks. Our operating expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the British pound and Euro. The effect of an immediate 10% adverse change in exchange rates on foreign denominated receivables as of December 31, 2006 would result in a loss of approximately \$1.3 million. To date, we have not entered into any hedging contracts although we may do so in the future. Fluctuations in currency exchange rates could harm our business in the future.

*Interest Rate Sensitivity*

We had unrestricted cash and cash equivalents totaling \$36.0 million, \$28.9 million and \$39.0 million at December 31, 2005, December 31, 2006 and March 31, 2007, respectively. These amounts were invested primarily in money market funds. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We



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believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates fell by 10% in 2006, our interest income would have declined approximately \$46,000, assuming consistent investment levels.

At December 31, 2005, December 31, 2006 and March 31, 2007, we had \$23.8 million, \$28.4 million and \$34.0 million, respectively, of debt outstanding. Our debt interest rate is variable and adjusts periodically based on the prime rate. If overall interest rates increased by 10% in 2006, our interest expense would have increased approximately \$0.2 million.

## **Controls and Procedures**

In connection with the audit of our financial statements for 2005 and 2006, our management and our independent registered public accounting firm have reported to our board of directors material weaknesses in the design and operation of our internal control over financial reporting. A material weakness is defined by the standards issued by the American Institute of Certified Public Accountants as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Our management and independent registered public accounting firm did not perform an evaluation of our internal control over financial reporting during any period in accordance with the provisions of the Sarbanes-Oxley Act. Had we and our independent registered public accounting firm performed an evaluation of our internal control over financial reporting in accordance with the provisions of the Sarbanes-Oxley Act, additional material weaknesses may have been identified.

Our independent registered public accounting firm communicated the following material weaknesses:

in 2005, we did not timely reflect or capture certain manufacturing costs in our inventory records and our inventory analysis contained computational errors; and

in 2006, our review did not identify manual computational errors in our ratable revenue analysis and our net loss per common share calculations.

The material weakness in 2005 related to our inventory valuation process existed as of December 31, 2005 and resulted in adjustments to our financial statements for 2005 prior to their issuance, affecting our inventory, deferred inventory costs, research and development expenses and cost of ratable revenue. We believe we have remediated the material weakness identified in 2005 related to our inventory valuation process by implementing additional procedures and controls, hiring additional accounting personnel and increasing management review and oversight.

The material weakness in 2006 relates to our non-routine manual accounting and reporting processes involving our revenue and net loss per common share disclosure processes that existed as of December 31, 2006 and resulted in restatements of our financial statements for 2006, reducing our ratable revenue by \$0.5 million in 2006 and increasing our annual net loss per common share in 2002, 2003, 2004, 2005 and 2006. We have developed a remediation plan to address the material weakness identified in 2006 related to our non-routine manual accounting and reporting processes involving our revenue and net loss per common share disclosure process. We intend to hire additional personnel and implement new accounting procedures and controls and documentation standards. We also intend to explore having developed customized modules for our financial reporting system to minimize our reliance on manual processes and procedures in calculating revenue, deferred revenue, inventory costs and net loss per common share.

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The remediation policies and procedures we have implemented and plan to implement may be insufficient to address our material weaknesses and additional material weaknesses may be discovered in the future. The existence of one or more material weaknesses precludes a conclusion that we maintain effective internal control over financial reporting. Such conclusion would be required to be disclosed in our future Annual Reports on Form 10-K and may impact the accuracy and timing of our financial reporting and the reliability of our internal control over financial reporting.

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**Table of Contents****BUSINESS****Overview**

Infinera has developed a solution that we believe will change the economics, operating simplicity, flexibility, reliability and scalability of optical communications networks. At the core of our Digital Optical Network architecture is what we believe to be the world's only commercially-deployed, large-scale photonic integrated circuit, or PIC. Our PICs transmit and receive 100 Gbps of optical capacity and incorporate the functionality of over 60 discrete optical components into a pair of indium phosphide chips approximately the size of a child's fingernail. We have used our PIC technology to design a new digital optical communications system called the DTN System. The DTN System is designed to enable cost-efficient optical to electrical to optical conversion of communications signals. The DTN System is architected to improve significantly communications service providers' economics and service offerings as compared to traditional systems. Our DTN System is designed to provide greater signal quality and network management flexibility. Our carrier-class DTN System runs our Infinera IQ Network Operating System and is integrated with our Infinera Management Suite software, which together enhance and simplify network monitoring, management and control.

Our goal is to establish our Digital Optical Network as a leading architecture for optical communications networks. We believe that photonic integrated circuits will significantly change optical communications networks in a fashion similar to the integrated circuit's impact on electronics beginning in the 1950's. We also believe that our DTN System can provide benefits to our customers in the \$3.7 billion wavelength division multiplexing segment of the global optical communications equipment market, which is estimated by Ovum-RHK, a third-party industry analyst, to be nearly \$12 billion in 2006. As of March 31, 2007, we have sold our DTN System for deployment in the optical networks of 28 customers worldwide, including Internet2, Interoute, Level 3 Communications and Qwest Communications.

We believe that rapid growth of communications traffic and proliferation of next-generation bandwidth-intensive services such as video will expand the need and increase demand for optical network capacity. Our DTN System is designed to serve as the key element for long-haul and metro optical transport networks of U.S. and international communications service providers. Customer deployments of our DTN System have ranged from two to hundreds of network access points.

Our DTN System is designed to provide several advantages over traditional systems, including:

*Operating simplicity and cost savings*

*Ease of deployment and scalability.* Our DTN System provides optical capacity in 100 Gbps increments (10 channels at 10 Gbps), enabling our customers to more easily scale their optical networks with the initial installation of the DTN System and to add capacity to existing DTN Systems in less time and with fewer service calls;

*Management and personnel.* Our DTN System offers built-in software intelligence to route services across complex optical communications networks and is designed to simplify our customers' network planning, engineering and operations; and

*Efficiency and reliability.* Given the high level of photonic integration and digital processing, our DTN System is designed to consume less power, enable simplified testing and improve system reliability;

*Enhanced revenue generation*

*Expand services reach.* Our DTN System lowers the cost of optical to electrical to optical conversion, which enables our customers to access markets cost-effectively that had previously not been served due to cost

constraints;



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*Optimal use of network capacity.* Our DTN System enables communications service providers to combine streams of network traffic from various points throughout the network onto a single wavelength, thereby optimizing existing capacity and increasing revenue opportunities; and

*Accelerate service provisioning.* Our DTN System's ability to deploy optical capacity in 100 Gbps increments and to process and manage data at each DTN System location remotely enables communications service providers to add customers and provision new services more rapidly than traditional systems; and

*Capital cost savings.* Our DTN System integrates the functionality of over 60 discrete optical components into a single PIC pair, reducing capital expenditures and the physical space required for a given amount of optical network capacity. We began commercial shipment of our DTN System in November 2004. In the third quarter of 2005 we believe we achieved, and have since maintained through the fourth quarter of 2006, the largest market share of 10 Gbps long-haul ports shipped worldwide. We believe we achieved over 30% of the market share for all 10 Gbps long-haul interface ports shipped worldwide in 2006. We believe this rapid customer acceptance is due to the benefits that our PIC-based digital optical communications system offers over traditional systems.

**Industry Background**

Optical communications equipment carries digital information as analog light waves over fiber optic networks. Fiber optic networks provide significantly greater data transport capacity than traditional electrical over copper transport technology. The advent of wavelength division multiplexing systems has enabled the transmission of larger amounts of data by using multiple wavelengths over a single optical fiber. Service providers often use wavelength division multiplexing systems to carry communications traffic between cities, referred to as long-haul networks, and within large metropolitan areas, referred to as metro networks. Most fiber optic networks carry all types of communications traffic, from conventional long-distance telephone calls to e-mails and web sessions to high-definition video streams. As traffic grows, service providers add capacity to existing networks or purchase and deploy additional systems to keep pace with bandwidth demands and service expansion. Fiber optic networks are expensive and complex, and service providers have traditionally experienced significant challenges in generating new revenue while reducing operating and capital costs.

*Increased Demand for Network Capacity*

The global market for optical communications equipment is estimated by Ovum-RHK, a third party industry analyst, to be nearly \$12 billion in 2006. Our DTN System currently competes in the wavelength division multiplexing segments of this market, which we estimate to be \$3.7 billion in 2006. We intend to address a larger portion of the optical communications equipment market opportunity with enhancements to our existing DTN System and with new product releases in the future.

*Drivers of Increases in Demand for Network Capacity*

We believe that a number of trends in the communications industry are driving growth in demand for network capacity and ultimately will increase demand for optical communications systems, including our DTN System. These trends include:

*Growth of Internet usage and Internet protocol traffic.* Internet protocol network traffic continues to grow significantly as bandwidth consumed per Internet user and the total number of Internet users increases;

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*Increasing broadband penetration and high capacity services.* Communications service providers are offering broadband internet access to an increasing number of subscribers to support voice, video and high speed data offerings. In addition, adoption of new consumer applications such as video and music downloads and business applications such as videoconferencing necessitates an increase in network capacity to accommodate high-quality delivery of these bandwidth-intensive services; and

*Availability of more bandwidth capacity.* Competition, particularly in the United States, among cable and communications service providers in providing bundled services such as the Triple Play (voice, video and data) has encouraged greater consumption of bandwidth.

### *Challenges Faced by Communications Service Providers*

Service providers face significant challenges in meeting increasing bandwidth demands, including:

*Price competition pressuring network costs.* Competition between communications service providers places pressure on service pricing and thus network costs. The optical communications network is a significant source of overall network cost, and thus service providers are aggressively seeking ways to reduce their optical network operating and capital costs;

*Operational complexity.* Optical communications network design, planning and engineering involves considerable complexity. This complexity is costly and may slow network expansion and service delivery which, in some cases, results in lost revenue;

*Limited service reach.* Many network operators have optical facilities that pass through small- to mid-sized cities but determine that it is cost-prohibitive to deploy expensive optical systems that would allow them to offer services to potential customers in these locations;

*Slow service provisioning.* Optical communications networks often require fixed allocation of bandwidth between customer sites. Communications service providers often must add capacity to their networks to accommodate new subscribers and services. Adding capacity generally involves complex and costly re-engineering of the existing network and a lengthy time period to implement, test and prepare the network to provide service;

*Lack of protection and management features.* Most traditional long-haul optical communications systems do not offer protection capabilities to restore service in the event of equipment or fiber failure. As a result, communications service providers must purchase, deploy, and manage additional equipment to support protected services, which further increases cost and network complexity; and

*Exposure to equipment failures.* Traditional optical communications systems and sub-systems contain dozens of discrete interconnected optical components. Most failures occur at these connections resulting in reduced system reliability and potential loss of service.

### **Limitations of Traditional Optical Approaches**

#### *Optical Components and Sub-systems*

Optical component technology today shares many characteristics with electronic component technology in the 1950 s. At that time, all electronic devices were comprised of discrete components, each requiring a separate package to perform a given function. As in traditional systems today, individual components were largely manually-wired to their packages, resulting in higher cost and lower

reliability. Due to the numerous discrete connected parts, electronic systems were physically

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large, consumed significant amounts of power and were prone to failure. These problems were significantly reduced with the advent of the integrated circuit, which led to the proliferation of high-performance, mass-market, low-cost and reliable semiconductor chips suitable for a wide range of computing applications.

Several companies have developed forms of optical sub-system integration, which consist of co-packaging discrete components within a common module. Optical subsystems provide modest space and package savings and some cost reductions in final production and testing. However, we believe that the total cost savings associated with these devices is limited because each must undergo its own manufacturing, separation, testing and production process steps before final integration within a subsystem package. In addition, we believe that these optical subsystems approaches provide minimal improvement in quality or reliability compared to discrete optical components.

### *Optical Communications Systems*

Optical components and sub-systems are the key building blocks of traditional systems. Traditional systems vendors typically rely on a limited number of component and sub-system suppliers, resulting in limited product differentiation. In addition, the ability of traditional systems vendors to benefit from photonic integration is constrained by the development efforts of their optical component and sub-system suppliers.

Optical communications systems typically transport communications signals between cities as wavelengths and switch or add/drop those signals using digital electronics at network access points where services are provided. Most optical communications networks utilize wavelength division multiplexing technology that transmits multiple signals, each as separate colors of light, or wavelengths, on a single fiber in a communications service provider's network. The principal benefit of wavelength division multiplexing systems is that they enable the transmission of large amounts of data on multiple wavelengths over a single optical fiber. In optical communications networks, communications service providers cannot access or manage these wavelengths of light, or analog signals, and must convert the wavelengths of light to electrical or digital signals. Once this traffic has been converted into the digital domain, it can be processed by the communications service provider. This processing can include adding/dropping, monitoring or regenerating the traffic. After the digital signal is processed, it is converted back to wavelengths of light so that it can be transported to the next network destination. The process of converting the optical signal to an electrical signal for processing and then converting it back to an optical signal to enable digital processing is known as optical to electrical to optical conversion. Optical to electrical to optical conversion enables access to data that allows communications service providers to differentiate their networks and to generate revenue through value-added services. Optical to electrical to optical conversion utilizing traditional systems can be expensive.

With some traditional systems, communications service providers must choose at multiple network access points whether to utilize a wavelength division multiplexing system that enables high-performance digital management and processing but with high optical to electrical to optical conversion costs, or to use an all-optical architecture that reduces optical to electrical to optical conversion costs but also may limit service reach and add cost.

### *Traditional Wavelength Division Multiplexing Systems*

Traditional wavelength division multiplexing systems have several disadvantages, including:

- significant capital cost, space and power requirements;

- requirement of discrete components to execute optical to electrical to optical conversions for each wavelength, which adds significant cost and reduces reliability;

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expansion of the network is often manually intensive as communications service providers may need to redesign the network, re-allocate available wavelengths or deploy additional hardware at multiple locations each time a new circuit is added;

limited flexibility to alter traffic flows because dedicated network capacity must be purchased and deployed in advance; and

high costs associated with implementing advanced features, such as network-wide provisioning or optical layer protection, because additional equipment may be required.

### *All-Optical Communications Systems*

Several optical communications systems vendors have attempted to reduce the cost of transporting data on optical networks by limiting the need for optical to electrical to optical conversions. The resulting architecture, known as the all-optical network, utilizes a new generation of wavelength division multiplexing systems to manage and switch traffic as analog light waves. Reconfigurable optical add/drop multiplexers and wavelength selectable switches are examples of all-optical systems. However, we believe these all-optical approaches possess inherent weaknesses, including:

limited ability to digitally process the data, which prevents these systems from efficiently adding and dropping traffic at intermediate network access points; this can result in a reduced network footprint and decreased revenue opportunities for communications service providers, particularly in smaller regions and markets;

more costly and time-consuming network planning and service provisioning, because adding new services requires complex engineering calculations involving power levels, dispersion compensation and other optical non-linear effects;

higher installation costs, because this process may require complicated components to minimize signal degradation over long distances; all-optical systems also lack the ability to effectively view network performance statistics and reconfigure traffic patterns; and

overall network capacity can be limited by wavelength blocking, which is the inability to use wavelengths of light because they are already in use in another part of the network.

We believe significant demand exists for an optical communications system that is simple and easy to operate and that reduces operating and capital costs for communications service providers.

### **The Infinera Solution**

Our PIC technology facilitates a network architecture that allows communications service providers to realize the benefits of both wavelength division multiplexing and digital processing more fully and cost-effectively. We believe that our DTN System and our Digital Optical Network architecture enables the improvement of the economics, operating simplicity, flexibility, reliability and scalability of our customers' optical networks.

Our PICs enable our DTN System to provide lower-cost optical to electrical to optical conversions at every network access point to provide communications service providers with the ability to digitally process the information being transported across their optical networks. Our DTN System's software enables our customers to leverage this digital information to simplify and speed the delivery of differentiated services and to optimize the utilization of their optical networks.

Our DTN System is designed to enable the Digital Optical Network architecture for long-haul and metro optical transport systems of communications service providers and to offer the following key technical benefits:

*Photonic integration.* Our DTN System integrates the functionality of over 60 discrete optical components within a single PIC pair, reducing capital expenditure and physical space

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requirements for a given amount of optical network capacity. Our PIC technology also enables our DTN System to allow service providers to add 10 wavelengths of 10 Gbps capacity concurrently, as compared to one wavelength in traditional systems;

*Digital processing.* Our DTN System processes traffic digitally, which ensures significantly greater signal quality and network management flexibility than analog, or all optical, systems. With our DTN System, communications traffic can be cost-effectively added/dropped, monitored and regenerated through digital processing of data; and

*High value-add software content.* Our DTN System's software utilizes digital data to enable network provisioning, management, testing and control that provides intelligence not available in traditional optical communications systems. These distinctive technical features provide significant advantages to our customers, including:

### *Operating simplicity and cost savings*

- *Ease of deployment and scalability.* Our DTN System deploys optical capacity in 100 Gbps increments, which enables our customers to rapidly deploy the initial DTN System and to add capacity to existing DTN Systems in less time and with fewer service calls than with traditional systems;
- *Management and personnel.* Our DTN System offers built-in software intelligence to route and signal services across complex optical communications networks. In addition, our DTN System's digital protection and manageability enables carriers to offer a broad range of service qualities without requiring a separate synchronous optical network, or its international equivalent, synchronous digital hierarchy, or optical switching layer for protection and management. These features are designed to provide our customers with flexible management and control of their networks while significantly reducing the amount of information technology personnel and hours dedicated to planning, engineering and operating their optical communications networks; and
- *Efficiency and reliability.* Given its high level photonic integration and digital processing, our DTN System occupies a fraction of the physical space, generally consumes less power than traditional systems for a given amount of capacity, enables simplified testing and is designed to improve system reliability. We are able to deliver both increased simplicity and reliability to our customers through our differentiated PIC technology and unique approach to optical networking architecture. By enabling frequent optical to electrical to optical conversions across their optical networks, we allow our customers to manipulate traffic in the digital domain, which we believe is simpler than architecting traffic and provisioning services with all-optical systems. Likewise, our PICs efficiently perform optical to electrical to optical conversions without a need for dozens of discrete components, which in turn require hundreds of failure-prone individual connections. As such, we believe our customers' service quality can be improved significantly due to our DTN System's simplified product design.

### *Enhanced revenue generation*

- *Expand services reach.* Our DTN System significantly lowers optical to electrical to optical conversion cost, which enables our customers to access markets cost-effectively that had previously not been served due to cost constraints. This provides our customers with new revenue opportunities and can reduce or eliminate the cost paid to other service providers for use of their networks to complete a services connection. Our DTN System also supports a variety of communications interfaces, including separate synchronous optical network/synchronous digital hierarchy, Gigabit and 10 Gigabit Ethernet;

- *Optimal use of network capacity.* Our DTN System enables communications service providers to combine streams of network traffic from various points throughout the network



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onto a single wavelength, thereby optimizing existing capacity and increasing revenue opportunities. In contrast, traditional systems often require that communications service providers reserve an entire wavelength for a single stream of traffic, which may consume only a fraction of the available capacity; and

- *Accelerate service provisioning.* Our DTN System's ability to deploy optical capacity in 100 Gbps increments and to process and manage data at each DTN System location remotely enables communications service providers to add customers and provision new services more rapidly than traditional optical communications systems; and

*Capital cost savings.* Our DTN System can require less capital expenditure for a given amount of optical network capacity. We believe that photonic integration enables a faster rate of innovation than is possible using conventional discrete optical components and will result in a continued decline in costs and complexity.

### **The Infinera Strategy**

Our goal is to be a preeminent provider of optical systems to communications service providers. Key aspects of our strategy are:

*Increase our customer footprint.* We initially targeted North American competitive long-haul service providers. We intend to increase penetration of our installed base of communications service providers while also targeting new U.S. and international communications service providers, including U.S. regional bell operating companies, international postal, telephone and telegraph companies, cable multiple system operators and U.S. competitive local exchange carriers;

*Penetrate adjacent markets.* We believe that our PIC technology can benefit the metro core and metro access networks in the same way it does long-haul networks. We intend to increase our addressable market by adding functionality to our DTN System by developing new products and by creating the service and support infrastructure needed to address these markets;

*Maintain and extend our technology lead.* We intend to incorporate the functionality of additional discrete components into our PICs and to pursue further functional integration in our DTN System in order to enhance the performance, scalability and economics of our DTN System;

*Deliver systems to scale and deliver additional functionality.* Our DTN System is, to our knowledge, the only commercially-available system which provides 100 Gbps of transport capacity on a single line card. We recognize the need to continually increase our scalability and functionality to maintain product leadership in optical transport networks as demonstrated by expanding our system transport capacity from 400 Gbps to 800 Gbps in 2006; and

*Continue investment in PIC manufacturing activities.* We believe that our manufacturing capabilities serve as a competitive advantage and intend to continue to invest in the manufacturing capabilities needed to produce new generations of our PICs.

### **Products**

#### *Infinera DTN System*

Our DTN System utilizes our PIC technology to enable digital processing and management of data with the capability both to generate wavelength division multiplexing wavelengths and to add, drop, switch, manage, protect and restore network traffic digitally. Our DTN System is comprised of two elements, a Digital Transport Node, or DTN, which houses our PIC and enables optical to electrical to optical conversion, and an optical line amplifier, or OLA, which extends the optical reach between



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DTNs. The DTN can automate the connection of circuits and provisioning of new services without costly and cumbersome manual intervention.

Our DTN System is modular in design to enable our customers with the ability to add capacity in a cost-efficient manner. The initial deployment of our DTN System at a customer involves the installation of common equipment, which includes a chassis, optical line amplifiers and related equipment. Customers can purchase additional common equipment to expand the reach of the DTN System and can increase the capacity of existing common equipment for the DTN System by purchasing our Digital Line Modules, or DLMs, Tributary Adapter Modules, or TAMs and Tributary Optical Modules, or TOMs. Each DTN System is composed of one or two half rack chassis, each of which supports up to 4 DLM cards. Each DLM card in turn supports up to 5 TAMs. Each DLM contains a pair of PICs that provide 100 Gbps of transport capacity; thus, a single DTN System supports up to 800 Gbps (8 DLMs x 100 Gbps each) of transmit/receive capacity per fiber pair. The individual TAMs serve as client-side interface modules, which support line rates from 155 Mbps to 10 Gbps. Given both the density and the modular architecture of each DTN, our DTN System enables significant flexibility and scalability for communications service providers.

Our DTN System is carrier-class, which means that it complies with applicable Telcordia and equivalent major international standards for central office-based network elements. Our DTN System supports a broad range of optical service interfaces including Ethernet (Gigabit Ethernet and 10 GbE) and separate synchronous optical network/synchronous digital hierarchy (OC-3/STM-1, or 155 Mbps, to OC-192/STM-64, or 10 Gbps).

*Infinera Optical Line Amplifier*

Our OLA is a bidirectional amplifier that extends the optical reach between DTNs. Communications service providers purchase our OLAs for network access points where customer access to data is not required. Our OLA is a small form-factor device that can be managed seamlessly within the DTN System.

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### *Infinera IQ Network Operating System and Management Suite*

Our DTN System utilizes proprietary embedded software, the IQ Network Operating System, to enable our customers to simplify and speed up the tasks they perform to deliver, differentiate, and manage services and to optimize the utilization of their networks. The IQ Network Operating System software utilizes the DTN System's digital switching and IP-based technologies, including generalized multiprotocol label switching for end-to-end provisioning, protection and restoration services, and a host of performance monitoring and software-definable testing capabilities.

In addition to our IQ Network Operating System software, we offer a broad set of standards-based network and element management tools and Operations Support System integration interfaces. Our management suite software includes our Digital Network Administrator, a scalable, robust, feature-rich Element Management System, and our Graphical Node Manager, an easy-to-use web-based management interface.

## **Technology**

### *Digital Optical Network Architecture*

Our founders have experience in the optical communications market and understood the inherent limitations of both traditional wavelength division multiplexing systems and all-optical networking systems and sought to develop a product that offered the key benefits of both approaches. They founded Infinera with a vision to increase the functionality and improve the economics of optical transport systems. To that end, our core engineering team is comprised of optical component and systems experts who have collaborated to create an innovative optical communications architecture that is designed to combine enhanced performance, system-wide simplicity and efficiency, with the ability to be manufactured in a cost-efficient manner. We have focused our efforts, time and capital on developing our Digital Optical Network architecture and DTN System based on our PIC technology.

Our Digital Optical Network architecture is based on our belief that network operators can expand service reach, expedite service provisioning, ensure reliability and more effectively manage, monitor and scale their networks by processing data digitally rather than in analog format. We further believe that the key to delivering this capability in a cost-effective manner is integrating the functionality of multiple discrete devices into a single set of semiconductor chips. This integration allows us to eliminate separate optical packages for each discrete optical device, which we believe is the largest cost challenge facing traditional systems. This integration has further enabled us to provide additional functionality and intelligence to our optical communications systems.

### *Infinera PIC*

We believe that our proprietary PICs are a key source of our value proposition and competitive advantage. We manufacture and package our PICs at our own facilities for use exclusively with our DTN System. We began the simultaneous design and manufacture of our PICs shortly after we were founded in December 2000. We employ a multi-disciplinary approach towards the development and manufacturing of our PICs, with significant interaction between our manufacturing, system engineering and advanced technology groups. As a leader in the development of photonic integration, we have protected the intellectual property associated with our PIC manufacturing through a combination of trade secrets, patents and contractual protections. We believe that as a result of the combination of the multiple disciplines that were required to develop our PIC, together with the intellectual property protections that we have established, it will be difficult for others to duplicate the technology we have developed.

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Our DTN System transmits 100 Gbps of optical capacity, utilizing a pair of PICs, one transmitter PIC and one receiver PIC. Our transmitter PIC integrates the functionality of 51 optical components onto a single chip, including lasers and modulators. In addition, our receiver PIC integrates the functionality of 11 components onto a single chip, including photodetectors and an optical de-multiplexer.

We expect our PIC technology to enable continued innovation in additional applications and systems beyond the optical transport market currently being served by the DTN System. In March 2006, we demonstrated a next generation PIC prototype that is capable of transporting 1.6 terabits of data. We believe this is 40 times the capacity of the most advanced commercial discrete photonics devices today.

## **Customers**

Our DTN System has been sold to telecommunications carriers, cable operators, internet content providers and other service providers. As of March 31, 2007, we have sold our DTN System for deployment in the optical network of 28 customers worldwide, including:

BOREAS Net;

Citynet, LLC;

FLAG Telecom Group Limited;

FPL Fibernet;

Freenet Cityline GmbH;

Global Crossing International Networks Ltd.;

Integra Telecom Holdings, Inc.;

Internet2;

Interoute Communications Limited;

Level 3 Communications;

Mid-Atlantic Broadband Cooperative;

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Qwest Communications International, Inc.; and

XO Communications Services, Inc.

Level 3 and Broadwing Corporation, which Level 3 acquired in January 2007, together accounted for approximately 75% of our revenue in 2006.

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### **Support and Services**

We offer our customers a range of support offerings, including product training, installation and deployment services, extended warranties and 24x7 multi-level technical support. These product support services consist of software warranty, updates and unspecified upgrades and product support. Our support services are provided by our employees and third-party support partners. We believe that providing ongoing support is critical to successful long-term relationships with, and follow-on sales to, our customers. We are committed to providing our customers with the highest levels of support and service.

### **Sales and Marketing**

We market and sell our DTN System and related support services primarily through our direct sales force, supported by marketing and product management personnel. We may also use distribution or support partners to enter new markets or when requested by a potential customer. Our sales team has significant previous experience with the buying process and sales cycles typical of high-value telecommunications products. We expect to continue to add sales and support employees as we grow our business.

The sales process for our DTN System entails discussions with prospective customers, analyzing their existing networks and identifying how they can utilize our DTN System capabilities within their network. This process requires developing strong customer relationships, and we expect to leverage our sales force and customer support capabilities to establish relationships with both domestic and international service providers.

Over the course of the sales cycle, service providers often test our DTN System before buying. Prior to commercial deployment, the service provider will generally perform a field trial of our DTN System. Upon successful completion, the service provider generally accepts the products installed in its network and may continue with commercial deployment of additional DTN systems. We anticipate that our sales cycle, from initial contact with a service provider through the signing of a purchase agreement, may, in some cases, take several quarters.

*Direct Sales Force.* Our sales team sells directly to service providers worldwide. We maintain sales presences throughout the United States as well as in China, France, Germany, Japan, South Korea and the United Kingdom.

*Indirect Sales Force.* We have and will continue to employ business consultants, resale partners and sales agents to assist in our sales efforts to accelerate and strengthen our customer relationships. We expect to work with business partners to assist our customers in the deployment and maintenance of our systems and have entered into distribution and resale agreements to facilitate the sale of our DTN System in certain international markets.

*Marketing and Product Management.* Our product management team is responsible for defining the product features and roadmap required to maximize our success in the marketplace. Product management supports our sales efforts with product and application expertise. Our marketing team works to create demand for our DTN System by communicating our value proposition and differentiation in direct customer interaction, public relations, tradeshows, events and web and other marketing channels.

### **Research and Development**

Continued investment in research and development is critical to our business. To this end, we have assembled a team of engineers with expertise in various fields, including systems, sub-systems

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and components. Our research and development efforts are currently focused in Sunnyvale, California, Allentown, Pennsylvania, Columbia, Maryland and Bangalore, India. We have invested significant time and financial resources into the development of our Digital Optical Network architecture, our DTN System, including the IQ Network Operating System and Management Suite software, the PIC and our manufacturing capabilities. We will continue to expand our product offerings and capabilities in the future and plan to dedicate significant resources to these continued research and development efforts. We are continually increasing the scalability and software features of our current DTN System, and developing additional functionality and new products, including products for metro applications. We are also working to develop new generations of PICs, and we intend to leverage further integration in our Digital Optical Network architecture and our DTN System through continued research and development and investments in our manufacturing capabilities.

Our research and development expenses were \$46.3 million in 2004, \$25.0 million in 2005, \$39.0 million in 2006 and \$16.1 million in the three months ended March 31, 2007.

## **Manufacturing**

We have invested significant time and capital to develop and improve the manufacturing process that we use to produce and package our PIC. This includes significant investments in personnel and the facilities to manufacture and package our PIC in Sunnyvale, California and Allentown, Pennsylvania. We also have invested in automating our manufacturing process and in training and maintaining the quality of our manufacturing workforce. As a leader in the development of photonic integration, we have protected the intellectual property associated with our PIC manufacturing through a combination of trade secrets, patents and contractual provisions. We believe that as a result of the combination of the multiple disciplines that were required to develop our PIC, together with the intellectual property protections that we have established, it will be difficult for others to duplicate the technology we have developed. Our manufacturing process has been developed over several years and is protected by a significant number of trade secrets. We believe that the trade secrets associated with the manufacturing and packaging of our PIC provide us with a significant competitive advantage.

We outsource manufacturing of certain components of our DTN System. Our contract manufacturers manufacture our DTN System based on our specifications and bill of materials. In addition, the lead times associated with certain components are lengthy and preclude rapid changes in product specifications or delivery schedules. To date, we have not experienced any significant delays or material unanticipated costs resulting from the use of these contract manufacturers; however, such a strategy involves certain risks, including the potential absence of adequate capacity, the unavailability of or interruptions in access to certain process technologies, and reduced control over delivery schedules, manufacturing yields, quality and costs. Despite outsourcing manufacturing operations for cost-effective scale and flexibility, we perform rigorous in-house quality control testing to ensure the reliability of our DTN Systems.

Shortages in components that we use in our DTN System are possible and our ability to predict the availability of such components may be limited. Some of these components are available only from single or limited sources of supply. Our DTN System includes some components that are proprietary in nature and only available from a single source, as well as some components that are generally available from a number of suppliers. In some cases, significant time would be required to establish relationships with alternate suppliers or providers of proprietary components. We do not have any long-term contracts with any component providers that guarantee supply of components or their manufacturing services. If we encounter difficulty continuing our relationship with a supplier, or if a supplier is unable to meet our needs, we may encounter manufacturing delays that could adversely affect our business. Our ability to timely deliver products to our customers would be materially adversely impacted if we needed to qualify replacements for any of a number of the components used in our DTN Systems.



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We believe that our current manufacturing facilities can accommodate an increase in capacity for PIC production sufficient for the foreseeable future. Given the competitive advantage we believe is provided by our PIC product capabilities, we are continually investing in our manufacturing processes; however, we anticipate that increasing and enhancing production at this facility will not result in significant additional capital expenditures and personnel costs.

### **Backlog**

As of December 31, 2006, our backlog was \$32.8 million. These orders are subject to future events that could cause the amount or timing of the related revenue to change, and, in certain cases, may be cancelled without penalty. We do not believe that backlog should be viewed as an indicator of future performance. A backlogged order may not result in revenue in a particular period, and the actual revenue may not be equal to our backlog estimates. Our presentation of backlog may not be comparable with that of other companies in our industry.

### **Competition**

The optical communications network equipment market is highly competitive. Competition in this market is based on any one or a combination of the following factors:

price;

functionality;

existing business and customer relationships;

the ability of products and services to meet customers' immediate and future network requirements;

installation capability;

services;

scalability; and

manufacturing capability.

Competition in the optical communications market is dominated by a small number of very large, multi-national companies. Many of our competitors have substantially greater name recognition and technical, financial, and marketing resources, and greater manufacturing capacity, as well as better established relationships with the incumbent carriers, than we do. Many of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for these products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at below market pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers.

Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena, Cisco Systems, Fujitsu Limited, Huawei Technologies Co. Ltd., LM Ericsson Telephone Co., NEC Corporation, Nortel Networks, Siemens Systems GmbH, and ZTE Corporation. These companies have historically set the competitive benchmarks for price and functionality. There are also

smaller companies, including startups, which have announced plans or developed products that would compete for long-haul and metro optical transport business. We believe that we achieved over 30% of the market share for all 10 Gbps long-haul interface ports shipped worldwide in 2006.

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We also face additional competition in certain market segments from companies which offer one or more products that compete directly or indirectly with our DTN System. In addition, we may compete with other companies as we expand into new markets or as other companies develop products that are competitive with us.

### **Intellectual Property**

Our success as a company depends upon our ability to protect our core technology and intellectual property. To accomplish this, we rely on a combination of intellectual property rights, including patents, trade secrets, copyrights and trademarks, as well as customary contractual protections.

We rely primarily on trade secret protection for our PIC and PIC manufacturing processes, including design, fabrication and testing of our PICs. However, there can be no assurances that trade secrets will be sufficient to provide us with a competitive advantage or that others have not or will not reverse engineer our designs or discover, develop or disclose the same or similar designs and manufacturing processes.

As of March 31, 2007, we held 57 U.S. patents and one international patent expiring between 2021 and 2024, and have 75 U.S. and 30 foreign pending patent applications. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims.

We may not receive competitive advantages from the rights granted under our patents and other intellectual property. Any patents granted to us may be contested, circumvented or invalidated over the course of our business, and we may not be able to prevent third parties from infringing these patents. Therefore, the exact effect of the protection of these patents cannot be predicted with certainty.

We believe that the frequency of assertions of patent infringement is increasing as patent holders, including entities that are not in our industry and who purchase patents as an investment or to monetize such rights by obtaining royalties, use such actions as a competitive tactic as well as a source of additional revenue. We have been sued by Cheetah Omni for alleged infringement of their patent. See the section titled [Legal Proceedings](#) for additional information regarding this lawsuit. Any claim of infringement from a third party, even those without merit, could cause us to incur substantial costs defending against such claims, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from selling our DTN System. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful.

In addition to these protections, we generally control access to and the use of our proprietary software and other confidential information. This protection is accomplished through a combination of internal and external controls, including contractual protections with employees, contractors, customers, and partners, and through a combination of U.S. and international copyright laws. We incorporate a number of third party software programs into our DTN System pursuant to license agreements.

We license some of our software pursuant to agreements that impose restrictions on our customers' ability to use such software, such as prohibiting reverse engineering and limiting the use of copies. We also seek to avoid disclosure of our intellectual property by relying on non-disclosure and assignment of intellectual property agreements with our employees and consultants that acknowledge our exclusive ownership of all intellectual property developed by the individual during the course of his

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or her work with us. The agreements also require that each person maintain the confidentiality of all proprietary information disclosed to them. Other parties may not comply with the terms of their agreements with us, and we may not be able to enforce our rights adequately against these parties. We also rely on contractual rights to establish and protect our proprietary rights in our DTN System.

## **Employees**

As of March 31, 2007, we had 617 employees. A total of 124 of those employees were located outside of the United States. None of our employees is represented by labor unions or covered by a collective bargaining agreement. We have not experienced any work stoppages, and we consider our employee relationships to be good.

## **Facilities**

In Sunnyvale, California, we lease approximately 120,000 square feet of office and manufacturing space pursuant to leases that expire between 2007 and 2014. We lease approximately 38,500 square feet of office and manufacturing space in Columbia, Maryland, 35,000 square feet in Annapolis Junction, Maryland and 25,000 square feet in Allentown, Pennsylvania pursuant to leases that expire in 2008, 2012, and 2009, respectively. Internationally, we lease sales office space in Beijing, China that expires in 2007 and we have two leases in Bangalore, India for approximately 40,000 square feet used for research and development that expire in 2009 and 2011. We intend to add new facilities and to expand existing facilities as we add employees, and we believe that suitable additional or substitute space will be available as needed to accommodate any such expansion of our operations.

## **Legal Proceedings**

On May 9, 2006, we and Level 3 were sued by Cheetah Omni LLC for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of our DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. We are contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent our product is found to infringe, and we have assumed the defense of this matter. On July 20, 2006, we and Level 3 filed an amended response denying all infringement claims under patent No. 6,795,605 and asserting that the claims of the patent are invalid and that the DTN System does not infringe the patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, we and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under patent No. 7,142,347, and we and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, we and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and we and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, we submitted requests to the U.S. Patent and Trademark Office for inter partes reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347. On March 21, 2007, we and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347 asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art.

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On April 11, 2007, we and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. We believe the suit is without merit and intend to defend ourselves vigorously, but we are unable to predict the likelihood of an unfavorable outcome.

From time to time, we may be subject to other legal proceedings and claims in the ordinary course of our business.

**Table of Contents****MANAGEMENT****Executive Officers, Key Employees and Directors**

Our executive officers, key employees and directors, and their ages and positions as of March 31, 2007, are set forth below:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Jagdeep Singh	39	Chairman, President and Chief Executive Officer
Thomas J. Fallon	45	Chief Operating Officer
David F. Welch, Ph.D.	46	Chief Marketing and Strategy Officer
Duston M. Williams	48	Chief Financial Officer
Scott A. Chandler	39	Vice President, Worldwide Sales
Michael O. McCarthy III	41	Vice President and General Counsel
William R. Cumpston	45	Vice President, Systems Engineering
Frederick A. Kish, Jr., Ph.D.(1)	40	Vice President, PIC Development and Manufacturing
Drew D. Perkins(1)	43	Chief Technology Officer
Paul M. Whitney(1)	49	Vice President, Human Resources
Alexandre Balkanski, Ph.D.(3)(4)	46	Director
Kenneth A. Goldman(2)	57	Director
Reed E. Hundt(4)	59	Director
Hugh C. Martin(2)(3)	53	Director
Dan Maydan, Ph.D.(2)	71	Director
Carl Redfield(3)(4)	60	Director
Pradeep S. Sindhu, Ph.D.	54	Director

(1) Key employee

(2) Member of Audit Committee

(3) Member of Compensation Committee

(4) Member of Nominating and Corporate Governance Committee

**Jagdeep Singh** co-founded our company and has served as our President and Chief Executive Officer since January 2001, and as Chairman of our board of directors since March 2001. From December 1999 to December 2000, Mr. Singh served as co-founder and Chief Executive Officer of OnFiber Communications, Inc., or OnFiber, an optical telecommunications carrier. From January 1998 to March 1999, Mr. Singh served as co-founder and Chief Executive Officer of Lightera Networks, or Lightera, an optical switching equipment company, and upon Ciena Corporation's acquisition of Lightera in March 1999, served as President of Ciena's Core Switching Division. Mr. Singh holds a B.S. in Computer Science from the University of Maryland, an M.S. in Computer Science from Stanford University and an M.B.A. from the University of California, Berkeley.

**Thomas J. Fallon** has served as our Chief Operating Officer since October 2006. From April 2004 to September 2006, Mr. Fallon was our Vice President of Engineering and Operations. From August 2003 to March 2004, Mr. Fallon was Vice President, Corporate Quality and Development Operations of Cisco Systems, Inc., a networking and telecommunications company. From May 2001 to August 2003, Mr. Fallon served as Cisco's General Manager of the Optical Transport Business Unit. Mr. Fallon holds a B.S.M.E. and M.B.A. from the University of Texas at Austin.

**David F. Welch, Ph.D.** co-founded our company and has served as our Chief Marketing and Strategy Officer since January 2007. From May 2004 to January 2007, Dr. Welch served as our Chief Strategy Officer. From May 2001 to May 2004, he served as our Chief Development Officer/Chief Technology Officer. From May 2001 to November 2006, Dr. Welch also served as a member of our board of directors. From February 2001 to April 2001, Dr. Welch served as Chief Technology Officer of the Transmission Division of JDS Uniphase Corporation, an optical component company. From

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January 1985 to February 2001, Dr. Welch served in various executive roles, including Chief Technology Officer and Vice President of Corporate Development of SDL, an optical component company. Dr. Welch holds a B.S. in Electrical Engineering from the University of Delaware and a Ph.D. in Electrical Engineering from Cornell University.

**Duston M. Williams** has served as our Chief Financial Officer since June 2006. From December 2004 to June 2006, Mr. Williams was Executive Vice President and Chief Financial Officer of Maxtor Corporation, an information storage solutions company. From July 2003 to November 2004, Mr. Williams served as Chief Financial Officer of Aruba Networks, Inc., a network infrastructure company. From July 2001 to February 2003, Mr. Williams served as Chief Financial Officer of Rhapsody Networks, Inc., a storage networking provider. Mr. Williams holds a B.S. in Accounting from Bentley College and an M.B.A. from the University of Southern California.

**Scott A. Chandler** has served as our Vice President, Worldwide Sales since November 2004. From May 2003 to November 2004, Mr. Chandler served as our Vice President, Sales for North America. From October 1999 to May 2003, Mr. Chandler held a number of senior sales positions at Sonus Networks, Inc., a voice over IP infrastructure solutions company, including Vice President of Strategic Sales. Mr. Chandler holds a B.S. in Business Administration from Plymouth State College.

**Michael O. McCarthy III** has served as our Vice President and General Counsel since May 2003. From May 2001 to February 2003, Mr. McCarthy served as Senior Vice President of Worldwide Sales and Support at Ciena Corporation, a communications equipment company. From July 1999 to May 2001, Mr. McCarthy served as Ciena's Senior Vice President and General Counsel. Mr. McCarthy holds a B.A. in Mathematical-Economics from Colgate University and a J.D. from Vanderbilt University's School of Law.

**William R. Cumpston** has served as our Vice President, Systems Engineering since June 2006. From September 2005 to June 2006, Mr. Cumpston served as the Senior Vice President of Engineering at XenSource Inc., an enterprise grade platform virtualization solution company. From March 2003 to May 2005, Mr. Cumpston served as Chief Executive Officer of CloudShield Technologies, Inc., a provider of IP services control and security. From June 2002 to August 2002, Mr. Cumpston served as a Senior Vice President of Metro Products at Ciena Corporation. From August 1998 to June 2002, Mr. Cumpston served as Vice President, Engineering and Chief Operating Officer at ONI Systems Corporation, a fiber-optic communications equipment company. Mr. Cumpston holds a B.S. in Mathematics from the University of North Carolina.

**Frederick A. Kish, Jr., Ph.D.** has served as our Vice President, PIC Development and Manufacturing since May 2001. From November 1999 to May 2001, Dr. Kish served as R&D and Manufacturing Development Manager for the Fiber Optics Communications Division of Agilent Technologies, Inc., a measurement and technology company for communications, electronics, life sciences and chemical analysis. Dr. Kish holds B.S., M.S. and Ph.D. degrees in electrical engineering from the University of Illinois at Urbana-Champaign.

**Drew D. Perkins** co-founded our company and has served as our Chief Technology Officer since May 2001, and as a member of our board of directors from May 2001 to November 2006. From December 1999 to April 2001, he served as co-founder and Chief Technology Officer of OnFiber. From February 1998 to March 1999, Mr. Perkins served as co-founder and Chief Technology Officer of Lightera, and upon Ciena Corporation's acquisition of Lightera in March 1999, served as Chief Technology Officer of Ciena's Core Switching Division. From February 1993 to March 1997, he served in various senior engineering and management roles at FORE Systems, an internet switching equipment company. Mr. Perkins holds a B.S. in Electrical Engineering, Computer Engineering and Mathematics from Carnegie Mellon University.

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**Paul M. Whitney** has served as our Vice President of Human Resources since October 2006. From June 2004 to August 2006, Mr. Whitney was Vice President, Human Resources for Portal Software, a provider of billing and revenue management products. From December 2001 to November 2003, Mr. Whitney was International HR Director of Ascential Software, a maker of data integration tools. Mr. Whitney holds a B.S in Managerial and Administrative Science and an M.S in Human Resource Management from the University of Aston in Birmingham, United Kingdom.

**Alexandre Balkanski, Ph.D.** has been a member of our board of directors since October 2001. Dr. Balkanski has been a General Partner at Benchmark Capital, a venture capital firm, since April 2000. From August 1988 to April 2000, Dr. Balkanski was a co-founder and Chief Executive Officer of C-Cube Microsystems Inc., a digital video company. Dr. Balkanski holds a B.S. from Harvard College and an M.A. and a Ph.D. from Harvard University.

**Kenneth A. Goldman** has been a member of our board of directors since February 2005. Mr. Goldman has been the Executive Vice President and Chief Financial Officer of Dexterra, Inc., a provider of mobile enterprise software, since November 2006. From August 2000 until March 2006, Mr. Goldman served as Senior Vice President, Finance and Administration and Chief Financial Officer of Siebel Systems, Inc., a supplier of customer software solutions and services. From December 1999 to December 2003, Mr. Goldman served as an advisory council member of the Financial Accounting Standards Board Advisory Council. Mr. Goldman serves on the boards of directors of BigBand Networks, Inc., a provider of broadband multimedia infrastructure, Juniper Networks, Inc., an IP network solutions company, and Leadis Technology Inc., a semiconductor company. Mr. Goldman holds a B.S. in Electrical Engineering from Cornell University and an M.B.A. from the Harvard Business School.

**Reed E. Hundt** joined our board of directors in February 2007. Since 1998, he has acted as Co-Chairman of the Forum on Communications and Society at The Aspen Institute, a public policy organization, and as an independent advisor on information industries to McKinsey & Company, Inc., a management consulting firm. Mr. Hundt served as Chairman of the Federal Communications Commission from 1993 to 1997. Mr. Hundt currently serves on the board of directors of Intel Corporation. Mr. Hundt holds a B.A. in History from Yale University and a J.D. from Yale Law School.

**Hugh C. Martin** has been a member of our board of directors since July 2003. Since April 2004, Mr. Martin has served as Chairman and Chief Executive Officer of Pacific Biosciences, Inc., a biotechnology company. From September 2003 to April 2004, Mr. Martin acted as a consultant to Kleiner, Perkins, Caufield & Byers, a venture capital firm. From May 2002 to May 2003, Mr. Martin was a consultant to Ciena Corporation. From January 1998 to May 2002, Mr. Martin was the Chairman, President and Chief Executive Officer of ONI Systems Corporation, a fiber-optic communications equipment company. Mr. Martin holds a B.S.E.E. from Rutgers University.

**Dan Maydan, Ph.D.** has been a member of our board of directors since September 2001. From April 2003 to September 2005, Dr. Maydan served as the President Emeritus of Applied Materials, Inc., a company that manufactures semiconductor equipment, and was a member of its board of directors from June 1992 until March 2006. From December 1993 to April 2003, Dr. Maydan served as President of Applied Materials. Dr. Maydan serves on the boards of directors of Electronics for Imaging, Inc., a digital imaging and print management solutions company, and LaserCard Corporation, a secure ID solutions company. Dr. Maydan holds a B.S. and M.S. in Electrical Engineering from the Israel Institute of Technology and a Ph.D. in Physics from Edinburgh University of Scotland.

**Carl Redfield** has been a member of our board of directors since August 2006. Since September 2004, Mr. Redfield has served as Senior Vice President, New England executive sponsor, of Cisco Systems, Inc. From February 1997 through September 2004, Mr. Redfield served as Cisco's Senior Vice President, Manufacturing and Logistics. From September 1993 until February 1997,



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Mr. Redfield served as Vice President of Manufacturing of Cisco. Mr. Redfield is a member of the board of directors of VA Software Corporation, an online media, software and e-commerce company. Mr. Redfield holds a B.S. in Materials Engineering from Rensselaer Polytechnic Institute and has completed post-graduate studies at the Harvard Business School.

**Pradeep S. Sindhu, Ph.D.** has been a member of our board of directors since September 2001. In February 1996, Dr. Sindhu co-founded Juniper Networks, Inc., an IP network solutions company, and served as its Chief Executive Officer and Chairman of its board of directors until September 1996. Since September 1996, Dr. Sindhu has served as Chief Technical Officer and Vice Chairman of the board of directors of Juniper Networks. Dr. Sindhu holds a B.S.E.E. from the Indian Institute of Technology in Kanpur, an M.S.E.E. from the University of Hawaii and a Masters in Computer Science and Ph.D. in Computer Science from Carnegie-Mellon University.

## **Board Composition**

### ***Independent Directors***

Our board of directors is currently composed of 8 members. Messrs. Goldman, Hundt, Martin and Redfield and Drs. Balkanski, Maydan and Sindhu qualify as independent directors in accordance with the listing requirements of NASDAQ. The NASDAQ definition of independence includes a series of objective tests, such as that the director is not, and has not been for at least three years, one of our employees and that neither the director, nor any of his family members, has engaged in various types of business dealings with us. In addition, as further required by the NASDAQ rules, our board of directors has made a subjective determination as to each independent director that no relationships exist that, in the opinion of our board of directors, would interfere with his exercise of independent judgment in carrying out the responsibilities of a director. In making these determinations, our directors reviewed and discussed information provided by the directors and us with regard to each director's business and personal activities as they may relate to us and our management.

### ***Selection Arrangements***

Two of our current directors were elected pursuant to a voting agreement that we entered into with certain holders of our common and convertible preferred stock. The provisions of this voting agreement will terminate upon the closing of this offering, and there will be no further contractual obligations regarding the election of our directors. Our directors hold office until their successors have been elected and qualified or their earlier death, resignation or removal.

## **Classified Board**

Our amended and restated certificate of incorporation that will become effective as of the closing of this offering provides for a classified board of directors consisting of three classes of directors, each serving a staggered three-year term. Commencing in 2008, a portion of our board of directors will be elected each year for three-year terms. Upon the closing of this offering:

Drs. Balkanski and Sindhu will be designated Class I directors whose term will expire at the 2008 annual meeting of stockholders;

Messrs. Martin and Singh and Dr. Maydan will be designated Class II directors whose term will expire at the 2009 annual meeting of stockholders; and

Messrs. Goldman, Hundt and Redfield will be designated Class III directors whose term expires at the 2010 annual meeting of stockholders.

Our amended and restated certificate of incorporation and amended and restated bylaws that will become effective as of the closing of this offering provide that the number of authorized directors shall



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be determined from time to time by resolution of the board of directors. Any additional directorships resulting from an increase in the number of authorized directors will be distributed among the three classes so that, as nearly as reasonably possible, each class will consist of one-third of the directors. The classification of the board of directors may have the effect of delaying or preventing changes in control of our company. Under Delaware law, our directors may be removed for cause by the affirmative vote of the holders of a majority of our voting stock.

## **Board Committees**

Our board of directors has established an audit committee, a compensation committee and a nominating and governance committee. Our board of directors and its committees set schedules to meet throughout the year and also can hold special meetings and act by written consent from time to time, as appropriate. The independent members of our board of directors also will hold separate executive session meetings regularly at which only independent directors are present, generally at the regularly scheduled meetings of the board of directors. Our board of directors has delegated various responsibilities and authority to its committees as generally described below. The committees will report, as appropriate, their activities and actions to the full board of directors. Each member of each committee of our board of directors qualifies as an independent director in accordance with the NASDAQ standards described above. Each committee of our board of directors has a written charter approved by our board of directors. Upon the effectiveness of the registration statement of which this prospectus forms a part, copies of each charter will be posted on our web site at <http://www.infinera.com>. The inclusion of our web site address in this prospectus does not include or incorporate by reference the information on our web site into this prospectus.

## **Audit Committee**

The current members of the audit committee of our board of directors are Messrs. Goldman and Martin and Dr. Maydan, each of whom is independent under the rules and regulations of the SEC and the listing standards of NASDAQ. Mr. Goldman chairs our audit committee. In addition to qualifying as independent under the NASDAQ rules, each member of our audit committee can read and understand fundamental financial statements in accordance with NASDAQ Audit Committee requirements.

The audit committee of our board of directors reviews and monitors our corporate financial statements and reporting and our external audits, including, among other things, our internal controls and audit functions, the results and scope of the annual audit and other services provided by our independent registered public accounting firm and our compliance with legal matters that have a significant impact on our financial statements. Our audit committee also consults with our management and our independent registered public accounting firm prior to the presentation of financial statements to stockholders and, as appropriate, initiates inquiries into aspects of our financial affairs. Our audit committee is responsible for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by our employees of concerns regarding questionable accounting or auditing matters. In addition, our audit committee is directly responsible for the appointment, retention, compensation and oversight of the work of our independent registered public accounting firm, including approving services and fee arrangements. All related party transactions are subject to approval by our audit committee.

Our board of directors has determined that Mr. Goldman is an audit committee financial expert as defined under SEC regulations and the NASDAQ listing standards. The designation does not impose on Mr. Goldman any duties, obligations or liability greater than that generally imposed on him as a member of our audit committee and our board of directors. Both our independent registered public accounting firm and management periodically meet privately with our audit committee.

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### **Compensation Committee**

The current members of the compensation committee of our board of directors are Messrs. Martin and Redfield and Dr. Balkanski. Dr. Balkanski chairs the compensation committee. The compensation committee reviews, makes recommendations to the board of directors on and approves our compensation policies and all forms of compensation to be provided to our executive officers and directors, including, among other things, annual salaries, bonuses, equity, severance arrangements, change-of-control protections and any other compensatory arrangements (including, without limitation, perquisites and any other form of compensation). In addition, our compensation committee will administer our stock option plans, having the ability to grant stock options and other equity-based awards to individuals eligible for such grants (including our executive officers, but excluding the non-employee members of our board of directors). The compensation committee will also oversee the administration of other material employee benefit plans, including our 401(k) plan, and review and approve various other compensation policies and matters. Among the committee's responsibilities are the preparation of the Compensation Discussion and Analysis and Compensation Committee Report required by the rules of the SEC. Each member of our compensation committee is a non-employee director, as defined in Rule 16b-3 promulgated under the Securities Exchange Act of 1934, as amended, or the Exchange Act, an outside director, as defined pursuant to Section 162(m) of the Internal Revenue Code and satisfies the NASDAQ independence requirements.

### **Nominating and Governance Committee**

The current members of the nominating and governance committee of our board of directors are Messrs. Hundt and Redfield and Dr. Balkanski. Mr. Redfield chairs the nominating and governance committee. The nominating and governance committee will review and report to our board of directors on a periodic basis with regard to matters of corporate governance, and will review, assess and make recommendations on the effectiveness of our corporate governance policies. In addition, our nominating and governance committee will review and make recommendations to our board of directors regarding the size and composition of our board of directors and the appropriate qualities and skills required of our directors in the context of the then-current make-up of our board of directors. This will include an assessment of each candidate's independence, personal and professional integrity, financial literacy or other professional or business experience relevant to an understanding of our business, ability to think and act independently and with sound judgment, and ability to serve our stockholders' long-term interests. These factors, and others as considered useful by our nominating and governance committee, will be reviewed in the context of an assessment of the perceived needs of our board of directors at a particular point in time. As a result, the priorities and emphasis of our nominating and governance committee and of our board of directors may change from time to time to take into account changes in business and other trends, as well as the portfolio of skills and experience of current and prospective directors.

Our nominating and governance committee will lead the search for, select and recommend candidates for election to our board of directors. Consideration of new director candidates typically will involve a series of committee discussions, review of information concerning candidates and interviews with selected candidates. Candidates for nomination to our board of directors typically have been suggested by other members of our board of directors or by our executive officers. From time to time, our nominating and governance committee may engage the services of a third-party search firm to identify director candidates. Our nominating and governance committee will consider candidates proposed in writing by stockholders, provided such proposal meets the eligibility requirements for submitting stockholder proposals for inclusion in our next proxy statement and is accompanied by the required information about the candidate specified in our amended and restated bylaws. Candidates proposed by stockholders will be evaluated by our nominating and governance committee using the same criteria as for all other candidates.

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### **Code of Business Conduct and Ethics**

Our board of directors has adopted a code of business conduct and ethics. The code applies to all of our employees, officers (including our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions), agents and representatives, including directors and consultants. Upon the effectiveness of the registration statement of which this prospectus forms a part, the full text of our code of business conduct and ethics will be posted on our web site at <http://www.infinera.com>. We intend to disclose future amendments to certain provisions of our code of business conduct and ethics, or waivers of such provisions, applicable to any principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions or our directors on our web site identified above. The inclusion of our web site address in this prospectus does not include or incorporate by reference the information on our web site into this prospectus.

### **Compensation Committee Interlocks and Insider Participation**

The compensation committee of the board of directors currently consists of Messrs. Martin and Redfield and Dr. Balkanski. None of our executive officers has ever served as a member of the board of directors or compensation committee of any other entity that has or has had one or more executive officers serving as a member of our board of directors or our compensation committee.

### **Limitation of Liability and Indemnification**

Our amended and restated certificate of incorporation contains provisions that limit the liability of our directors for monetary damages to the fullest extent permitted by Delaware law. Consequently, our directors will not be personally liable to us or our stockholders for monetary damages for any breach of fiduciary duties as directors, except liability for:

any breach of the director's duty of loyalty to us or our stockholders;

any act or omission not in good faith or that involves intentional misconduct or a knowing violation of law;

unlawful payments of dividends or unlawful stock repurchases or redemptions as provided in Section 174 of the Delaware General Corporation Law; or

any transaction from which the director derived an improper personal benefit.

These limitations of liability do not apply to liabilities arising under federal securities laws and do not affect the availability of equitable remedies such as injunctive relief or rescission.

Our amended and restated certificate of incorporation and amended and restated bylaws, which will each become effective upon the closing of this offering, provide that we are required to indemnify our directors and officers, in each case to the fullest extent permitted by Delaware law. Any repeal of or modification to our amended and restated certificate of incorporation or amended and restated bylaws may not adversely affect any right or protection of a director or officer for or with respect to any acts or omissions of that director or officer occurring prior to that amendment or repeal. Our amended and restated bylaws also provide that we will advance expenses incurred by a director or officer in advance of the final disposition of any action or proceeding, and permit us to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in that capacity regardless of whether we would otherwise be permitted to indemnify him or her under the provisions of Delaware law. We have obtained such a directors' and officers' liability insurance policy. We have entered and expect to continue to enter into agreements to indemnify our directors and executive officers. With certain exceptions, these agreements provide for indemnification for related expenses including, among other things, attorneys' fees, judgments, fines and settlement amounts incurred by



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any of these individuals in any action or proceeding. We believe that these bylaw provisions and indemnification agreements are necessary to attract and retain qualified persons as directors and executive officers. We also maintain directors' and officers' liability insurance.

The limitation of liability and indemnification provisions in our amended and restated certificate of incorporation and amended and restated bylaws may discourage stockholders from bringing a lawsuit against our directors for breach of their fiduciary duties. They may also reduce the likelihood of derivative litigation against our directors and officers, even though an action, if successful, might benefit us and other stockholders. Further, a stockholder's investment may be adversely affected to the extent that we pay the costs of settlement and damage awards against directors and officers as required by these indemnification provisions. At present, there is no pending litigation or proceeding involving any of our directors or executive officers for which indemnification is sought, and we are not aware of any threatened litigation that may result in claims for indemnification. Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, executive officers or persons controlling us, we have been informed that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is therefore unenforceable.

## **Director and Executive Compensation**

### **Director Compensation**

Our directors do not currently receive any cash compensation for their services as members of our board of directors or any committee of our board of directors nor do we have a policy of reimbursing directors for travel, lodging and other expenses incurred in connection with their attendance at board or committee meetings. During 2006, each of our non-employee directors who was not a significant stockholder or affiliated with a significant stockholder of ours received an initial stock option award to purchase 75,000 shares of our common stock upon such director becoming a member of our board of directors, plus an additional annual stock option award of 18,750 shares. Furthermore, such directors received an option award of 12,500 shares if they served on our audit committee or compensation committee and an additional 6,250 shares if they served as chairman of our audit committee.

Beginning with the first day of the first full fiscal quarter after the closing of this offering, each non-employee member of our board of directors will be entitled to receive an annual retainer of \$20,000 and fees of \$2,000 per meeting attended in person and \$1,000 per meeting attended telephonically. In addition, each non-employee director serving on our audit committee, compensation committee and nominating and governance committee will be entitled to fees of \$1,000 per meeting attended in person or telephonically, and the chair of each such committee will be entitled to additional fees of \$1,000, \$500 and \$500, respectively, per meeting attended in person or telephonically.

Non-employee directors will be entitled to an initial stock option award to purchase 50,000 shares of our common stock upon such director becoming a member of our board of directors. Each initial option will become exercisable for the shares in 48 equal monthly installments. Each year thereafter, each non-employee director will receive an annual stock option award to purchase 12,500 shares of our common stock on the date of our annual stockholders meeting, each of which will vest in 12 equal monthly installments. All such options will be granted at the fair market value on the date of the award.

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The following table sets forth the annual director compensation paid or accrued by us to individuals who were directors during any part of 2006. The table excludes Mr. Singh and Dr. Welch who are named executive officers and who did not receive any compensation from us in their roles as directors in 2006. Dr. Welch's term as a director ended on November 20, 2006.

**Director Compensation**

**For Year Ended December 31, 2006**

Name	Option		Grant Date Fair Value of Option Awards(\$)
	Awards(1) (\$)	Options(#)	
Alexandre Balkanski, Ph.D.	\$		\$
Gregory Galanos(2)			
Kenneth A. Goldman	5,350	37,500	43,650
Vinod Khosla(2)			
Hugh C. Martin	8,999	43,750	50,925
Dan Maydan, Ph.D.	2,804	18,750	21,825
Drew D. Perkins(3)			
Carl Redfield	7,409	75,000	87,300
Thurman J. Rodgers, Ph.D.(4)	507		
Pradeep S. Sindhu, Ph.D.	5,549	18,750	21,825

(1) The value reported above in the Option Awards column is the amount we expensed during 2006 for each director's option award calculated in accordance with SFAS No. 123(R). All awards were granted under our 2000 Stock Plan.

(2) The terms of Messrs. Galanos and Khosla as directors ended on November 20, 2006.

(3) Mr. Perkins did not receive any options for his role as a director, and his term as a director ended on November 21, 2006.

(4) Dr. Rodgers' term as a director ended on August 16, 2006.

**Executive Compensation****COMPENSATION DISCUSSION AND ANALYSIS****For Named Executive Officers****Overview Compensation Objectives**

Our compensation and benefits programs seek to attract and retain our senior executives and to motivate them to pursue our corporate objectives. Through our annual goal setting process, individual objectives are aligned with organizational objectives. We evaluate and reward our executive officers based on their willingness to take a leadership position in improving our internal structures and processes and their ability to identify and exploit opportunities to grow our business. In addition, at the beginning of each year, our compensation committee establishes specific goals and objectives for compensating our employees, including our named executive officers.

Specifically, we have created a compensation program that has a mix of short- and long-term components, cash and equity elements and fixed and contingent payments in the proportions we believe will provide the proper incentives, reward our senior management team and help us achieve the following goals:

foster a goal oriented, highly-motivated management team whose participants have a clear understanding of business objectives and shared corporate values;

allocate company resources most effectively in the development of market-leading technology and products;



control costs in each facet of our business to maximize our efficiency;

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enable us to attract, retain and motivate a world class leadership team; and

achieve internal equity across our organization.

Our executive compensation program has been targeted at below median cash compensation and equity compensation at or above the median. With the relatively large equity weighting, this approach seeks to reward our executive officers when we achieve our goals and objectives and generate stockholder returns. At the same time, if our corporate goals are not achieved, a significant portion of the compensation for our key managers is at risk. In this way, our executive compensation is aligned with the interests of our stockholders.

### **Role of Our Compensation Committee**

Our compensation committee approves, administers and interprets our executive compensation and benefit policies. Our compensation committee was appointed by our board of directors, and consists entirely of directors who are outside directors for purposes of Section 162(m) of the Internal Revenue Code and non-employee directors for purposes of Rule 16b-3 under the Exchange Act. Our compensation committee is comprised of Messrs. Martin and Redfield and Dr. Balkanski, and is chaired by Dr. Balkanski.

Our compensation committee has taken the following steps, in consultation with Compensia, a compensation consulting firm that our compensation committee retained, to ensure that our executive compensation and benefit programs are consistent with both our compensation philosophy and our corporate governance guidelines:

evaluated our compensation practices and assisted in developing and implementing the executive compensation program and philosophy;

with input from our management team, developed a competitive peer group composed of public networking equipment companies and performed analyses of competitive performance and compensation levels for us and each of our competitive companies;

developed recommendations with regard to executive compensation structures based on targeting a competitive level of pay as measured against the peer group of companies that were reviewed and approved by our compensation committee and board of directors;

established a practice, in accordance with the rules of NASDAQ, of prospectively reviewing the performance and determining the compensation earned, paid or awarded to our chief executive officer independent of input from him;

established a policy, in accordance with the rules of NASDAQ, to review on an annual basis the performance of our other executive officers with assistance from our chief executive officer and determining what we believe to be appropriate total compensation based on competitive levels as measured against our peer group; and

established a policy to specify grant dates for both new hire and annual retention equity awards as a public company.

### **Competitive Market Review**

The market for experienced management is highly competitive in our industry. We aim to attract and retain the most highly qualified executives to manage each of our business functions. In doing so, we aim to draw upon a pool of talent that is highly sought after by both large and established networking equipment and transport companies in our geographic area and by other competitive companies in development or early stage phases. Established organizations in our industry seek to recruit top talent from emerging

companies in the sector just as smaller organizations look to attract

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and retain the best talent from the industry as a whole. The competition for technical and commercial skills is fierce across the sector and we expect it to remain high for the foreseeable future.

We must match market cash compensation levels and satisfy the day-to-day financial requirements of our candidates through competitive base salaries and cash bonuses. We also compete for key personnel on the basis of our vision of future success; our culture and company values; the cohesiveness and productivity of our teams; and the excellence of our technical and management personnel. In all of these areas, we compete with other emerging networking equipment/optical transport companies. In order to succeed in attracting and retaining top executive talent, we continuously draw upon surveys presented by Compensia, as well as other nationally recognized surveys. Our management and compensation committee review data that analyzes various cross-sections of our industry, as well as relevant geographical areas.

*Market Benchmarks: How We Define Our Market and How We Use Market Compensation Data*

In 2006, Compensia conducted an executive total compensation review that compares our executive s total compensation levels to those of other executives at our peer companies. Compensia works directly with the compensation committee and management to interpret the results, make certain specific and general recommendations and assist in setting compensation levels for our executive officers.

*Defining the Market.* For 2006, we used two market references to compare our total compensation practices for our executives and levels to those in the market:

*Select Peer Group.* We benchmarked our compensation levels for our executives against 17 companies, including a mix of publicly-traded U.S. networking and optical transport companies; and

*Radford High Technology Industry Report by Aon Consulting.* We reviewed and considered 166 companies with revenue between \$200 million and \$500 million that were part of a national survey of executive compensation levels and practices that covers approximately 80 positions in over 700 organizations.

Our peer group for benchmarking purposes consisted of the following companies:

Acme Packet, Inc.	Juniper Networks, Inc.
Agilent Technologies, Inc.	Motorola, Inc.
Broadcom Corporation	Polycom, Inc.
Ciena Corporation	QUALCOMM Incorporated
Cisco Systems, Inc.	Redback Networks, Inc.
F5 Networks, Inc.	Riverbed Technology, Inc.
Foundry Networks, Inc.	Sonus Networks, Inc.
Isilon Systems, Inc.	Tellabs, Inc.
JDS Uniphase Corporation	

*Determining Market Levels and Specific Comparisons.* We compare our practices and levels by each compensation component, by target annual cash compensation, which includes base salary and target annual incentive opportunity, and by total direct compensation, including base salary, target annual incentive opportunity and annual equity compensation components. The competitive comparisons made in this process are used to determine our approximate position relative to the appropriate market benchmark by compensation component and in the aggregate.

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### **Executive Compensation Program**

#### *Components of our Compensation Program*

Our performance-driven compensation program consists of five components:

base salary;

annual cash bonuses;

equity-based incentives;

benefits; and

severance/termination protection.

We chose to build our executive compensation program around each of the above elements because each individual component is useful in achieving one or more of the objectives of the program and we believe that, together, they have been and will continue to be effective in achieving our overall objectives. We utilize short-term compensation, including base salary and cash bonuses, to motivate and reward our key executives in accordance with our pay for performance philosophy. We are in the process of implementing and systematizing our review process, with the objective of measuring and providing feedback on individual performance as it relates to the goals we wish to achieve for the company as a whole and the employee individually.

#### *Basis for our Compensation Program*

We have an annual goal setting process that is open and collaborative in nature. Executive team members establish their functional objectives taking into account overall corporate goals and incorporating the feedback and commentary of their senior management colleagues and the board of directors. Towards the end of each calendar year, we engage in our annual goal setting process driven by our chief operating officer. In line with established financial objectives, each functional vice president who reports directly to our chief executive officer, submits departmental goals in support of that plan which are then consolidated by our chief operating officer. A meeting is convened and these same vice presidents attend and present their goals to their colleagues for comment and approval. Ultimately, our chief executive officer has final authority with respect to the goals that are established through this process.

To more successfully promote a team-oriented approach to company performance, each executive's annual incentive compensation is based on achievement against the same company performance objectives. We establish one set of company performance-oriented goals against which the entire management team is measured for purposes of determining annual incentive compensation. Annual incentive compensation is paid based on the average of percentage achievement against each of the corporate goals. We see this approach to our annual incentive compensation as an integral part of our culture of collaborative, team-oriented management. Individual performance and achievement against individual goals and objectives is only taken into account in setting base salaries and annual equity awards. The value of equity awards made to our senior executives will vary in value based on our stock price performance. Our senior executives' total compensation may vary significantly from year-to-year based on company and individual performance.

#### *Weighting of Elements in our Compensation Program*

The use and weight of each compensation element is based on a subjective determination by the compensation committee of the importance of each element in meeting our overall objectives. In general, we seek to put a significant amount of each executive's total potential compensation at risk based on corporate and individual performance. As a result, compensation paid in the form

of base

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salary and benefits represented less than half of each continuing executive's potential total compensation at target performance levels for 2007. We believe that, as is common in the technology sector, stock option and other equity-based awards are the primary compensation-related motivator in attracting and retaining employees and that salary and bonus levels are secondary considerations to many employees.

*Base Salary.* Base salary will typically be used to recognize the experience, skills, knowledge and responsibilities required of each executive officer, as well as competitive market conditions. In establishing the 2007 base salaries of our named executive officers, our compensation committee took into account a number of factors, including the executive's seniority, position and functional role and level of responsibility. For executives hired in 2006, we considered the base salary of the individual at his or her prior employment and any unique personal circumstances that motivated the executive to leave that prior position and join our company. In addition, in both cases we considered the competitive market for corresponding positions within comparable geographic areas and industries. For 2006 and 2007, base salaries for our senior executives were and are generally positioned below the median of our peer companies, consistent with our philosophy of linking total reward with performance objectives of the company.

The base salary of our named executive group will be reviewed on an annual basis and adjustments will be made to reflect performance-based factors, as well as competitive conditions. We will not apply specific formulas to determine increases. Generally, executive salaries will be adjusted effective January 1 of each year.

*Bonuses.* Annual performance bonuses for our executive officers are based on the achievement of company annual goals and objectives and are paid in cash. These objectives may change from year-to-year as the company continues to evolve and different priorities are established, but are subject to the review and approval of the compensation committee. Awards under our bonus programs are based on a thorough quantitative and qualitative review of all the facts and circumstances related to company performance when determining each individual's annual bonus. The compensation committee approves the annual incentive award for the chief executive officer. For all other executive officers, the compensation committee approves the annual incentive award with input from the chief executive officer.

During 2006, we introduced for the first time a management bonus plan which was applicable only to the second half of that year. Bonus targets were tied to revenue and gross margin. There were two levels of bonus dependent upon job title. The chief executive officer and all non-sales vice presidents could achieve 15% of base salary as a bonus for 100% achievement of goals for the second half of 2006 only. For all non-sales employees with a job title at Director level, the target bonus was 7.5% of 2006 base salary. For 2006, there was no maximum on these bonus amounts. For Mr. Chandler, our Vice President of Global Sales, a different variable compensation arrangement was put in place for 2006 that applied to all employees within the sales organization and that was in the form of a commission plan with targets based on invoiced shipments. This directly linked Mr. Chandler's earnings to the key sales related metric and aligned him directly with the rest of the sales team. This variable compensation arrangement provided for Mr. Chandler to be paid a percentage of his base salary as a bonus based on customer orders that were received by us prior to December 31, 2006, and shipped by us and accepted by the customer on or prior to January 31, 2007. The percentage paid to Mr. Chandler was determined so as to provide Mr. Chandler with a compensation payment equal to his base salary upon the achievement of a pre-determined shipment and acceptance threshold or a percentage of his base salary upon the achievement of a percentage of the shipment and acceptance threshold. This arrangement also provided for Mr. Chandler to be paid two times this predetermined percentage for all customer orders that were shipped and accepted by the customer prior to January 31, 2007 above one hundred percent and up to one hundred and twelve and one half percent (112.5%) of the predetermined base shipment and acceptance threshold and for Mr. Chandler

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to be paid three times this percentage for the amount of all customer orders that were shipped and accepted by the customer prior to January 31, 2007 above one hundred and twelve and one half percent (112.5%) of the predetermined base shipment and acceptance amount. Further details of the actual bonus payouts can be reviewed in the table titled Summary Compensation Table.

Under our 2007 Executive Bonus Plan, the corporate objectives for bonuses are a combination of financial related measures. The payouts under the bonus plan will be capped at 200% of targeted bonuses. Failure to achieve threshold performance against operating profit as adjusted for certain items, regardless of the achievement against other measures, will result in no bonus being paid. For 2007, the following target bonus percentages, as a percentage of base salary, will apply: Mr. Singh 100%, Mr. Williams 50%, Mr. McCarthy 40% and Dr. Welch 40%. The targets for our officer bonuses are tied to four financial metrics invoiced shipments, gross margin on invoiced shipments, cash from operations and operating income based on invoiced shipments and have been set to be challenging to achieve. In the future, cash bonuses are expected to be paid in a single installment during the month of February of the year following the measurement year.

*Equity-based incentives.* We believe that strong long-term corporate performance is achieved with a corporate culture that encourages long-term performance by our executive officers through the use of stock-based awards. Our equity incentive plans have been established to provide certain of our employees, including our executive officers, with incentives to help align those employees' interests with the interests of our stockholders. We have not adopted stock ownership guidelines, and, other than for our co-founders, our equity incentive plans have provided the principal method for our executive officers to acquire equity or equity-linked interests in our company. Prior to this offering, we granted equity awards under our 2000 Stock Plan. In connection with our initial public offering, our board of directors has adopted a 2007 Equity Incentive Plan, which permits the grant of stock options, stock appreciation rights, restricted stock, restricted stock units, performance units, performance shares and other stock-based awards. Our equity awards are designed to align management's performance objectives with the interests of our stockholders. Our compensation committee grants equity awards to key executives in order to enable them to participate in the long-term appreciation of our stockholder value, while reducing or eliminating the economic benefit of such awards in the event we do not perform well. Additionally, to the extent that stock options and other equity awards are given in the form of option grants these provide an important retention tool for key executives, as they are in almost all cases subject to vesting over an extended period of time.

In general, stock options for executive officers are granted annually in connection with our annual performance review in May of each year and are subject to vesting based on the executive's continued service. Most new hire option grants vest over a four year period with 25% vesting after the first twelve months of service and the remainder vesting ratably each month thereafter over the next three years. Annual option grants also vest over a four year period and vest ratably each month subject to continued service through each vesting date. All options are granted at the fair market value on the date of grant. Our compensation committee will consider alternative forms of equity, such as performance shares, restricted stock units or restricted stock awards, and alternative vesting strategies based on the achievement of milestones when we become a public reporting company.

The size and terms of the initial option grant made to each executive officer upon joining the company are primarily based on competitive conditions applicable to the executive officer's specific position. In addition, the compensation committee considers the number of options owned by other executives in comparable positions within our company using a blended model that considers options awarded as a percentage of shares outstanding and the aggregate value for each option grant. For 2006, the compensation committee recommended to the board of directors the annual equity-based incentive award for our chief executive officer. For all other executive officers in 2006, the compensation committee's recommendations were made with input from the chief executive officer.



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The compensation committee has established stock option targets for specified categories of executive officers.

We use a number of methodologies to make external comparisons when we set the number of options to be granted to each executive officer. On an individual basis, we compare the fair value of the grant to those to executives made at peer companies using a Black-Scholes valuation for equity awards that is consistent with SFAS 123(R), and the number of option shares granted by position as a percentage of total common shares outstanding. We believe these comparisons provide important additional context for comparing the competitiveness of our equity-based compensation practices versus the market.

The annual performance equity awards we make to our executive officers will be driven by our sustained performance over time, our executive officers' ability to impact our results that drive stockholder value, their organization level, their potential to take on roles of increasing responsibility, and competitive equity award levels for similar positions and organization levels in comparable companies. Equity forms a key part of the overall compensation for each executive officer and will be considered each year as part of the annual performance review process and incentive payout calculation.

During 2006, our board of directors granted stock options to our executive officers based upon the recommendations of our compensation committee in connection with our annual performance stock option grant process. All of these grants were made during meetings of our board of directors. The exercise price of options was determined by our board or directors after taking into account a wide variety of factors, including external valuation reports received from our independent valuation firms; the pricing of our most recently completed convertible preferred stock financing; the quality and growth of our management team; and market comparables within our industry. Subsequent to our initial public offering, our compensation committee intends to grant options for new hires on a monthly basis on the first business day of the month. All equity awards to our employees, including executive officers, and to our directors have been granted and reflected in our consolidated financial statements, based upon the applicable accounting guidance, with the exercise price equal to the fair market value on the grant date based on the valuation determined by our board of directors with the assistance of our independent valuation firms.

*Benefits.* We provide the following benefits to our named executive officers, generally on the same basis provided to all of our employees:

health, dental insurance and vision;

life insurance;

employee stock purchase plan;

employee assistance plan;

medical and dependant care flexible spending account;

short-and long-term disability, accidental death and dismemberment; and

a 401(k) plan.

We believe these benefits are consistent with companies with which we compete for employees.

*Severance Compensation & Termination Protection.* We intend to enter into change of control agreements with each of our vice president level officers and above. Our chief executive officer, chief financial officer and chief operating officer will receive the following benefits if we undergo a change of



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control transaction and such officer is terminated without cause or is constructively terminated within 12 months following the change of control, subject to the individual's prior execution of a general release in our favor:

50% of the shares subject to the new hire option grant or stock award made to such officer will vest;

100% of the unvested shares of each subsequent option or stock award will vest; and

the officer will be paid a lump sum equal to 12 months of base salary and will be provided with up to 12 months of COBRA.

Our other vice president level officers and above will receive the following benefits if we undergo a change of control transaction and such officer is terminated without cause or is constructively terminated within 12 months following the change of control, subject to the individual's prior execution of a general release in our favor:

50% of the shares subject to the new hire option grant or stock award made to such officer will vest;

50% of the unvested shares of each subsequent option or stock award will vest; and

the officer will be paid a lump sum equal to six months of base salary plus up to six months of COBRA.

**Accounting and Tax Considerations**

Internal Revenue Code Section 162(m) limits the amount that we may deduct for compensation paid to our chief executive officer and to each of our four most highly compensated officers to \$1,000,000 per person, unless certain exemption requirements are met. Exemptions to this deductibility limit may be made for various forms of performance-based compensation. In addition to salary and bonus compensation, upon the exercise of stock options that are not treated as incentive stock options, the excess of the current market price over the option price, or option spread, is treated as compensation and accordingly, in any year, such exercise may cause an officer's total compensation to exceed \$1,000,000. Under certain regulations, option spread compensation from options that meet certain requirements will not be subject to the \$1,000,000 cap on deductibility, and in the past we have granted options that we believe met those requirements. While the compensation committee cannot predict how the deductibility limit may impact our compensation program in future years, the compensation committee intends to maintain an approach to executive compensation that strongly links pay to performance. While the compensation committee has not adopted a formal policy regarding tax deductibility of compensation paid to our chief executive officer and our four most highly compensated officers, the compensation committee intends to consider tax deductibility under Rule 162(m) as a factor in compensation decisions.

**Table of Contents****Summary Compensation Table**

The following table provides information regarding the compensation of our principal executive officer, principal financial officer, former principal financial officer and each of the next three most highly compensated executive officers during our year ended December 31, 2006. We refer to these executive officers as our named executive officers.

<b>Name and Principal Position</b>	<b>Salary(\$)</b>	<b>Option Grants (\$)(1)</b>	<b>Non-Equity Incentive Plan Compensation (\$)(2)</b>	<b>All Other Compensation (\$)</b>	<b>Total (\$)</b>
Jagdeep Singh	\$ 200,000	\$ 44,572	\$ 32,526	\$	\$ 277,098
<b>President and Chief Executive Officer</b>					
Duston M. Williams(4)	129,808	44,856	40,657		215,321
<b>Chief Financial Officer</b>					
William R. Zerella(5)	142,109			125,000(3)	267,109
<b>former Chief Financial Officer</b>					
Scott A. Chandler	225,000	7,429	984,946(6)		1,217,375
<b>Vice President, Worldwide Sales</b>					
Michael O. McCarthy III	230,000	11,886	37,405		279,291
<b>Vice President and General Counsel</b>					
David F. Welch, Ph.D.	200,000	22,286	32,526		254,812
<b>Chief Marketing and Strategy Officer</b>					

- (1) Amounts represent the aggregate expense recognized for financial statement reporting purposes in 2006, calculated in accordance with SFAS No. 123(R), for awards of stock options to our named executive officers. See Note 1 of Notes to Consolidated Financial Statements for a discussion of assumptions made in determining the grant date fair value and compensation expense of our stock options.
- (2) The amounts in this column represent total performance-based bonuses earned for services rendered during 2006 under our 2006 Executive Bonus Plan, in which all executives who do not receive sales commissions participate. During 2006, we introduced the bonus plan which was applicable only to the second half of that year. Bonus targets were set related to revenue and margin, which were the key metrics in support of the business plan in effect at that time. 50% of the bonus was based on our performance relative to our revenue plan and the other 50% of the bonus was based on our performance relative to our gross margin plan. Payment of any bonus was contingent on our having achieved both (i) at least 80% of our revenue plan and (ii) at least 80% of our gross margin plan. Target bonus for each named executive officer was 15% of base salary. Bonuses earned in 2006 are anticipated to be paid in April 2007.
- (3) This amount represents the amount paid to Mr. Zerella as severance in connection with his termination of employment. See the section titled "Separation Agreement" for a discussion of Mr. Zerella's severance arrangement.
- (4) Mr. Williams became our chief financial officer in June 2006.
- (5) Mr. Zerella left Infinera in July 2006.
- (6) Mr. Chandler earned this amount during 2006 solely through sales commissions related to certain individual performance targets. \$158,633 of Mr. Chandler's non-equity incentive plan compensation was based on individual performance targets set in 2006 for which payment was contingent on shipments made in January 2007 and was paid in February 2007.

**Table of Contents****Grants of Plan-Based Awards**

The following table provides information regarding grants of plan-based awards to each of our named executive officers during the year ended December 31, 2006.

**Grants of Plan-Based Awards**  
**For Year Ended December 31, 2006**

Name	Estimated Future Payouts Under		Grant Date	All Other Option Awards: Number of Securities	Exercise or Base Price of Option	Grant Date Fair Value of Option Awards(3)
	Non-Equity Incentive Plan Awards Threshold\$(1)	Target\$(2)		Underlying Options(#)	Awards (\$/Sh)	
Jagdeep Singh(4)	\$ 24,000	\$ 30,000	8/8/2006	50,000	\$ 2.00	\$ 58,200
			8/8/2006	325,000	2.00	378,300
President and Chief Executive Officer						
Duston M. Williams(5)	30,000	37,500	8/8/2006	50,000	2.00	58,200
			8/8/2006	325,000	2.00	378,300
Chief Financial Officer						
William R. Zerella						
former Chief Financial Officer						
Scott A. Chandler(6)		225,000	8/8/2006	50,000	2.00	58,200
			8/8/2006	12,500	2.00	14,550
Vice President, Worldwide Sales						
Michael O. McCarthy III	27,600	34,500	8/8/2006	50,000	2.00	58,200
			8/8/2006	50,000	2.00	58,200
Vice President and General Counsel						
David F. Welch, Ph.D.	24,000	30,000	8/8/2006	137,500	2.00	160,050
			8/8/2006	50,000	2.00	58,200
Chief Marketing and Strategy Officer						

- (1) The threshold payments under our 2006 Executive Bonus Plan were set at 12% of each named executive officer's base salary. Please see the Summary Compensation Table above for the amounts our named executive officers earned under the 2006 Executive Bonus Plan.
- (2) The target payments under our 2006 Executive Bonus Plan were set at 15% of each named executive officer's base salary. Please see the Summary Compensation Table above for the amounts our named executive officers earned under the 2006 Executive Bonus Plan.
- (3) Amounts reflect the total fair value of stock options granted in 2006, calculated in accordance with SFAS No. 123(R).
- (4) The stock option award to Mr. Singh was in recognition of his duties and responsibilities as our President and Chief Executive Officer.
- (5) The stock option award to Mr. Williams reflects his new hire grant.
- (6) Mr. Chandler was compensated under our sales commission plan, not under our 2006 Executive Bonus Plan. Under our sales commission plan, there was no threshold or maximum commission for Mr. Chandler to earn. The target payment under the sales commission plan was set at 100% of Mr. Chandler's base salary if we hit our invoiced shipment target for 2006.

**Table of Contents****Outstanding Equity Awards at December 31, 2006**

The following table presents certain information concerning outstanding equity awards held by each of our named executive officers at December 31, 2006.

Name	Number of Securities Underlying Unexercised Options Exercisable(#)	Option Awards Number of Securities Underlying Exercised Options That Have Not Vested(#)	Option Exercise Price(\$)	Option Expiration Date
Jagdeep Singh	75,757(1)		\$ 1.32	11/27/2015
President and Chief Executive Officer	199,242(2)		1.32	11/27/2015
	50,000(3)		2.00	8/7/2016
	325,000(4)		2.00	8/7/2016
		60,306(5)		
		111,568(5)		
Duston M. Williams	50,000(6)		2.00	8/7/2016
Chief Financial Officer	325,000(7)		2.00	8/7/2016
William R. Zerella				
former Chief Financial Officer				
Scott A. Chandler	33,750(8)		1.84	5/15/2013
Vice President, Worldwide Sales	15,000(9)		2.24	7/5/2014
	17,500(10)		0.76	2/1/2015
	66,250(11)		1.32	11/27/2015
	50,000(12)		2.00	8/7/2016
	12,500(13)		2.00	8/7/2016
Michael O. McCarthy III	5,937(14)		1.84	5/15/2013
Vice President and General Counsel	3,750(15)		2.24	7/5/2014
	26,515(16)		1.32	11/27/2015
	35,985(17)		1.32	11/27/2015
	50,000(18)		2.00	8/7/2016
	50,000(19)		2.00	8/7/2016
		37,761(20)		

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David F. Welch, Ph.D.	137,500(21)		2.00	8/7/2016
	50,000(22)		2.00	8/7/2016
Chief Marketing and Strategy Officer		60,306(23)		
		42,818(23)		
		48,926(24)		
		20,500(24)		

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- (1) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 26,830 shares were fully vested and 48,927 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
  - (2) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 70,565 shares were fully vested and 128,677 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
  - (3) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 6,250 shares were fully vested and 43,750 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
  - (4) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 40,625 shares were fully vested and 284,375 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.

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- (5) Shares of common stock acquired pursuant to the early exercise of options, but which are unvested and, therefore, subject to our right to repurchase as of December 31, 2006. Our right to repurchase is at a price per share of \$0.76.
- (6) The option is subject to an early exercise provision and is immediately exercisable. The option vests as to 1/4<sup>th</sup> of the shares of the underlying common stock on the first anniversary of the vesting commencement date and 1/48<sup>th</sup> of the shares of underlying common stock monthly thereafter. As of December 31, 2006, no shares were fully vested and 50,000 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (7) The option is subject to an early exercise provision and is immediately exercisable. The option vests as to 1/4<sup>th</sup> of the shares of the underlying common stock on the first anniversary of the vesting commencement date and 1/48<sup>th</sup> of the shares of underlying common stock monthly thereafter. As of December 31, 2006, no shares were fully vested and 325,000 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (8) The option is subject to an early exercise provision and is immediately exercisable. The option vests as to 1/4<sup>th</sup> of the shares of the underlying common stock on the first anniversary of the vesting commencement date and 1/48<sup>th</sup> of the shares of underlying common stock monthly thereafter. As of December 31, 2006, 30,234 shares were fully vested and 3,516 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (9) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 9,687 shares were fully vested and 5,313 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (10) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 9,114 shares were fully vested and 8,386 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (11) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 23,463 shares were fully vested and 42,787 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (12) The option is subject to early exercise provisions and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 6,250 shares were fully vested and 43,750 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (13) The option is subject to early exercise provisions and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 1,562 shares were fully vested and 10,938 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (14) The option is subject to an early exercise provision and is immediately exercisable. The option vests as to 1/4<sup>th</sup> of the shares of the underlying common stock on the first anniversary of the vesting commencement date and 1/48<sup>th</sup> of the shares of underlying common stock monthly thereafter. As of December 31, 2006, 2,969 shares were fully vested and 2,969 will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (15) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 2,500 shares were fully vested and 1,250 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (16) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 1,657 shares were fully vested and 24,858 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (17) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 6,155 shares were fully vested and 29,830 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (18) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 7,292 shares were fully vested and 42,709 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (19) The option is subject to an early exercise provision and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 7,292 shares were fully vested and 42,709 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (20) Shares of common stock acquired pursuant to the early exercise of options, but which are unvested and, therefore, subject to our right of repurchase as of December 31, 2006. Our right to repurchase is at a price per share of \$0.76.
- (21) The option is subject to early exercise provisions and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 17,187 shares were fully vested and 120,313 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (22) The option is subject to early exercise provisions and is immediately exercisable. The option vests monthly as to 1/48<sup>th</sup> of the shares of the underlying common stock. As of December 31, 2006, 6,250 shares were fully vested and 43,750 shares will vest ratably over the remainder of the vesting period, subject to continued service to us.
- (23) Shares of common stock acquired pursuant to the early exercise of options, but which are unvested and, therefore, subject to our right to repurchase as of December 31, 2006. Our right to repurchase is at a price per share of \$0.76.
- (24) Shares of common stock acquired pursuant to the early exercise of options, but which are unvested and, therefore, subject to our right to repurchase as of December 31, 2006. Our right to repurchase is at a price per share of \$1.32.



**Table of Contents****Option Exercises and Restricted Stock Vesting During 2006**

The following table presents certain information on an aggregated basis concerning the exercise of options by, and vesting of restricted stock held by, each of our named executive officers during 2006.

Name	Option Awards	
	Number of Shares Acquired on Exercise(#)	Value Realized on Exercise\$(1)
Jagdeep Singh		\$
President and Chief Executive Officer		
Duston M. Williams		
Chief Financial Officer		
William R. Zerella	107,811	1,319,607
former Chief Financial Officer		
Scott A. Chandler		
Vice President, Worldwide Sales		
Michael O. McCarthy III	129,061(2)	1,520,820
Vice President and General Counsel		
David F. Welch, Ph.D.	107,499(3)	1,255,588
Chief Marketing and Strategy Officer		

- (1) The aggregate dollar amount realized upon the exercise of an option represents the difference between the aggregate market price of the shares of our common stock underlying that option on the date of exercise, which is \$13.00, our initial public offering price, and the aggregate exercise price of the option.
- (2) As of December 31, 2006, 37,760 of the 129,061 shares with a value of \$490,880, based on \$13.00, our initial public offering price, are unvested and subject to repurchase by us at a price per share of \$0.76.
- (3) As of December 31, 2006, 89,583 of the 107,499 shares with a value of \$1,164,579, based on \$13.00, our initial public offering price, are unvested and subject to repurchase by us at a price per share of \$1.32.

**Offer Letters**

We are party to the following agreements contained in employment offer letters with our named executive officers.

***Duston M. Williams***

On May 1, 2006, Mr. Williams executed our written offer of employment to serve as our Vice President and Chief Financial Officer. The written offer of employment, which has been partially superceded by the change of control severance agreement we entered into with Mr. Williams, specifies that Mr. Williams' employment with us is at will. The offer letter provides for an annual base salary of \$250,000 and on August 8, 2006 we granted Mr. Williams an option to purchase an aggregate of 375,000 shares of our common stock. The option vests 1/4<sup>th</sup> on the one year anniversary of the June 19, 2006 vesting commencement date and then 1/48<sup>th</sup> per month thereafter. The letter also provides Mr. Williams with certain severance and change of control benefits. See the section titled "Potential Payments Upon Termination or Change in Control" below.

***Scott A. Chandler***

On February 26, 2003, Mr. Chandler executed our written offer of employment, which has been superceded by the change of control severance agreement we entered into with Mr. Chandler, to serve as our Vice President, Sales for North America. In

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November 2004, Mr. Chandler was promoted to the position of Vice President, Worldwide Sales. The written offer of employment specifies that Mr. Chandler's employment with us is at will. The offer letter provides for an annual base salary of

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\$200,000, a signing bonus of \$10,000, a performance bonus of \$10,000 per year, and a grant of an option to purchase 33,750 shares of our common stock. The option vests 1/4<sup>th</sup> on the one year anniversary of the May 15, 2003 vesting commencement date and then 1/48<sup>th</sup> per month thereafter.

**Michael O. McCarthy III**

On January 16, 2003, Mr. McCarthy executed our written offer of employment to serve as our Vice President and General Counsel. The written offer of employment, which has been superceded by the change of control severance agreement we entered into with Mr. McCarthy, specifies that Mr. McCarthy's employment with us is at will. The offer letter provides for an annual base salary of \$230,000 and a grant of options to purchase 47,500 shares of our common stock. The option vests 1/4<sup>th</sup> on the one year anniversary of the May 5, 2003 vesting commencement date and then 1/48<sup>th</sup> per month thereafter. See the section titled "Potential Payments Upon Termination or Change in Control" below.

**Separation Agreement****William R. Zerella**

Mr. Zerella's employment terminated as our chief financial officer on July 1, 2006. On June 29, 2006, we entered into a separation agreement and general release with Mr. Zerella pursuant to which we agreed to make a lump sum cash payment to Mr. Zerella of \$125,000. Also as part of this agreement, we agreed to accelerate the vesting of approximately one-third of Mr. Zerella's unvested stock options, 28,125 of his then 84,978 unvested and outstanding options, and to extend Mr. Zerella's ability to exercise his stock options until December 31, 2006. In 2006, Mr. Zerella exercised all of the 107,811 vested shares pursuant to his options. We also agreed to continue to pay for Mr. Zerella's health benefits until the earlier of (i) the date of his full-time employment with another entity; and (ii) December 31, 2006. Receipt of these benefits was made contingent upon Mr. Zerella's execution of a general release of claims against us, which we obtained. Such payments and benefits had a value of:

<b>Compensation and Benefits</b>	<b>Termination of Employment</b>	<b>Separation Agreement(\$)</b>
Cash		\$ 125,000
Equity Acceleration(1)		344,250
Health Care Benefits(2)		

(1) 28,125 shares of common stock subject to Mr. Zerella's options were accelerated under the terms of his separation agreement. The amount indicated in the table is calculated as the spread value of the options subject to accelerated vesting on December 31, 2006 but assuming a price per share of \$13.00, our initial public offering price.

(2) We did not pay any COBRA health benefits for Mr. Zerella.

**Potential Payments Upon Termination or Change in Control**

We have entered into change of control agreements and/or maintain employee benefits plans that require specific payments and/or benefits to be provided to the following named executive officers in the event of termination of employment. The following tables describe the payments and/or benefits which are owed by us to each of our named executive officers upon termination of employment in the following situations and for the following reasons described below. The terms "Cause," "Constructively Terminated" and "Change of Control" have the meanings set forth in the relevant agreements.

**Jagdeep Singh**

On October 28, 2004, we granted Mr. Singh options to purchase an aggregate of 374,999 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four year period. Under the terms of our change of control agreement with Mr. Singh, if, within a one-year period after a Change of Control,

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Mr. Singh is terminated without Cause or Constructively Terminated, then Mr. Singh would be entitled to acceleration of 100% of the unvested shares underlying these option grants.

On November 28, 2005, we granted Mr. Singh options to purchase an aggregate of 274,999 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period from the July 26, 2005 vesting commencement date. Under the terms of our change of control agreement with Mr. Singh, if, within a one-year period after a Change of Control, Mr. Singh is terminated without Cause or Constructively Terminated, then Mr. Singh would be entitled to acceleration of 100% of the unvested shares underlying these option grants.

On August 8, 2006, we granted Mr. Singh options to purchase an aggregate of 375,000 shares of common stock. The options vest 1/48<sup>th</sup> per month from the June 29, 2006 vesting commencement date. Under the terms of the change of control agreement, if Mr. Singh is terminated without Cause or Constructively Terminated within a one-year period after a Change of Control, Mr. Singh would be entitled to acceleration of 100% of the unvested shares underlying these option grants.

In addition, the change of control agreement that we entered into with Mr. Singh requires us to pay him a lump sum equal to twelve months of base salary plus twelve months of COBRA if he is terminated without Cause or Constructively Terminated within a one-year period after a Change of Control.

Assuming Mr. Singh's employment terminated on December 31, 2006, by virtue of the agreements described above, he would be entitled to benefits with the value set forth in the table below:

<b>Termination of Employment</b>	<b>Termination Without Cause or Constructively Terminated After Change of Control(\$)</b>
<b>Compensation and Benefits</b>	
Equity Acceleration(1)	\$ 7,787,189
Salary	200,000
Health Care Benefits	13,000

(1) The vesting of 677,574 shares of common stock subject to Mr. Singh's options or subject to our right of repurchase would accelerate and vest if he were terminated without Cause or Constructively Terminated in connection with a Change of Control on December 31, 2006. The amount indicated in the table is calculated as the spread value of the options or shares subject to repurchase subject to accelerated vesting on December 31, 2006 but assuming a price per share of \$13.00, our initial public offering price.

**Duston M. Williams**

On August 8, 2006, we granted Mr. Williams options to purchase an aggregate of 375,000 shares of common stock. The options vest 1/4<sup>th</sup> on the one year anniversary of the June 19, 2006 vesting commencement date and then 1/48<sup>th</sup> per month thereafter. Under the terms of the related option agreements, his offer letter and our change of control agreement with Mr. Williams, if, within a one-year period after a Change of Control Mr. Williams is terminated without Cause or Constructively Terminated, then Mr. Williams will be entitled to acceleration of 50% of the unvested shares underlying these option grants. Mr. Williams would also be entitled to such acceleration if he is terminated without Cause after the appointment of a new chief executive officer.

In addition, the change of control agreement that we entered into with Mr. Williams requires us to pay him a lump sum equal to twelve months of base salary plus twelve months of COBRA if he is terminated without Cause or Constructively Terminated within a one-year period after a Change of Control.

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Assuming Mr. Williams' employment terminated on December 31, 2006, by virtue of the agreements described above, he would be entitled to benefits with the value set forth in the table below:

Compensation and Benefits	Termination of Employment	
	Termination Without Cause In Connection with Appointment of a New CEO(\$)	Termination Without Cause or Constructively Terminated After Change of Control(\$)
Equity Acceleration(1)	\$ 2,062,500	\$ 2,062,500
Salary		250,000
Health Care Benefits		13,000

(1) The vesting of 187,500 shares of common stock subject to Mr. Williams' options or subject to our right of repurchase would accelerate and vest if he were terminated without Cause or Constructively Terminated in connection with a Change of Control, or if he is terminated without Cause in connection with the appointment of a new chief executive officer, on December 31, 2006. The amount indicated in the table is calculated as the spread value of the options or shares subject to repurchase subject to accelerated vesting on December 31, 2006 but assuming a price per share of \$13.00, our initial public offering price.

**Scott A. Chandler**

On May 16, 2003, we granted Mr. Chandler options to purchase 33,750 shares of common stock. The options vest 1/4<sup>th</sup> after one year from the May 15, 2003 vesting commencement date and then 1/48<sup>th</sup> per month thereafter. Under the terms of our change of control agreement with Mr. Chandler, if within a one-year period after a Change of Control, Mr. Chandler is terminated without Cause or Constructively Terminated, then Mr. Chandler will be entitled to acceleration of 100% of the unvested shares underlying these option grants.

On July 6, 2004, we granted Mr. Chandler options to purchase 15,000 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period. Under the terms of our change of control agreement with Mr. Chandler, if within a one-year period after a Change of Control, Mr. Chandler is terminated without Cause or Constructively Terminated, then Mr. Chandler will be entitled to acceleration of 50% of the unvested shares underlying these option grants.

On February 2, 2005, we granted Mr. Chandler options to purchase 17,500 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period. Under the terms of our change of control agreement with Mr. Chandler, if within a one-year period after a Change of Control, Mr. Chandler is terminated without Cause or Constructively Terminated, then Mr. Chandler will be entitled to acceleration of 50% of the unvested shares underlying these option grants.

On November 28, 2005, we granted Mr. Chandler options to purchase 66,250 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period. Under the terms of our change of control agreement with Mr. Chandler, if within a one-year period after a Change of Control, Mr. Chandler is terminated without Cause or Constructively Terminated, then Mr. Chandler will be entitled to acceleration of 50% of the unvested shares underlying these option grants.

On August 8, 2006, we granted Mr. Chandler options to purchase an aggregate of 62,500 shares of common stock. The options vest 1/48<sup>th</sup> per month from June 28, 2006. Under the terms of the related option agreements and the change of control agreement with Mr. Chandler, if, within a one-year period after a Change of Control, Mr. Chandler is terminated without Cause or Constructively Terminated, then Mr. Chandler will be entitled to acceleration of 50% of the shares underlying these option grants (or the remainder if more than 50% are then vested).

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In addition, the change of control agreement that we entered into with Mr. Chandler requires us to pay him a lump sum equal to six months of base salary plus six months of COBRA if he is terminated without Cause or Constructively Terminated within a one-year period after a Change of Control.

Assuming Mr. Chandler's employment terminated on December 31, 2006, by virtue of the agreements described above, he would be entitled to benefits with the value set forth in the table below:

<b>Termination of Employment</b>	<b>Termination Without Cause or Constructively Terminated After Change of Control (\$)</b>
<b>Compensation and Benefits</b>	
Equity Acceleration(1)	\$ 669,759
Salary	112,500
Health Care Benefits	13,000

- (1) The vesting of 59,099 shares of common stock subject to Mr. Chandler's options or subject to our right of repurchase would accelerate and vest if he were terminated without Cause or Constructively Terminated in connection with a Change of Control on December 31, 2006. The amount indicated in the table is calculated as the spread value of the options or shares subject to repurchase subject to accelerated vesting on December 31, 2006 but assuming a price per share of \$13.00, our initial public offering price.

**Michael O. McCarthy III**

On May 16, 2003, we granted Mr. McCarthy options to purchase 47,500 shares of common stock. The options vest 1/4<sup>th</sup> one year from the May 5, 2003 vesting commencement date and then 1/48<sup>th</sup> per month thereafter. Under the terms of our change of control agreement with Mr. McCarthy, if within a one-year period after a Change of Control, Mr. McCarthy is terminated without Cause or Constructively Terminated, then Mr. McCarthy will be entitled to acceleration of 100% of the unvested shares underlying these option grants.

On July 6, 2004, we granted Mr. McCarthy options to purchase 3,750 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period. Under the terms of our change of control agreement with Mr. McCarthy, if within a one-year period after a Change of Control, Mr. McCarthy is terminated without Cause or Constructively Terminated, then Mr. McCarthy will be entitled to acceleration of the 50% of the unvested shares underlying these option grants.

On May 11, 2005, we granted Mr. McCarthy options to purchase 62,500 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period. Under the terms of our change of control agreement with Mr. McCarthy, if within a one-year period after a Change of Control, Mr. McCarthy is terminated without Cause or Constructively Terminated, then Mr. McCarthy will be entitled to acceleration of 50% of the unvested shares underlying these option grants.

On November 28, 2005, we granted Mr. McCarthy options to purchase an aggregate of 87,500 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period. Under the terms of our change of control agreement with Mr. McCarthy, if within a one-year period after a Change of Control, Mr. McCarthy is terminated without Cause or Constructively Terminated, then Mr. McCarthy will be entitled to acceleration of 50% of the unvested shares underlying these option grants.

On August 8, 2006, we granted Mr. McCarthy options to purchase an aggregate of 100,000 shares of common stock. The options vest 1/48<sup>th</sup> per month from June 29, 2006. Under the terms of the related option agreements and the change of control agreement with Mr. McCarthy, if, within a one-year period after a Change of Control, Mr. McCarthy is terminated without Cause or Constructively

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Terminated, then Mr. McCarthy will be entitled to acceleration of 50% of the shares underlying these option grants (or the remainder if more than 50% are then vested).

In addition, the change of control agreement that we entered into with Mr. McCarthy will require us to pay him a lump sum equal to six months of base salary plus six months of COBRA if he is terminated without Cause or Constructively Terminated within a one-year period after a Change of Control.

Assuming Mr. McCarthy's employment terminated on December 31, 2006, by virtue of the agreements described above, he would be entitled to benefits with the value set forth in the table below:

<b>Termination of Employment</b>	<b>Termination Without Cause or Constructively Terminated After Change of Control(\$)</b>
<b>Compensation and Benefits</b>	
Equity Acceleration(1)	\$ 1,104,724
Salary	115,000
Health Care Benefits	200

(1) The vesting of 96,497 shares of common stock subject to Mr. McCarthy's options or subject to our right of repurchase would accelerate and vest if he were terminated without Cause or Constructively Terminated in connection with a Change of Control on December 31, 2006. The amount indicated in the table is calculated as the spread value of the options or shares subject to repurchase subject to accelerated vesting on December 31, 2006 but assuming a price per share of \$13.00, our initial public offering price.

**David F. Welch**

On October 28, 2004, we granted Dr. Welch options to purchase an aggregate of 224,999 shares of common stock. The options vest 1/48<sup>th</sup> per month from the October 28, 2004 vesting commencement date. Under the terms of the change of control agreement with Dr. Welch, if, within a one-year period after a Change of Control, Dr. Welch is terminated without Cause or Constructively Terminated, then Dr. Welch will be entitled to acceleration of 100% of the unvested shares underlying these option grants.

On November 28, 2005, we granted Dr. Welch options to purchase an aggregate of 107,499 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four-year period from the July 26, 2005 vesting commencement date. Under the terms of our change of control agreement with Dr. Welch, if, within a one-year period after a Change of Control, Dr. Welch is terminated without Cause or Constructively Terminated, then Dr. Welch will be entitled to acceleration of 50% of the unvested shares underlying these option grants.

On August 8, 2006, we granted Dr. Welch options to purchase an aggregate of 187,500 shares of common stock. The options vest 1/48<sup>th</sup> per month over a four year period from June 29, 2006. Under the terms of the related option agreements and the change of control agreement with Dr. Welch, if, within a one-year period after a Change of Control, Dr. Welch is terminated without Cause or Constructively Terminated, then Dr. Welch will be entitled to acceleration of 50% of the shares underlying these option grants (or the remainder if more than 50% are then vested).

In addition, the change of control agreement that we entered into with Dr. Welch will require us to pay him a lump sum equal to six months of base salary plus six months of COBRA if he is terminated without Cause or Constructively Terminated within a one-year period after a Change of Control.

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Assuming Dr. Welch's employment terminated on December 31, 2006, by virtue of the agreements described above, he would be entitled to benefits with the value set forth in the table below:

<b>Termination of Employment</b>	<b>Termination Without Cause or Constructively Terminated After Change of Control(\$)</b>
<b>Compensation and Benefits</b>	
Equity Acceleration(1)	\$ 3,180,198
Salary	100,000
Health Care Benefits	13,000

(1) The vesting of 275,338 shares of common stock subject to Dr. Welch's options or subject to our right of repurchase would accelerate and vest if he were terminated without Cause or Constructively Terminated in connection with a Change of Control on December 31, 2006. The amount indicated in the table is calculated as the spread value of the options or shares subject to repurchase subject to accelerated vesting on December 31, 2006 but assuming a price per share of \$13.00, our initial public offering price.

**Equity Benefit Plans****2000 Stock Plan**

Our board of directors adopted our 2000 Stock Plan on December 6, 2000 and stockholders approved it on December 6, 2000. Certain amendments were made to the plan as of March 16, 2001; September 25, 2001; April 12, 2002; December 5, 2002; March 12, 2003; April 29, 2003; March 25, 2004; November 18, 2004; September 23, 2005; June 29, 2006 and December 12, 2006. Our 2000 Stock Plan provides for the grant of incentive stock options, within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, to our employees and any parent and subsidiary corporations' employees. The plan also provides for the grant of nonstatutory stock options, and stock purchase rights that permit us to grant awards of restricted stock, to our employees, directors and consultants and our parent and subsidiary corporations' employees and consultants.

*Share Reserve*

We have reserved an aggregate of 15,762,128 shares of our common stock for issuance pursuant to the 2000 Stock Plan. As of March 31, 2007, options to purchase 8,220,738 shares of our common stock were outstanding, and 1,056,438 shares were available for future grant under this plan. Our board of directors has decided not to grant any additional options or other awards under the plan following the completion of this offering. However, the plan will continue to govern the terms and conditions of the outstanding awards previously granted under the plan.

*Administration*

Our board of directors or a committee of our board, or a combination thereof, administers our 2000 Stock Plan. Our plan may be administered by different administrative bodies with respect to different classes of participants and, if permitted by the applicable laws, our board may authorize one or more officers to make awards under the plan. The board may increase or reduce the size of any committee to the extent permitted by the applicable laws and as permitted by Rule 16b-3 or Section 162(m) of the Internal Revenue Code. The administrator has the power to determine the terms of the awards, including the exercise price, the number of shares subject to each such award, the exercisability of the awards and the form of consideration payable upon exercise. The administrator also has the authority to institute an option exchange program whereby outstanding options are exchanged for options with a lower exercise price or are amended to decrease the exercise price as a result of a decline in the fair market value of the common stock.



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### *Transferability*

Under our 2000 Stock Plan incentive stock options and stock purchase rights may not be sold, pledged, assigned, hypothecated, transferred or disposed of in any manner other than by will or by the laws of descent or distribution. Prior to the date our common stock becomes a listed security, the administrator may provide that nonstatutory stock options may be transferred by instrument to an inter vivos or testamentary trust in which the options are to be passed to beneficiaries upon the death of the trustor (settlor) or by gift to immediate family, on such terms and conditions as the administrator deems appropriate. After our common stock becomes a listed security, the administrator may provide that nonstatutory stock options will be transferable on such terms and conditions as the administrator deems appropriate.

### *Change in Control Transaction*

Our 2000 Stock Plan provides that subject to any required action by our stockholders, the number of shares covered by each outstanding option or stock purchase right, and the number of shares that have been authorized for issuance under the plan but as to which no options or stock purchase rights have yet been granted or that have been returned to the plan upon cancellation or expiration of an option or stock purchase right, as well as the price per share covered by each such outstanding option or stock purchase right, shall be proportionately adjusted for any increase or decrease in the number of issued shares of common stock resulting from a stock split, reverse stock split, stock dividend, combination, recapitalization or reclassification of our common stock, or any other increase or decrease in the number of issued shares of common stock effected without receipt of consideration by us; provided, however, that conversion of any convertible securities of the company shall not be deemed to have been effected without receipt of consideration.

In the event of a corporate transaction, each outstanding option or stock purchase right shall be assumed or an equivalent option or right shall be substituted by such successor corporation or a parent or subsidiary of such successor corporation, unless the successor corporation does not agree to assume the award or to substitute an equivalent option or right, in which case the option or stock purchase right will terminate upon the consummation of the transaction.

### *Plan Amendment and Termination*

Our 2000 Stock Plan will automatically terminate in 2010, unless we terminate it sooner. In addition, our board of directors has the authority to amend, suspend or terminate the 2000 Stock Plan provided such action does not impair the rights of any participant without his or her consent.

### ***2007 Equity Incentive Plan***

Our board of directors adopted our 2007 Equity Incentive Plan in February 2007 and our stockholders approved the plan in May 2007. Our 2007 Equity Incentive Plan provides for the grant of incentive stock options, within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, to our employees and any parent and subsidiary corporations' employees, and for the grant of nonstatutory stock options, restricted stock, restricted stock units, stock appreciation rights, performance units and performance shares to our employees, directors and consultants and our parent and subsidiary corporations' employees and consultants.

### *Share Reserve*

We have reserved a total of 13,600,000 shares of our common stock for issuance pursuant to the 2007 Equity Incentive Plan. In addition, our 2007 Equity Incentive Plan provides for annual increases in

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the number of shares available for issuance thereunder on the first day of each fiscal year, beginning with our 2008 fiscal year, equal to the least of:

5% of the outstanding shares of our common stock on the last day of the immediately preceding fiscal year;

9,000,000 shares; or

such other amount as our board of directors or a committee of our board may determine.

### *Administration*

Our board of directors or a committee of our board administers our 2007 Equity Incentive Plan. Different committees with respect to different groups of service providers may administer our 2007 Equity Incentive Plan. In the case of options intended to qualify as performance based compensation within the meaning of Section 162(m) of the Internal Revenue Code, the committee will consist of two or more outside directors within the meaning of Section 162(m) of the Internal Revenue Code. The administrator has the power to determine the terms of the awards, including the exercise price, the number of shares subject to each such award, the exercisability of the awards and the form of consideration payable upon exercise. The administrator also has the authority to institute an exchange program whereby the exercise prices of outstanding awards may be reduced, outstanding awards may be surrendered in exchange for awards with a lower exercise price, or outstanding awards may be transferred to a third party.

### *Stock Options*

The exercise price of options granted under our 2007 Equity Incentive Plan must at least be equal to the fair market value of our common stock on the date of grant. The term of an incentive stock option may not exceed ten years, except that with respect to any participant who owns 10% of the voting power of all classes of our outstanding stock as of the grant date, the term must not exceed five years and the exercise price must equal at least 110% of the fair market value on the grant date. The administrator determines the term of all other options.

After termination of an employee, director or consultant, he or she may exercise his or her option for the period of time stated in the option agreement. Generally, if termination is due to death or disability, the option will remain exercisable for twelve months. In all other cases, the option will generally remain exercisable for three months. However, an option generally may not be exercised later than the expiration of its term.

### *Stock Appreciation Rights*

Stock appreciation rights may be granted under our 2007 Equity Incentive Plan. Stock appreciation rights allow the recipient to receive the appreciation in the fair market value of our common stock between the exercise date and the date of grant. The administrator determines the terms of stock appreciation rights, including when such rights become exercisable and whether to pay the increased appreciation in cash or with shares of our common stock, or a combination thereof. Stock appreciation rights expire under the same rules that apply to stock options.

### *Restricted Stock*

Restricted stock may be granted under our 2007 Equity Incentive Plan. Restricted stock awards are shares of our common stock that vest in accordance with terms and conditions established by the administrator. The administrator will determine the number of shares of restricted stock granted to any employee, director or consultant. The administrator may impose whatever conditions to vesting it

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determines to be appropriate. For example, the administrator may set restrictions based on the achievement of specific performance goals. Shares of restricted stock that do not vest are subject to our right of repurchase or forfeiture.

### *Restricted Stock Units*

Restricted stock units may be granted under our 2007 Equity Incentive Plan. Restricted stock units are awards of restricted stock, performance shares or performance units that are paid out in installments or on a deferred basis. The administrator determines the terms and conditions of restricted stock units including the vesting criteria and the form and timing of payment.

### *Performance Units and Performance Shares*

Performance units and performance shares may be granted under our 2007 Equity Incentive Plan. Performance units and performance shares are awards that will result in a payment to a participant only if performance goals established by the administrator are achieved or the awards otherwise vest. The administrator will establish organizational or individual performance goals in its discretion, which, depending on the extent to which they are met, will determine the number and/or the value of performance units and performance shares to be paid out to participants. Performance units will have an initial dollar value established by the administrator on or prior to the grant date. Performance shares will have an initial value equal to the fair market value of our common stock on the grant date. Payment for performance units and performance shares may be made in cash or in shares of our common stock with equivalent value, or in some combination, as determined by the administrator.

### *Transferability*

Unless the administrator provides otherwise, our 2007 Equity Incentive Plan does not allow for the transfer of awards and only the recipient of an award may exercise an award during his or her lifetime.

### *Change in Control Transaction*

Our 2007 Equity Incentive Plan provides that in the event of our change in control, as defined in the 2007 Equity Incentive Plan, each outstanding award will be treated as the administrator determines. The administrator is not required to treat all awards similarly. If there is no assumption or substitution of outstanding awards, all options and stock appreciation rights will fully vest and become fully exercisable, all restrictions on restricted stock will lapse, and all performance goals or other vesting requirements for performance shares and units will be deemed achieved at 100% of target levels, and all other terms and conditions met. The administrator will provide notice to the recipient that he or she has the right to exercise the option and stock appreciation right as to all of the shares subject to the award, and the option or stock appreciation right will terminate upon the expiration of the period of time the administrator provides in the notice.

### *Plan Amendment and Termination*

Our 2007 Equity Incentive Plan will automatically terminate in 2017, unless we terminate it sooner. In addition, our board of directors has the authority to amend, suspend or terminate the 2007 Equity Incentive Plan provided such action does not impair the rights of any participant.

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### ***2007 Employee Stock Purchase Plan***

Concurrently with this offering, we have established the 2007 Employee Stock Purchase Plan. Our board of directors adopted the 2007 Employee Stock Purchase Plan in February 2007, and our stockholders approved the plan in May 2007.

#### *Share Reserve*

A total of 1,812,500 shares of our common stock will be made available for sale. In addition, our 2007 Employee Stock Purchase Plan provides for annual increases in the number of shares available for issuance under the 2007 Employee Stock Purchase Plan on the first day of each fiscal year, beginning with our 2008 fiscal year, equal to the least of:

1% of the outstanding shares of our common stock on the first day of the fiscal year;

1,875,000 shares; or

such other amount as our board of directors or a committee of our board may determine.

#### *Administration*

Our board of directors or a committee of our board administers the 2007 Employee Stock Purchase Plan. Our board of directors or its committee has full and exclusive authority to interpret the terms of the 2007 Employee Stock Purchase Plan and determine eligibility.

#### *Eligibility*

All of our employees are eligible to participate if they are customarily employed by us or any participating subsidiary for at least twenty hours per week and more than five months in any calendar year. However, an employee may not be granted rights to purchase stock if:

such employee immediately after the grant would own stock or options possessing 5% or more of the total combined voting power or value of all classes of our capital stock; or

such employee's rights to purchase stock under all of our employee stock purchase plans would accrue at a rate that exceeds \$25,000 worth of our stock for each calendar year in which such rights are outstanding.

#### *Offering Periods*

Our 2007 Employee Stock Purchase Plan is intended to qualify under Section 423 of the Internal Revenue Code, and provides for consecutive six-month offering periods. The offering periods generally start on the first trading day on or after February 15 and August 15 of each year, except for the first such offering period which will commence on the first trading day on or after the effective date of this offering and will end on the first trading day on or after February 15, 2008.

#### *Limitations*

Our 2007 Employee Stock Purchase Plan permits participants to purchase common stock through payroll deductions of up to 15% of their eligible compensation which includes a participant's straight time gross earnings, commissions, overtime and shift premium, exclusive of payments for incentive compensation, bonuses and other compensation. A participant may purchase a maximum of 3,000 shares of common stock during an offering period.



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### *Purchase of Shares*

Amounts deducted and accumulated by the participant are used to purchase shares of our common stock at the end of each offering period. The purchase price is 85% of the fair market value of our common stock on the first day of the offering date or on the exercise date (i.e., the last day of the offering period), whichever is lower. Participants may end their participation at any time during an offering period, and will be paid their payroll deductions to date. Participation ends automatically upon termination of employment with us.

### *Transferability*

A participant may not transfer rights granted under the 2007 Employee Stock Purchase Plan other than by will, the laws of descent and distribution or as otherwise provided under the 2007 Employee Stock Purchase Plan.

### *Change in Control Transaction*

In the event of our merger or change in control, as defined under the 2007 Employee Stock Purchase Plan, a successor corporation may assume or substitute each outstanding purchase right. If the successor corporation refuses to assume or substitute for the outstanding purchase rights, the offering period then in progress will be shortened, and a new exercise date will be set.

### *Plan Amendment and Termination*

Our 2007 Employee Stock Purchase Plan will automatically terminate in 2027, unless we terminate it sooner. In addition, our board of directors has the authority to amend, suspend or terminate our 2007 Employee Stock Purchase Plan, except that, subject to certain exceptions described in the 2007 Employee Stock Purchase Plan, no such action may adversely affect any outstanding rights to purchase stock under our 2007 Employee Stock Purchase Plan.

### **401(k) Plan**

We maintain a retirement plan, the 401(k) Plan, which is intended to be a tax-qualified retirement plan. The 401(k) Plan covers substantially all of our employees. Participants may elect to defer a percentage of their eligible pretax earnings each year up to the maximum contribution permitted by the Internal Revenue Code. All participants' interests in his or her deferrals are 100% vested when contributed. The 401(k) Plan is intended to qualify under Sections 401(a) and 501(a) of the Internal Revenue Code. As such, contributions to the 401(k) Plan and earnings on those contributions are not taxable to participants until distributed from the 401(k) Plan, and all contributions are deductible by us when made.

**Table of Contents****CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS**

Since January 1, 2004, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which we were or are a party in which the amount involved exceeded or exceeds \$120,000 and in which any of our directors, executive officers, holders of more than 5% of any class of our voting securities, or any member of the immediate family of any of the foregoing persons, had or will have a direct or indirect material interest, other than compensation arrangements with directors and executive officers, which are described where required under the Management section of this prospectus, and the transactions described below.

**Private Placement Financings**

The following table summarizes purchases of our convertible preferred stock since January 1, 2004 by our directors, executive officers and holders of more than 5% of our capital stock and their affiliated entities. Immediately prior to the closing of this offering, all of our convertible preferred stock will convert to common stock.

Purchasers	Shares of Convertible Preferred Stock		Aggregate Purchase Price(\$)
	Series E(#)	Series G(#)	
<b>Executive Officers and Directors(1):</b>			
Jagdeep Singh	989,316	46,296	\$ 2,624,360
Thomas F. Fallon	125,000		300,000
Michael O. McCarthy III		18,518	100,001
David F. Welch	981,977	46,296	2,606,747
Kenneth A. Goldman		18,518	100,000
Hugh C. Martin		46,296	250,000
Carl Redfield(2)		67,934	500,000
Thurman J. Rodgers(3)	296,228		710,950
<b>5% Stockholders(4):</b>			
Advanced Equities, Inc.		5,859,936	31,643,673
KPCB Holdings, Inc., as Nominee	3,132,196	925,925	12,517,271
Mobius VI, LLC	3,132,194		7,517,265
RWI Ventures, L.P.	555,016	2,504,628	14,857,037
Benchmark Capital Partners IV, L.P.(5)	1,534,980		3,683,955
Worldview Technology Partners	1,106,687		2,656,053
<b>Dates</b>	September 2004 to November 2004	October 2005 to June 2006	
<b>Sale Price</b>	\$ 2.40	\$ 5.40(2)	

(1) Includes immediate family members and affiliated entities of our executive officers and directors.

(2) The 67,934 shares of Series G convertible preferred stock sold to Carl Redfield in October 2006 were at a purchase price of \$7.36 per share.

(3) Dr. Rodgers resigned as a member of our board of directors on August 16, 2006. Includes shares purchased by Cypress Semiconductor. Dr. Rodgers is the President and Chief Executive Officer of Cypress Semiconductor.

(4) Includes current 5% or greater holders as well as individuals or entities that were 5% or greater holders at the time of a related party transaction since January 1, 2004.

(5) Dr. Balkanski, one of our directors, is a managing member of Benchmark Capital Management Co. IV, L.L.C., the general partner of Benchmark Capital Partners IV, L.P.

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### ***Investors Rights Agreement***

In connection with the private placements referenced above, we have entered into an amended and restated Investors Rights Agreement with certain of our founders and stockholders. Pursuant to this agreement, we granted such parties certain registration rights with respect to shares of our common stock and common stock issuable upon conversion of the shares of the convertible preferred stock held by them. For more information regarding this agreement, see the section titled Description of Capital Stock Registration Rights. In addition to the registration rights, the amended and restated Investors Rights Agreement provides for certain information rights and rights of first refusal. The provisions of the amended and restated investors rights agreement, other than those relating to registration rights, will terminate upon the closing of this offering.

### ***Voting Agreement***

We have entered into an amended and restated voting agreement with certain of our founders and stockholders. This agreement concerns the composition of our board of directors, and requires parties to it to vote in favor of certain designees of our stockholders. Upon the closing of this offering, the voting agreement will terminate in its entirety and none of our stockholders will have any special rights regarding the election or designation of members of our board of directors.

### ***Indemnification Agreements***

We have entered into indemnification agreements with each of our directors and executive officers. These agreements, among other things, require us to indemnify each director and executive officer to the fullest extent permitted by Delaware law, including indemnification of expenses such as attorneys fees, judgments, fines and settlement amounts incurred by the director or executive officer in any action or proceeding, including any action or proceeding by or in right of us, arising out of the person's services as a director or executive officer.

### ***Employment Arrangements***

Certain of our executive officers have signed offer letters describing certain terms of their employment. See the section titled Management Offer Letters for additional information.

### ***Change of Control Arrangements***

We intend to enter into certain severance and change of control agreements with each of our executive officers. For information regarding these arrangements, see the section titled Management Executive Compensation Program and Potential Payments Upon Termination or Change in Control.

### ***Separation Arrangements***

We entered into a separation agreement with William R. Zerella, our former chief financial officer on June 29, 2006. For information regarding this agreement, see the section titled Management Separation Agreement.

### ***Stock Options Granted to Executive Officers and Directors***

We have granted stock options to our executive officers and directors. For more information regarding these stock options, see the section titled Management Compensation Discussion and Analysis.



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***Equity Grants Since March 31, 2007***

On April 24, 2007, our board of directors granted options to purchase an aggregate of 158,371 shares of common stock to certain of our new employees with exercise prices of \$10.72 per share. On May 7, 2007, our compensation committee approved the grant of options to purchase an aggregate of an additional 3,076,779 shares of common stock to certain of our employees and members of our board of directors in connection with our annual focal review process, including an aggregate of 1,347,500 shares to our executive officers and 75,000 shares to members of our board of directors. These grants are effective as of the date of this prospectus, and have an exercise price equal to \$13.00, our initial public offering price.

The options to purchase shares of common stock granted to our executive officers and directors shall be in the following amounts:

Jagdeep Singh - 412,500 shares

Duston M. Williams - 206,250 shares

Scott A. Chandler - 123,750 shares

Michael O. McCarthy - 96,250 shares

David F. Welch - 206,250 shares

Thomas J. Fallon - 206,250 shares

William R. Cumpston - 96,250 shares

Alexandre Balkanski - 12,500 shares

Kenneth A. Goldman - 12,500 shares

Hugh C. Martin - 12,500 shares

Dan Maydan - 12,500 shares

Carl Redfield - 12,500 shares

Pradeep Sindhu - 12,500 shares

Our compensation committee also intends to issue restricted stock units to certain of our employees in connection with our annual focal review process.

***Other Transactions with our Significant Stockholders***

On April 11, 2005, we entered into a long-term supply agreement with BTE Equipment, LLC, an affiliate of Level 3, for the supply of our DTN System and support services. On May 19, 2005, August 20, 2005, November 15, 2006 and February 23, 2007, we amended the terms of our supply agreement with Level 3. Certain of these amendments were entered into when Level 3 owned more than 5% of our outstanding shares. Pursuant to the agreement, we recognized \$1.0 million of revenue in 2005 and \$36.2 million of revenue in 2006. In addition, Level 3 acquired Broadwing in January 2007. We recognized \$7.2 million of revenue from Broadwing in 2006. In June 2005, Level 3 purchased 2.6 million shares of our Series F convertible preferred stock and became a 5% stockholder. Following our sales of Series G convertible preferred stock, Level 3 still held 2.6 million shares of our capital stock, but is no longer a 5% stockholder.

On June 22, 2005, we entered into a Finder Agreement with Advanced Equities, Inc., or AEI, a holder of more than 5% of our capital stock, pursuant to which we engaged AEI as our non-exclusive agent in connection with the proposed sale by private placement of our Series G convertible preferred stock. Under the terms of the agreement, as amended, we agreed to pay AEI a placement fee equal to

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5% of the aggregate purchase price of the Series G convertible preferred stock sold to certain qualified investors by AEI, or the Placement Amount, and to issue a warrant to purchase shares of Series G convertible preferred stock equal to the quotient of (i) 5% multiplied by the Placement Amount divided by (ii) the price per share of the Series G convertible preferred stock, with the Placement Amount being capped at \$24 million for closings of Series G convertible preferred stock taking place after March 31, 2006. We paid AEI \$3.9 million pursuant to this agreement and issued AEI warrants to purchase 600,784 shares of our Series G convertible preferred stock. We also agreed to reimburse AEI for up to \$20,000 worth of printing fees.

***Policies and Procedures for Related Party Transactions***

We have adopted a formal policy that our executive officers, directors, and principal stockholders, including their immediate family members and affiliates, are not permitted to enter into a related party transaction with us without the prior consent of our audit committee, or other independent members of our board of directors in the case it is inappropriate for our audit committee to review such transaction due to a conflict of interest. Any request for us to enter into a transaction with an executive officer, director, principal stockholder, or any of such persons' immediate family members or affiliates, in which the amount involved exceeds \$120,000 must first be presented to our audit committee for review, consideration and approval. All of our directors, executive officers and employees are required to report to our audit committee any such related party transaction. In approving or rejecting the proposed agreement, our audit committee shall consider the relevant facts and circumstances available and deemed relevant to the audit committee, including, but not limited to the risks, costs and benefits to us, the terms of the transaction, the availability of other sources for comparable services or products, and, if applicable, the impact on a director's independence. Our audit committee shall approve only those agreements that, in light of known circumstances, are in, or are not inconsistent with, our best interests, as our audit committee determines in the good faith exercise of its discretion. All of the transactions described above were entered into prior to the adoption of this policy.

**Table of Contents****PRINCIPAL STOCKHOLDERS**

The following table provides information concerning beneficial ownership of our capital stock as of March 31, 2007, and as adjusted to reflect our sale of the common stock being sold in this offering, by:

each stockholder, or group of affiliated stockholders, known to us to be the beneficial owner of more than 5% of our common stock;

each of our named executive officers;

each of our directors; and

all of our directors and executive officers as a group.

The following table lists the number of shares and percentage of shares beneficially owned based on 69,136,638 shares of common stock outstanding as of March 31, 2007. The table also lists the applicable percentage beneficial ownership based on 83,136,638 shares of common stock outstanding upon completion of this offering, assuming no exercise by the underwriters of their option to purchase up to an aggregate of 2,100,000 shares of our common stock to cover over-allotments.

Beneficial ownership is determined in accordance with the rules of the SEC, and generally includes voting power and/or investment power with respect to the securities held. Shares of common stock subject to options currently exercisable or exercisable within 60 days of March 31, 2007, are deemed outstanding and beneficially owned by the person holding such options for purposes of computing the number of shares and percentage beneficially owned by such person, but are not deemed outstanding for purposes of computing the percentage beneficially owned by any other person. Except as indicated in the footnotes to this table, and subject to applicable community property laws, the persons or entities named have sole voting and investment power with respect to all shares of our common stock shown as beneficially owned by them.

Unless otherwise indicated, the principal address of each of the stockholders below is c/o Infinera Corporation, 169 Java Drive, Sunnyvale, CA 94089.

	Number	Shares Beneficially Owned Percent	
		Before Offering	After Offering
<b>5% Stockholders</b>			
Entities affiliated with Advanced Equities Investments(1)	6,460,720	9.3%	7.7%
Entities affiliated with Kleiner Perkins Caufield & Byers(2)	6,422,311	9.3	7.7
Entities affiliated with Mobius Venture Capital(3)	5,364,334	7.8	6.5
Entities affiliated with RWI Ventures(4)	3,450,269	5.0	4.2
<b>Directors and Named Executive Officers</b>			
Alexandre Balkanski, Ph.D.(5)	2,732,763	4.0	3.3
Kenneth A. Goldman(6)	106,018	*	*
Reed E. Hundt(7)	75,000	*	*
Hugh C. Martin(8)	140,046	*	*
Dan Maydan, Ph.D.(9)	68,750	*	*
Carl Redfield(10)	142,934	*	*
Pradeep S. Sindhu, Ph.D.(11)	50,000	*	*
Jagdeep Singh(12)	3,174,392	4.6	3.8
Duston M. Williams(13)	375,000	*	*

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William R. Zerella	107,811	*	*
Scott A. Chandler(14)	195,000	*	*
Michael O. McCarthy III(15)	319,766	*	*
David F. Welch, Ph.D.(16)	2,801,887	4.0	3.4
All current directors and executive officers as a group (14 persons)(17)	11,201,551	15.6	13.2

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- \* Less than 1% of the outstanding shares of common stock.
- (1) Consists of (i) 2,443,494 shares held of record by Advanced Equities Investments XXVII, LLC; (ii) 272,237 shares held of record by Advanced Equities Investments XXVIII, LLC; (iii) 1,107,169 shares held of record by Advanced Equities Investments XXXI, LLC; (iv) 1,851,851 shares held of record by AEI 2006 Venture Investments I, LLC; (v) 185,185 shares held of record by AEI Trilogy Fund I, LLC; and (vi) 600,784 shares issuable upon the exercise of warrants held by Advanced Equities, Inc. that are immediately exercisable at an exercise price of \$5.40 per share. The address for these entities is 311 S. Wacker Drive, Suite 1650, Chicago, Illinois 60606.
  - (2) Includes (i) 4,394,857 shares held by Kleiner Perkins Caufield & Byers X-A, L.P., (ii) 123,952 shares held by Kleiner Perkins Caufield & Byers X-B, L.P. and (iii) 1,903,502 shares held by individuals affiliated with Kleiner Perkins Caufield & Byers. The general partner of both Kleiner Perkins Caufield & Byers X-A, L.P. and Kleiner Perkins Caufield & Byers X-B, L.P. is Kleiner Perkins Caufield & Byers X Associates, LLC. Shares are held for convenience in the name of KPCB Holdings, Inc. as nominee for the account of entities affiliated with Kleiner Perkins Caufield & Byers and others. KPCB Holdings, Inc. has no voting, dispositive or pecuniary interest in any such shares. The address for all entities and individuals affiliated with Kleiner Perkins Caufield & Byers is 2750 Sand Hill Road, Menlo Park, California 94025.
  - (3) Consists of (i) 2,492,271 shares held of record by Mobius Technology Ventures VI L.P.; (ii) 101,921 shares held of record by Mobius Technology Ventures Side Fund VI L.P.; (iii) 97,093 shares held of record by Mobius Technology Ventures Advisors Fund VI L.P.; and (iv) 2,673,049 shares held of record by SOFTBANK U.S. Ventures Fund VI L.P. The address for these entities is 100 Superior Plaza Way, Suite 200, Superior, Colorado 80027.
  - (4) Consists of (i) 1,954,899 shares held of record by RWI Ventures I, L.P. and (ii) 1,495,370 shares held of record by RWI Ventures II, L.P. The general partner of RWI Ventures I, L.P. is RWI Ventures I, LLC; the general partner of RWI Ventures II, L.P. is RWI Ventures Management II, LLC. The address of these entities is 2440 Sand Hill Road, Suite 100, Menlo Park, California 94025.
  - (5) Consists of (i) options to purchase 75,000 shares exercisable within 60 days of March 31, 2007, none of which are vested and (ii) 2,657,763 shares held of record by Benchmark Capital Partners IV, L.P., as nominee for Benchmark Capital Partners IV, L.P., Benchmark Founders Fund IV, L.P., Benchmark Founders Fund IV-A, L.P., Benchmark Founders Fund IV-B, L.P., Benchmark Founders Fund IV-X, L.P. and related individuals. Dr. Balkanski is a managing member of Benchmark Capital Management Co. IV, L.L.C., which is the general partner of Benchmark Capital Partners IV, L.P. Dr. Balkanski disclaims beneficial ownership of the shares held by this fund except to the extent of his pecuniary interest therein. On May 7, 2007, our compensation committee approved the grant to Dr. Balkanski of an option to purchase 12,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 48 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007. The address of Dr. Balkanski and this fund is c/o Benchmark Capital Partners, 2480 Sand Hill Road, Suite 200, Menlo Park, California 94025.
  - (6) Consists of (i) 50,000 shares held of record by Kenneth A. Goldman, 22,526 of which are subject to a repurchase option we hold as of March 31, 2007; (ii) 18,518 shares held of record by the Goldman-Valeriotte Family Trust u/a/d 11/15/95; and (iii) options to purchase 37,500 shares exercisable within 60 days of March 31, 2007, of which 8,593 are fully vested. On May 7, 2007, our compensation committee approved the grant to Mr. Goldman of an option to purchase 12,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 48 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007. Mr. Goldman is a limited partner in certain Kleiner Perkins Caufield & Byers funds, RWI Ventures funds and Benchmark Capital Partners funds that hold 6,422,311, 3,450,269 and 2,657,763 shares of our common stock, respectively, as disclosed in footnotes 2, 4 and 5 to this table. Mr. Goldman disclaims beneficial ownership of these shares, except to the extent of his pecuniary interest therein.
  - (7) Consists of (i) 50,000 shares held of record by Reed Hundt, all of which are subject to a repurchase option we hold as of March 31, 2007 and (ii) options to purchase 25,000 shares exercisable within 60 days of March 31, 2007, none of which are vested. Mr. Hundt is a limited partner in certain Benchmark Capital Partners funds that hold an aggregate of 2,657,763 shares of our common stock, as disclosed in footnote 5 to this table. Mr. Hundt disclaims beneficial ownership of these shares, except to the extent of his pecuniary interest therein.

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- (8) Consists of (i) 50,000 shares held of record by Hugh Martin, 17,838 of which are subject to a repurchase option we hold as of March 31, 2007; (ii) 46,296 shares held of record by Hugh Martin and Moira Cullen Martin, Trustees of the HMCM Trust U/T/A October 14, 1992; and (iii) options to purchase 43,750 shares exercisable within 60 days of March 31, 2007, of which 10,026 are fully vested. On May 7, 2007, our compensation committee agreed to grant Mr. Martin an option to purchase 12,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 48 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (9) Consists of (i) 18,750 shares held of record by Dan Maydan, 15,234 of which are subject to a repurchase option we hold as of March 31, 2007; and (ii) 50,000 shares held of record by Dan Maydan, TTEE, Maydan Marital Share One UAD 05/06/00. On May 7, 2007, our compensation committee agreed to grant Dr. Maydan an option to purchase 12,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 48 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (10) Consists of (i) 75,000 shares held of record by Carl Redfield, all of which are subject to a repurchase option we hold as of March 31, 2007; and (ii) 67,934 shares held of record by Carl Redfield, Trustee of Carl Redfield Annuity Trust III dated November 6, 2006. On May 7, 2007, our compensation committee agreed to grant Mr. Redfield an option to purchase 12,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 48 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (11) Consists of 50,000 shares held of record by Pradeep Sindhu, 31,510 of which are subject to a repurchase option we hold as of March 31, 2007. On May 7, 2007, our compensation committee agreed to grant Dr. Sindhu an option to purchase 12,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 48 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (12) Consists of (i) 125,000 shares held of record by Jagdeep Singh Trustee of the Roshni Singh Annuity Trust dated 6/21/05; (ii) 1,802,874 shares held of record by Jagdeep Singh and Roshni Singh Trustees of the Singh Family Trust UDT dated 10/3/96; (iii) 125,000 shares held of record by Jagdeep Singh Trustee of the Jagdeep Singh Annuity Trust dated 6/21/06; (iv) 471,519 shares held of record by Jagdeep Singh, 148,437 of which are subject to a repurchase option we hold as of March 31, 2007; and (v) options to purchase 649,999 shares exercisable within 60 days of March 31, 2007, of which 211,979 are fully vested. On May 7, 2007, our compensation committee agreed to grant Mr. Singh an option to purchase 412,500 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 60 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007. As of March 31, 2007, Mr. Singh also holds proxies to vote an aggregate of 168,750 shares; by their terms, these proxies expire as of the consummation of an initial public offering and, as such, have been excluded from the numbers provided above. Mr. Singh is a limited partner in certain Kleiner Perkins Caufield & Byers funds and Benchmark Capital Partners that hold 6,422,311 and 2,657,763 shares of our common stock, respectively, as disclosed in footnotes 2 and 5 to this table. Mr. Singh is also a limited partner in certain Accel Partners funds that hold 1,419,023 shares of our common stock. Mr. Singh disclaims beneficial ownership of the shares held by Kleiner Perkins Caufield & Byers, Benchmark Capital Partners and Accel Partners, except to the extent of his pecuniary interest therein.
- (13) Consists of (i) 125,000 shares held of record by Duston Williams, 125,000 of which are subject to a repurchase option we hold as of March 31, 2007 and (ii) options to purchase 250,000 shares exercisable within 60 days of March 31, 2007, none of which are vested. On May 7, 2007, our compensation committee approved the grant to Mr. Williams of an option to purchase 206,250 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is

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- declared effective and will vest and become exercisable in 60 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (14) Consists of options to purchase 195,000 shares exercisable within 60 days of March 31, 2007, 100,623 of which are vested. On May 7, 2007, our compensation committee approved the grant to Mr. Chandler of an option to purchase 123,750 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 60 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (15) Consists of (i) 18,518 shares held of record by Michael O. and Jennifer D. McCarthy JTWROS; (ii) 174,326 shares held of record by Mike McCarthy, 63,775 of which are subject to a repurchase option we hold as of March 31, 2007; and (iii) options to purchase 126,922 shares exercisable within 60 days of March 31, 2007, 21,477 of which are fully vested. On May 7, 2007, our compensation committee approved the grant to Mr. McCarthy of an option to purchase 96,250 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 60 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007.
- (16) Consists of (i) 553,750 shares held of record by SEI Private Trust Company, Trustee of Welch Family Heritage Trust I u/l dated 9/24/01; (ii) 329,998 shares held of record by David Welch, 99,686 of which are subject to a repurchase option we hold as of March 31, 2007; (iii) 500,000 shares held of record by Welch Group, L.P., a limited partnership of which Dr. Welch is the general partner; (iv) 1,214,284 shares held of record by LRFA, LLC, a limited liability company of which Dr. Welch is the sole managing member; (v) 16,355 shares held of record by Welch Family Trust dated 4/3/96; and (vi) options to purchase 187,500 shares exercisable within 60 days of March 31, 2007, of which 42,968 are fully vested. On May 7, 2007, our compensation committee approved the grant to Dr. Welch of an option to purchase 206,250 shares of our common stock. This option will be effective as of the date the registration statement, of which this prospectus forms a part, is declared effective and will vest and become exercisable in 60 equal monthly installments. The securities underlying this option have been excluded from the numbers provided above as no shares subject to the option were beneficially owned as of March 31, 2007. As of March 31, 2007, Dr. Welch also holds proxies to vote an aggregate of 23,750 shares; by their terms, these proxies expire as of the consummation of an initial public offering and, as such, have been excluded from the numbers provided above.
- (17) Consists of (i) 9,132,880 shares held of record by the current directors and executive officers, 785,535 of which are subject to repurchase rights we hold as of March 31, 2007; and (ii) options to purchase 2,068,671 shares exercisable within 60 days of March 31, 2007, of which 489,396 are fully vested. This number excludes the shares held of record by William R. Zerella, our former chief financial officer, who left the company in July 2006.



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**DESCRIPTION OF CAPITAL STOCK**

**General**

The following is a summary of our capital stock and certain provisions of our amended and restated certificate of incorporation and amended and restated bylaws, as they will be in effect upon the closing of this offering. This summary does not purport to be complete and is qualified in its entirety by the provisions of our amended and restated certificate of incorporation and amended and restated bylaws, copies of which have been filed as exhibits to the registration statement of which this prospectus is a part.

Following the closing of this offering, our authorized capital stock will consist of 500,000,000 shares of common stock, par value \$0.001 per share, and 25,000,000 shares of convertible preferred stock, par value \$0.001 per share.

As of March 31, 2007, assuming the conversion of all outstanding shares of our convertible preferred stock into common stock, we had outstanding 69,136,638 shares of common stock, held of record by 604 stockholders.

**Common Stock**

The holders of common stock are entitled to one vote per share on all matters to be voted upon by the stockholders. The holders of common stock are entitled to receive ratably such dividends, if any, as may be declared from time to time by the board of directors out of funds legally available, subject to preferences that may be applicable to convertible preferred stock, if any, then outstanding. See the section titled "Dividend Policy." In the event of a liquidation, dissolution or winding up of our company, the holders of common stock are entitled to share ratably in all assets remaining after payment of liabilities, subject to prior distribution rights of convertible preferred stock, if any, then outstanding. The common stock has no preemptive or conversion rights or other subscription rights. There are no redemption or sinking fund provisions applicable to the common stock. All outstanding shares of common stock are fully paid and non-assessable, and the shares of common stock to be issued upon completion of this offering will be fully paid and non-assessable.

**Convertible Preferred Stock**

Upon the closing of this offering,

the 3,690,629 shares of our Series A convertible preferred stock will be converted into 3,812,409 shares of common stock;

the 2,112,529 shares of our Series B convertible preferred stock will be converted into 2,367,932 shares of common stock;

the 1,334,776 shares of our Series C convertible preferred stock will be converted into 1,580,242 shares of common stock;

the 6,919,591 shares of our Series D convertible preferred stock will be converted into 6,919,591 shares of common stock;

the 21,590,036 shares of our Series E convertible preferred stock will be converted into 21,590,036 shares of common stock;

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the 2,722,563 shares of our Series F convertible preferred stock will be converted into 2,722,563 shares of common stock; and

the 20,434,833 shares of our Series G convertible preferred stock will be converted into 20,434,833 shares of common stock.

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Our board of directors is authorized to issue convertible preferred stock in one or more series, to establish the number of shares to be included in each such series and to fix the designation, powers, preferences and rights of such shares and any qualifications, limitations or restrictions thereof. The issuance of convertible preferred stock may have the effect of delaying, deferring or preventing a change in control of our company without further action by the stockholders and may adversely affect the voting and other rights of the holders of common stock. The issuance of convertible preferred stock with voting and conversion rights may adversely affect the voting power of the holders of common stock, including the loss of voting control to others. At present, we have no plans to issue any of the convertible preferred stock.

## **Warrants**

As of March 31, 2007, we had outstanding warrants to purchase:

36,299 shares of our common stock at an exercise price of \$8.96 per share, which after this offering will remain outstanding and will become exercisable for a like number of shares of our common stock;

135,000 shares of our Series A convertible preferred stock at an exercise price of \$10.00 per share, which after this offering will remain outstanding and will become exercisable for 139,455 shares of our common stock;

15,884 shares of our Series B convertible preferred stock at an exercise price of \$13.944 per share, which after this offering will remain outstanding and will become exercisable for 17,803 shares of our common stock;

291,664 shares of our Series E convertible preferred stock at an exercise price of \$2.40 per share, which after this offering will remain outstanding and will become exercisable for a like number of shares of our common stock;

19,824 shares of our Series F convertible preferred stock at an exercise price of \$3.7832 per share, which after this offering will remain outstanding and will become exercisable for a like number of shares of our common stock; and

827,635 shares of our Series G convertible preferred stock at an exercise price of \$5.40 per share, which after this offering will remain outstanding and will become exercisable for a like number of shares of our common stock.

## **Registration Rights**

The holders of an aggregate of 59,427,606 shares of our common stock, including shares of common stock issuable upon the conversion of our convertible preferred stock, are entitled to the Demand, Piggyback and Form S-3 registration rights set forth below with respect to registration of the resale of such shares under the Securities Act pursuant to an investors' rights agreement by and among us and certain of our stockholders. In addition, the holders of an additional 407,172 shares of registrable securities issued or issuable upon exercise of warrants are also entitled to certain registration rights. Finally, the holders of an aggregate of 3,000,000 shares of our common stock, specifically founders shares purchased by Jagdeep Singh, Drew D. Perkins and David F. Welch, are entitled to the Piggyback registration rights set forth below. As applicable, we refer to these shares collectively as registrable securities.

Registration of shares of common stock in response to exercise of the following rights would result in the holders being able to trade these shares without restriction under the Securities Act when the applicable registration statement is declared effective. We generally must pay all expenses, other than underwriting discounts, taxes and commissions, related to any registration effected pursuant to the exercise of these registration rights.



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The registration rights terminate upon the earlier of five years after completion of this offering, or with respect to the registration rights of an individual holder, when the holder of one percent or less of our outstanding common stock can sell all of such holder's registrable securities in any three-month period without registration, in compliance with Rule 144 of the Securities Act or another similar exception.

### *Demand Registration Rights*

If, at any time after the earlier to occur of six months after completion of this offering or June 10, 2010, the holders of at least 40% of the registrable securities request in writing that an amount of securities covering at least 40% of the registrable securities outstanding be registered, we may be required to register their shares. We are only obligated to effect one registration in response to these demand registration rights for the holders of registrable securities. Depending on certain conditions, however, we may defer such registration for up to 120 days. The underwriters of any underwritten offering have the right to limit the number of shares registered by these holders for marketing reasons.

### *Piggyback Registration Rights*

If at any time we propose to register any shares of our common stock under the Securities Act after this offering, subject to certain exceptions, the holders of registrable securities will be entitled to notice of the registration and to include their share of registrable securities in the registration. The underwriters of any underwritten offering have the right to limit the number of shares registered by these holders for marketing reasons, subject to certain limitations.

### *Form S-3 Registration Rights*

The holders of at least 20% of the registrable securities may request in writing that we effect a registration on Form S-3 under the Securities Act, when registration of our shares under Form S-3 becomes possible, and when the proposed aggregate offering price of the shares to be registered by the holders requesting registration is at least \$5,000,000, subject to certain exceptions.

## **Anti-Takeover Effects of Our Charter and Bylaws and Delaware Law**

Some provisions of Delaware law and our amended and restated certificate of incorporation and amended and restated bylaws could make the following transactions more difficult:

acquisition of our company by means of a tender offer, a proxy contest or otherwise; and

removal of our incumbent officers and directors.

These provisions, summarized below, are expected to discourage and prevent coercive takeover practices and inadequate takeover bids. These provisions are designed to encourage persons seeking to acquire control of our company to first negotiate with our board of directors. They are also intended to provide our management with the flexibility to enhance the likelihood of continuity and stability if our board of directors determines that a takeover is not in our best interests or the best interests of our stockholders. These provisions, however, could have the effect of discouraging attempts to acquire us, which could deprive our stockholders of opportunities to sell their shares of common stock at prices higher than prevailing market prices. We believe that the benefits of these provisions, including increased protection of our potential ability to negotiate with the proponent of an unfriendly or unsolicited proposal to acquire or restructure our company, outweigh the disadvantages of discouraging takeover proposals, because negotiation of takeover proposals could result in an improvement of their terms.

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*Classified Board.* Our amended and restated certificate of incorporation that will become effective as of the closing of this offering provides for a classified board of directors consisting of three classes of directors, each serving a staggered three-year term. Commencing in 2008 a portion of our board of directors will be elected each year for three-year terms. Upon the closing of this offering:

Drs. Balkanski and Sindhu will be designated Class I directors whose term will expire at the 2008 annual meeting of stockholders;

Messrs. Martin and Singh and Dr. Maydan will be designated Class II directors whose term will expire at the 2009 annual meeting of stockholders; and

Messrs. Goldman, Hundt and Redfield will be designated Class III directors whose term expires at the 2010 annual meeting of stockholders.

*Election and Removal of Directors.* Our amended and restated certificate of incorporation and our amended and restated bylaws contain provisions that establish specific procedures for appointing and removing members of the board of directors. Under our amended and restated certificate of incorporation and amended and restated bylaws, vacancies and newly created directorships on the board of directors may be filled only by a majority of the directors then serving on the board. Under our amended and restated certificate of incorporation and amended and restated bylaws, directors may be removed by the stockholders only for cause.

*Special Stockholder Meetings.* Under our amended and restated bylaws, only the chairperson of our board of directors, our chief executive officer, our president (in the absence of our chief executive officer) or a majority of the authorized number of our directors may call special meetings of stockholders.

*Requirements for Advance Notification of Stockholder Nominations and Proposals.* Our amended and restated bylaws establish advance notice procedures with respect to stockholder proposals and the nomination of candidates for election as directors.

*Delaware Anti-Takeover Law.* We are subject to Section 203 of the Delaware General Corporation Law, which is an anti-takeover law. In general, Section 203 prohibits a publicly-held Delaware corporation from engaging in a business combination with an interested stockholder for a period of three years following the date that the person became an interested stockholder, unless the business combination or the transaction in which the person became an interested stockholder is approved in a prescribed manner. Generally, a business combination includes a merger, asset or stock sale, or another transaction resulting in a financial benefit to the interested stockholder. Generally, an interested stockholder is a person who, together with affiliates and associates, owns, or within three years prior to the date of determination of interested stockholder status did own, 15% or more of the corporation's voting stock. The existence of this provision may have an anti-takeover effect with respect to transactions that are not approved in advance by our board of directors, including discouraging attempts that might result in a premium over the market price for the shares of common stock held by stockholders.

*Elimination of Stockholder Action by Written Consent.* Our amended and restated certificate of incorporation and amended and restated bylaws eliminate the right of stockholders to act by written consent without a meeting.

*No Cumulative Voting.* Our amended and restated certificate of incorporation and amended and restated bylaws do not provide for cumulative voting in the election of directors. Cumulative voting allows a minority stockholder to vote a portion or all of its shares for one or more candidates for seats on the board of directors. Without cumulative voting, a minority stockholder will not be able to gain as many seats on our board of directors based on the number of shares of our stock the stockholder holds

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as the stockholder would be able to gain if cumulative voting were permitted. The absence of cumulative voting makes it more difficult for a minority stockholder to gain a seat on our board of directors to influence our board of director s decision regarding a takeover.

*Undesignated Preferred Stock.* The authorization of undesignated preferred stock makes it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to change control of our company.

These and other provisions may have the effect of deferring hostile takeovers or delaying changes in control or management.

**Transfer Agent and Registrar**

The transfer agent and registrar for our common stock will be Wells Fargo Shareowner Services. Their address is 161 North Concord Exchange, South St. Paul, Minnesota 55075 and telephone number is (800) 401-1957.

**NASDAQ Global Market Listing**

Our common stock has been approved for listing on the NASDAQ Global Market under the symbol INFN.

**Table of Contents****SHARES ELIGIBLE FOR FUTURE SALE**

Prior to this offering, there has been no public market for our common stock, and we cannot assure you that a significant public market for our common stock will develop or be sustained after this offering. As described below, no shares currently outstanding will be available for sale immediately after this offering due to certain contractual and securities law restrictions on resale. Sales of substantial amounts of our common stock in the public market after the restrictions lapse could cause the prevailing market price to decline and limit our ability to raise equity capital in the future.

Upon completion of this offering, we will have outstanding an aggregate of 83,136,638 shares of common stock, assuming no exercise of the underwriters' option to purchase additional shares and no exercise of options or warrants to purchase common stock that were outstanding as of March 31, 2007. The shares of common stock being sold in this offering will be freely tradable without restriction or further registration under the Securities Act unless purchased by our affiliates.

The remaining 69,136,638 shares of common stock held by existing stockholders are restricted securities as that term is defined in Rule 144 under the Securities Act. Restricted securities may be sold in the public market only if registered or if they qualify for an exemption from registration under Section 4(1) or Rules 144, 144(k) or 701 promulgated under the Securities Act. We describe these rules in greater detail below.

The following table shows approximately when the 69,136,638 shares of our common stock that are not being sold in this offering, but which will be outstanding when this offering is complete, will be eligible for sale in the public market:

**Eligibility of Restricted Shares for Sale in the Public Market**

<b>Days After Date of this Prospectus</b>	<b>Shares Eligible for Sale</b>	<b>Comment</b>
180 days, subject to reduction or extension	68,665,254	Lock-up released, subject to modification or extension; shares saleable under Rules 144, 144(k) and 701
Thereafter	471,384	Restricted securities held for one year or less
Resale of 26,767,349 of the restricted shares that will become available for sale in the public market starting 180 days after the effective date will be limited by volume and other resale restrictions under Rule 144 because the holders are our directors, executive officers or are otherwise our affiliates.		

**Lock-up Agreements**

Our officers, directors and substantially all of our stockholders have agreed not to transfer or dispose of, directly or indirectly, any shares of our common stock, or any securities convertible into or exercisable or exchangeable for shares of our common stock, for a period of 180 days after the date of this prospectus, without the prior written consent of Goldman, Sachs & Co., which period of restriction may be extended for up to an additional 34 days under certain limited circumstances. Goldman, Sachs & Co. currently does not anticipate shortening or waiving any of the lock-up agreements and does not have any pre-established conditions for such modifications or waivers. Goldman, Sachs & Co. may, however, in its sole discretion at any time and without notice, release for sale in the public market all or any portion of the shares subject to the lock-up agreement.



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### **Rule 144**

In general, under Rule 144 as currently in effect, beginning 90 days after the date of this prospectus, a person who has beneficially owned restricted shares for at least one year, including the holding period of any prior owner except an affiliate, would be entitled to sell within any three month period a number of shares that does not exceed the greater of:

1% of the number of shares of common stock then outstanding that will equal approximately 831,366 shares immediately after this offering; or

the average weekly trading volume of the common stock during the four calendar weeks preceding the filing of a Form 144 with respect to such sale.

Sales under Rule 144 are also subject to certain manner of sale provisions and notice requirements and to the availability of current public information about us.

Under Rule 144(k), a person who is not deemed to have been one of our affiliates at any time during the three months preceding a sale, and who has beneficially owned the shares proposed to be sold for a least two years, including the holding period of any prior owner except an affiliate, is entitled to sell such shares without complying with the manner of sale, public information, volume limitation or notice provisions of Rule 144.

### **Rule 701**

Rule 701, as currently in effect, permits resales of shares in reliance upon Rule 144 but without compliance with certain restrictions, including the holding period requirement, of Rule 144. An employee, officer or director of or consultant to us who purchased shares under a written compensatory plan or contract may be entitled to rely on the resale provisions of Rule 701. Rule 701 permits affiliates to sell their Rule 701 shares under Rule 144 without complying with the holding period requirements of Rule 144. Rule 701 further provides that non-affiliates may sell such shares in reliance on Rule 144 without having to comply with the holding period, public information, volume limitation or notice provisions of Rule 144. All holders of Rule 701 shares are required to wait until 90 days after the date of this prospectus before selling such shares. All Rule 701 shares are, however, subject to lock-up agreements and will only become eligible for sale upon the expiration of the 180-day lock up agreements. Goldman, Sachs & Co. may, in its sole discretion and at any time without notice, release all or any portion of the securities subject to lock up agreements.

### **Registration Rights**

Upon the closing of this offering, the holders of 62,427,606 shares of our common stock and the holders of warrants to purchase 407,172 shares of our common stock have the right to have their shares registered under the Securities Act. See the section titled Description of Capital Stock Registration Rights. All such shares are covered by lock-up agreements. Following the expiration of the lock-up period, registration of these shares under the Securities Act would result in the shares becoming freely tradable without restriction under the Securities Act immediately upon the effectiveness of the registration, except for shares purchased by our affiliates.

We have agreed not to file any registration statements during the 180-day period after the date of this prospectus with respect to the registration of any shares of common stock or any securities convertible into or exercisable or exchangeable into common stock, other than one or more registration statements on Form S-8 covering securities under our stock plans, without the prior written consent of Goldman, Sachs & Co.

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**Form S-8 Registration Statement**

Following the effective date of this offering, we will file a Registration Statement on Form S-8 registering 24,035,738 shares of common stock outstanding, subject to outstanding options or reserved for future issuance under our stock plans. As of March 31, 2007, options to purchase a total of 8,220,738 shares were outstanding. Effective on the date of this prospectus, June 6, 2007, we have 13,600,000 shares reserved for issuance under our 2007 Equity Incentive Plan and 1,812,500 shares of common stock reserved for issuance under our 2007 Employee Stock Purchase Plan. See the section titled "Management Equity Benefit Plans." Subject to the lock-up agreements described above and any applicable vesting restrictions, shares registered under these registration statements will be available for resale in the public market immediately upon the effectiveness of these registration statements, except with respect to Rule 144 volume limitations that apply to our affiliates.

**Table of Contents****UNDERWRITING**

The company and the underwriters named below have entered into an underwriting agreement with respect to the shares being offered. Subject to certain conditions, each underwriter has severally agreed to purchase the number of shares indicated in the following table. Goldman, Sachs & Co., Citigroup Global Markets Inc., J.P. Morgan Securities Inc., Lehman Brothers Inc. and Thomas Weisel Partners LLC are the representatives of the underwriters.

Underwriters	Number of Shares
Goldman, Sachs & Co.	6,300,000
Citigroup Global Markets Inc.	2,100,000
J.P. Morgan Securities Inc.	2,100,000
Lehman Brothers Inc.	2,100,000
Thomas Weisel Partners LLC	1,400,000
<b>Total</b>	<b>14,000,000</b>

The underwriters are committed to take and pay for all of the shares being offered, if any are taken, other than the shares covered by the option described below unless and until this option is exercised.

If the underwriters sell more shares than the total number set forth in the table above, the underwriters have an option to buy up to an additional 2,100,000 shares from the company to cover such sales. They may exercise that option for 30 days. If any shares are purchased pursuant to this option, the underwriters will severally purchase shares in approximately the same proportion as set forth in the table above.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriters by the company. Such amounts are shown assuming both no exercise and full exercise of the underwriters' option to purchase additional shares.

	Paid by Infinera	No Exercise	Full Exercise
Per Share		\$ 0.91	\$ 0.91
Total		\$ 12,740,000	\$ 14,651,000

Shares sold by the underwriters to the public will initially be offered at the initial public offering price set forth on the cover of this prospectus. Any shares sold by the underwriters to securities dealers may be sold at a discount of up to \$0.55 per share from the initial public offering price. If all the shares are not sold at the initial public offering price, the representatives may change the offering price and the other selling terms.

The company and its officers, directors, and holders of substantially all of the company's common stock have agreed with the underwriters, subject to certain exceptions, not to dispose of or hedge any of their common stock or securities convertible into or exchangeable for shares of common stock during the period from the date of this prospectus continuing through the date 180 days after the date of this prospectus except with the prior written consent of the representatives. The representatives do not have specific criteria for providing an exception to this restricted period. Any such exceptions will be made at the sole discretion of the representatives. This agreement does not apply to any existing employee benefit plans. See "Shares Eligible for Future Sale" for a discussion of certain transfer restrictions.

The 180-day restricted period described in the preceding paragraph will be automatically extended if: (1) during the last 17 days of the 180-day restricted period the company issues an earnings release or announces material news or a material event; or (2) prior to the expiration of the 180-day restricted

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period, the company announces that it will release earnings results during the 15-day period following the last day of the 180-day period, in which case the restrictions described in the preceding paragraph will continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release or the announcement of the material news or material event.

Prior to the offering, there has been no public market for the shares. The initial public offering price was negotiated among the company and the representatives. Among the factors considered in determining the initial public offering price of the shares, in addition to prevailing market conditions, was the company's historical performance, estimates of the business potential and earnings prospects of the company, an assessment of the company's management and the consideration of the above factors in relation to market valuation of companies in related businesses.

The common stock has been approved for listing on the NASDAQ Global Market under the symbol `INFN`.

In connection with the offering, the underwriters may purchase and sell shares of common stock in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. Covered short sales are sales made in an amount not greater than the underwriters' option to purchase additional shares from the company in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase additional shares pursuant to the option granted to them. Naked short sales are any sales in excess of such option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common stock in the open market after pricing that could adversely affect investors who purchase in the offering. Stabilizing transactions consist of various bids for or purchases of common stock made by the underwriters in the open market prior to the completion of the offering.

The underwriters may also impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representatives have repurchased shares sold by or for the account of such underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions, as well as other purchases by the underwriters for their own accounts, may have the effect of preventing or retarding a decline in the market price of the company's stock, and together with the imposition of the penalty bid, may stabilize, maintain or otherwise affect the market price of the common stock. As a result, the price of the common stock may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued at any time. These transactions may be effected on NASDAQ Global Market, in the over-the-counter market or otherwise.

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), each underwriter has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the Relevant Implementation Date) it has not made and will not make an offer of shares to the public in that Relevant Member State prior to the publication of a prospectus in relation to the shares which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority

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in that Relevant Member State, all in accordance with the Prospectus Directive, except that it may, with effect from and including the Relevant Implementation Date, make an offer of shares to the public in that Relevant Member State at any time:

- (a) to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;
- (b) to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than €43,000,000 and (3) an annual net turnover of more than €50,000,000, as shown in its last annual or consolidated accounts;
- (c) to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the representatives for any such offer; or
- (d) in any other circumstances which do not require the publication by the Issuer of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an offer of shares to the public in relation to any shares in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the shares to be offered so as to enable an investor to decide to purchase or subscribe the shares, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

Each underwriter has represented and agreed that:

- 1.1 it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of section 21 of FSMA) received by it in connection with the issue or sale of the shares in circumstances in which Section 21(1) of the FSMA would not, if the issuer was not an authorised person, apply to the issuer; and
- 1.2 it has complied and will comply with all applicable provisions of FSMA with respect to anything done by it in relation to the shares in, from or otherwise involving the United Kingdom.

The shares may not be offered or sold by means of any document other than (i) in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap. 32, Laws of Hong Kong), or (ii) to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder, or (iii) in other circumstances which do not result in the document being a prospectus within the meaning of the Companies Ordinance (Cap. 32, Laws of Hong Kong), and no advertisement, invitation or document relating to the shares may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to shares which are or are intended to be disposed of only to persons outside Hong Kong or only to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder.

This prospectus has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the shares may not be circulated or



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distributed, nor may the shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the SFA ), (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the shares are subscribed or purchased under Section 275 by a relevant person which is: (a) a corporation (which is not an accredited investor) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries' rights and interest in that trust shall not be transferable for 6 months after that corporation or that trust has acquired the shares under Section 275 except: (1) to an institutional investor under Section 274 of the SFA or to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA; (2) where no consideration is given for the transfer; or (3) by operation of law.

The securities have not been and will not be registered under the Securities and Exchange Law of Japan (the Securities and Exchange Law) and each underwriter has agreed that it will not offer or sell any securities, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

The underwriters do not expect sales to discretionary accounts to exceed five percent of the total number of shares offered.

The company estimates that its share of the total expenses of the offering, excluding underwriting discounts and commissions, will be approximately \$4.1 million.

The company has agreed to indemnify the several underwriters against certain liabilities, including liabilities under the Securities Act.

Certain of the underwriters and their respective affiliates have, from time to time, performed, and may in the future perform, various financial advisory and investment banking services for the company, for which they received or will receive customary fees and expenses.

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**INDUSTRY AND MARKET DATA**

We obtained the industry, market and competitive position data throughout this prospectus from our own internal estimates and research as well as from industry and general publications and research, surveys and studies conducted by third parties. Industry publications, studies and surveys generally state that they have been obtained from sources believed to be reliable, although they do not guarantee the accuracy or completeness of such information. While we believe that each of these studies and publications is reliable, we have not independently verified market and industry data from third-party sources. While we believe our internal company research is reliable and the market definitions are appropriate, neither such research nor these definitions have been verified by any independent source.

**LEGAL MATTERS**

The validity of the common stock being offered will be passed upon for the company by Wilson Sonsini Goodrich & Rosati, Professional Corporation, Palo Alto, California. The underwriters are being represented by Cooley Godward Kronish LLP, Palo Alto, California. As of the date of this prospectus, an attorney employed by Wilson Sonsini Goodrich & Rosati, Professional Corporation beneficially owns 20,000 shares of our common stock.

**EXPERTS**

Ernst & Young, LLP, an independent registered public accounting firm, has audited our consolidated financial statements at December 31, 2005 and 2006 for each of the three years in the period ended December 31, 2006, as set forth in their report. We have included our financial statements in the prospectus and elsewhere in the registration statement in reliance on Ernst & Young, LLP's report, given on their authority as experts in accounting and auditing.

**WHERE YOU CAN FIND MORE INFORMATION**

We have filed with the SEC a registration statement on Form S-1 under the Securities Act with respect to the shares of common stock we are offering. This prospectus contains all information about us and our common stock that may be material to an investor in this offering. The registration statement includes exhibits to which you should refer for additional information about us.

You may inspect a copy of the registration statement and the exhibits and schedules to the registration statement without charge at the offices of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You may obtain copies of all or any part of the registration statement from the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549 upon the payment of the prescribed fees. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains a web site at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements and other information regarding registrants like us that file electronically with the SEC. You can also inspect our registration statement on this web site.



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**REPORT OF ERNST & YOUNG LLP, INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders

Infinera Corporation

We have audited the accompanying consolidated balance sheets of Infinera Corporation as of December 31, 2005 and 2006, and the related consolidated statements of operations, convertible preferred stock and stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Infinera Corporation at December 31, 2005 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 1 and 2 to the consolidated financial statements, on January 1, 2006, the Company adopted FASB No. 123 (revised 2004), *Share-Based Payment* and on July 1, 2005, the Company adopted FASB Staff Position 150-5 (FSP 150-5) *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*.

/s/ ERNST & YOUNG LLP

San Jose, California

May 3, 2007, except as to Note 1, as to which the date is May 15, 2007

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**INFINERA CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except per share data)

	December 31,		March 31,	Pro Forma Stockholders Equity as of March 31, 2007 (see Note 1) (Unaudited)
	2005	2006	2007	
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 36,013	\$ 28,884	\$ 38,970	
Short-term investments	1,099	688	692	
Accounts receivable	3,410	42,148	19,951	
Receivables from disposition of acquired assets	1,450			
Inventory	24,653	58,269	57,329	
Deferred inventory costs	5,084	62,936	70,127	
Prepaid expenses and other current assets	790	3,115	5,293	
<b>Total current assets</b>	<b>72,499</b>	<b>196,040</b>	<b>192,362</b>	
Property, plant and equipment, net	14,534	26,665	29,484	
Intangible assets	788	1,806	1,740	
Deferred inventory costs, non-current	11,603	4,317	3,331	
Other non-current assets	1,488	1,638	953	
<b>Total assets</b>	<b>\$ 100,912</b>	<b>\$ 230,466</b>	<b>\$ 227,870</b>	
<b>LIABILITIES, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)</b>				
Current liabilities:				
Accounts payable	\$ 14,518	\$ 41,767	\$ 27,069	
Accrued expenses	6,039	16,574	16,609	
Accrued compensation and related benefits	2,507	7,628	6,573	
Accrued warranty	798	1,339	3,112	
Deferred revenue	6,636	101,080	121,099	
Preferred stock warrant liability		5,409	7,909	
Current portion of debt obligation	12,422	20,025	22,860	
<b>Total current liabilities</b>	<b>42,920</b>	<b>193,822</b>	<b>205,231</b>	
Long-term portion of debt obligation	11,351	8,357	11,036	
Accrued warranty, non-current	894	1,378	3,696	
Deferred revenue, non-current	16,564	9,873	7,321	
Preferred stock warrant liability, non-current	1,941			
Long-term exercised unvested options	359	996	1,489	
Other long-term liabilities	446	1,811	2,957	

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

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**INFINERA CORPORATION**  
**CONSOLIDATED BALANCE SHEETS (Continued)**

(In thousands, except per share data)

	December 31,		March 31,	Pro Forma Stockholders Equity as of March 31, 2007 (see Note 1) (Unaudited)
	2005	2006	2007	
Commitments and contingencies (Note 9)				
Convertible preferred stock (total aggregate liquidation preference of \$325,227 as of December 31, 2006 and March 31, 2007 (unaudited)):				
Series A convertible preferred stock, \$0.001 par value:				
Authorized shares 3,919 in 2005, 2006 and March 31, 2007 (unaudited); issued and outstanding shares 3,691 in 2005, 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$36,906 as of December 31, 2006 and March 31, 2007 (unaudited))	36,789	36,789	36,789	
Series B convertible preferred stock, \$0.001 par value:				
Authorized shares 2,128 in 2005, 2006 and March 31, 2007 (unaudited); issued and outstanding shares 2,112 in 2005, 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$29,457 as of December 31, 2006 and March 31, 2007 (unaudited))	29,350	29,350	29,350	
Series C convertible preferred stock, \$0.001 par value:				
Authorized shares 1,335 in 2005, 2006 and March 31, 2007 (unaudited); issued and outstanding shares 1,335 in 2005, 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$24,400 as of December 31, 2006 and March 31, 2007 (unaudited))	24,301	24,301	24,301	
Series D convertible preferred stock, \$0.001 par value:				
Authorized shares 7,143 in 2005, 2006 and March 31, 2007 (unaudited); issued and outstanding shares 6,920 in 2005, 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$62,000 as of December 31, 2006 and March 31, 2007 (unaudited))	61,749	61,749	61,749	
Series E convertible preferred stock, \$0.001 par value:				
Authorized shares 22,975 in 2005, 2006 and March 31, 2007 (unaudited); issued and outstanding shares 21,590 in 2005, 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$51,816 as of December 31, 2006 and March 31, 2007 (unaudited))	53,167	53,167	53,167	
Series F convertible preferred stock, \$0.001 par value:				
Authorized shares 3,000 in 2005, 2006 and March 31, 2007 (unaudited); issued and outstanding shares 2,723 in 2005, 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$10,300 as of December 31, 2006 and March 31, 2007 (unaudited))	10,252	10,252	10,252	
Series G convertible preferred stock, \$0.001 par value:				
Authorized shares 9,500 in 2005 and 21,500 in 2006 and March 31, 2007 (unaudited); issued and outstanding shares 6,304 in 2005 and 20,435 in 2006 and March 31, 2007 (unaudited); and no shares outstanding pro forma (unaudited) (aggregate liquidation preference of \$110,348 as of December 31, 2006 and March 31, 2007 (unaudited))	31,539	104,942	104,942	
Total convertible preferred stock:	247,147	320,550	320,550	

## Edgar Filing: Shutterstock, Inc. - Form 10-Q

### Stockholders' equity (deficit):

Common stock, \$0.001 par value;

Authorized shares 67,500, 79,500 and 79,500 in 2005, 2006 and March 31, 2007 (unaudited), respectively, and 79,500 shares authorized pro forma (unaudited); issued and outstanding shares 6,000, 9,054 and 9,710 in 2005, 2006, and March 31, 2007 (unaudited), respectively, and 69,137 shares outstanding at March 31, 2007, pro forma (unaudited)

	6	9	10	69
Additional paid-in capital	3,523	7,911	9,624	338,024
Accumulated other comprehensive loss	(86)	(153)	(143)	(143)
Accumulated deficit	(224,153)	(314,088)	(333,901)	(333,901)
Total stockholders' equity (deficit)	(220,710)	(306,321)	(324,410)	\$ 4,049
Total liabilities, convertible preferred stock and stockholders' equity (deficit)	\$ 100,912	\$ 230,466	\$ 227,870	

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

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

(In thousands, except per share data)

	Years Ended December 31,			Three Months Ended	
	2004	2005	2006	March 31, 2006	March 31, 2007 (Unaudited)
<b>Revenue:</b>					
Ratable product and related support and services	\$	\$ 4,127	\$ 52,978	\$ 2,653	\$ 45,947
Product		599	5,258		3,245
Total revenue		599	4,127	58,236	2,653
<b>Cost of revenue:</b>					
Cost of ratable product and related support and services			17,759	48,072	5,485
Lower of cost or market adjustment	1,587	9,696	21,693	4,325	1,067
Cost of product	5,653		1,660		1,363
Total cost of revenue	7,240	27,455	71,425	9,810	37,273
Gross profit (loss)	(6,641)	(23,328)	(13,189)	(7,157)	11,919
<b>Operating expenses:</b>					
Sales and marketing	8,294	11,053	20,682	2,701	7,636
Research and development	46,306	24,986	38,967	6,446	16,058
General and administrative	2,888	4,328	12,650	1,378	5,557
Amortization of intangible assets			56		37
Total operating expenses	57,488	40,367	72,355	10,525	29,288
Loss from operations	(64,129)	(63,695)	(85,544)	(17,682)	(17,369)
<b>Other income (expense), net:</b>					
Interest income	1,166	686	2,100	226	185
Interest expense	(1,949)	(2,768)	(4,852)	(990)	(1,063)
Other gain (loss), net	(1,568)	(174)	(1,567)	268	(1,537)
Total other income (expense), net	(2,351)	(2,256)	(4,319)	(496)	(2,415)
Loss before provision of income taxes and cumulative effect of change in accounting principle	(66,480)	(65,951)	(89,863)	(18,178)	(19,784)
Provision for income taxes		12	72	15	29
Loss before cumulative effect of change in accounting principle	(66,480)	(65,963)	(89,935)	(18,193)	(19,813)
Cumulative effect of change in accounting principle		(1,137)			
Net loss	\$ (66,480)	\$ (64,826)	\$ (89,935)	\$ (18,193)	\$ (19,813)
Net loss per common share, basic and diluted	\$ (17.94)	\$ (14.08)	\$ (14.90)	\$ (3.63)	\$ (2.62)
<b>Weighted average shares used in computing basic and diluted net loss per common share</b>					
	3,705	4,605	6,036	5,010	7,560

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Pro forma net loss per common share, basic and diluted (unaudited)	\$ (1.49)	\$ (0.36)	\$ (0.30)
Weighted average shares used in computing pro forma basic and diluted net loss per common share (unaudited)	60,389	50,762	66,988

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

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## INFINERA CORPORATION

## CONSOLIDATED STATEMENTS OF CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)

For the Years Ended December 31, 2004, 2005, 2006 and the Three Months Ended March 31, 2007

(In thousands, except per share data)

	Convertible Preferred Stock		Common Stock		Additional Deferred		Accumulated		Total
	Shares	Amount	Shares	Amount	Capital	Compensation	Loss	Deficit	
Balance at December 31, 2003	13,835	\$ 151,865	4,275	\$ 4	\$ 2,091	\$ (225)	\$ (223)	\$ (92,847)	\$ (91,200)
Exercise of stock options			559	1	730				731
Reclassification of options exercised but not vested					90				90
Issuance of Series D convertible preferred stock for cash at \$8.96 per share, net of issuance costs of \$58	446	3,942							
Transfer of Series D convertible preferred stock at \$8.96 per share to Series E convertible preferred stock at \$2.40 per share	(223)	(2,000)							
Issuance of Series E convertible preferred stock at \$2.40 per share, net of issuance costs of \$111	21,590	51,705							
Issuance of Series E convertible preferred stock in exchange for Series D convertible preferred stock		1,464							
Amortization of deferred stock-based compensation related to change in employment status						180			180
Issuance of warrants to purchase Series E convertible preferred stock at \$2.40 per share in connection with debt		339							
Issuance of warrants to purchase common stock at \$8.96 per share in connection with debt					29				29
Stock options issued to non-employees					34				34
Comprehensive loss:									
Unrealized gain on available-for-sale investments							133		133
Foreign currency translation adjustment							12		12
Net loss								(66,480)	(66,480)
Total comprehensive loss									(66,335)
Balance at December 31, 2004	35,648	\$ 207,315	4,834	\$ 5	\$ 2,974	\$ (45)	\$ (78)	\$ (159,327)	\$ (156,471)



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

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## INFINERA CORPORATION

## CONSOLIDATED STATEMENTS OF CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)

For the Years Ended December 31, 2004, 2005, 2006 and the Three Months Ended March 31, 2007 (Continued)

(In thousands, except per share data)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Deferred Compensation	Other Comprehensive Loss	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount					
Balance at December 31, 2004 (brought forward)	35,648	\$ 207,315	4,834	\$ 5	\$ 2,974	\$ (45)	\$ (78)	\$ (159,327)	\$ (156,471)
Issuance of common stock			1,162	1	994				995
Issuance of Series F convertible preferred stock at \$3.78 per share, net of issuance costs of \$53	2,723	10,247							
Issuance of Series G convertible preferred stock at \$5.40 per share, net of issuance costs of \$2,451 and receivable of \$50	6,304	31,717							
Issuance of restricted stock at \$1.84 per share in exchange for services			8		14				14
Repurchase of common stock at \$1.84 per share			(4)		(7)				(7)
Reclassification of options exercised but not vested					(520)				(520)
Reclassification of warrants to liabilities		(2,132)			(29)				(29)
Stock options issued to non-employees					7				7
Amortization of deferred stock-based compensation related to change in employment status						45			45
Compensation charge related to non-recourse notes					90				90
Comprehensive loss:									
Unrealized gain on available-for-sale investments							71		71
Foreign currency translation adjustment							(79)		(79)
Net loss								(64,826)	(64,826)
Total comprehensive loss									(64,834)
Balance at December 31, 2005	44,675	\$ 247,147	6,000	\$ 6	\$ 3,523	\$	\$ (86)	\$ (224,153)	\$ (220,710)

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



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## INFINERA CORPORATION

## CONSOLIDATED STATEMENTS OF CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)

For the Years Ended December 31, 2004, 2005, 2006 and the Three Months Ended March 31, 2007 (Continued)

(In thousands, except per share data)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss		Deficit	Total
	Shares	Amount	Shares	Amount		Loss	Accumulated		
Balance at December 31, 2005 (brought forward)	44,675	\$ 247,147	6,000	\$ 6	\$ 3,523	\$ (86)	\$ (224,153)	\$ (220,710)	
Stock options exercised			3,066	3	4,374			4,377	
Stock options repurchased			(12)		(7)			(7)	
Issuance of Series G convertible preferred stock at \$5.40 and \$7.36 per share, net of issuance costs of \$3,089	14,131	73,403							
Proceeds from non-recourse notes					261			261	
Stock options issued to non-employees					22			22	
Reclassification of options exercised but not vested					(1,335)			(1,335)	
Stock-based compensation					876			876	
Stock-based compensation expense related to non-recourse notes					197			197	
Comprehensive loss:									
Unrealized gain on available-for-sale investments						(2)		(2)	
Foreign currency translation adjustment						(65)		(65)	
Net loss							(89,935)	(89,935)	
Total comprehensive loss								(90,002)	
Balance at December 31, 2006	58,806	\$ 320,550	9,054	\$ 9	\$ 7,911	\$ (153)	\$ (314,088)	\$ (306,321)	

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

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## INFINERA CORPORATION

## CONSOLIDATED STATEMENTS OF CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)

For the Years Ended December 31, 2004, 2005, 2006 and the Three Months Ended March 31, 2007 (Continued)

(In thousands, except per share data)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Accumulated		Total
	Shares	Amount	Shares	Amount		Loss	Deficit	
Balance at December 31, 2006 (brought forward)	58,806	\$ 320,550	9,054	\$ 9	\$ 7,911	\$ (153)	\$ (314,088)	\$ (306,321)
Stock options exercised (unaudited)			666	1	1,643			1,644
Stock options repurchased (unaudited)			(10)		(20)			(20)
Stock options issued to non-employees (unaudited)					42			42
Reclassification of options exercised but not vested (unaudited)					(1,123)			(1,123)
Stock-based compensation (unaudited)					527			527
Stock-based compensation expense related to non-recourse notes (unaudited)					644			644
Comprehensive loss:								
Unrealized gain on available-for-sale investments (unaudited)						(1)		(1)
Foreign currency translation adjustment (unaudited)						11		11
Net loss (unaudited)							(19,813)	(19,813)
Total comprehensive loss (unaudited)								(19,803)
Balance at March 31, 2007 (unaudited)	58,806	\$ 320,550	9,710	\$ 10	\$ 9,624	\$ (143)	\$ (333,901)	\$ (324,410)

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

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**INFINERA CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
<b>Cash Flows from Operating Activities:</b>					
Net loss	\$ (66,480)	\$ (64,826)	\$ (89,935)	\$ (18,193)	\$ (19,813)
Adjustments to reconcile net loss to net cash used in operating activities:					
Depreciation and amortization	5,561	6,374	7,458	1,674	2,253
In-process research and development			4,474		
Amortization of debt discount	345	219	218	57	83
Issuance of warrants			189		
Revaluation of warrant liabilities		(883)	2,376	(119)	2,500
Stock-based compensation expense related to employees			876	70	527
Amortization of deferred stock-based compensation	180	45			
Stock-based compensation expense related to non-recourse notes		90	197		644
Stock-based compensation expense for stock options granted to non-employees	34	7	22	2	42
Gain from disposal of fixed assets					(20)
Gain on sale of assets held for sale					(894)
Changes in assets and liabilities:					
Accounts receivable	(2,947)	(463)	(38,738)	(4,410)	22,193
Inventory	(8,030)	(16,466)	(33,616)	(1,808)	940
Prepaid expenses and other current assets	(172)	93	(2,325)	(12)	(2,178)
Deferred inventory costs		(16,686)	(50,566)	(9,862)	(6,205)
Other non-current assets	1,406	92	(555)	(9)	538
Accounts payable	4,379	7,793	27,249	(6,157)	(14,698)
Accrued liabilities and other expenses	3,061	3,711	16,123	5,629	(507)
Deferred revenue	441	22,759	87,753	11,149	17,467
Accrued warranty		1,692	1,025	364	4,091
<b>Net cash provided by (used in) operating activities</b>	<b>(62,222)</b>	<b>(56,449)</b>	<b>(67,775)</b>	<b>(21,625)</b>	<b>6,963</b>
<b>Cash Flows from Investing Activities:</b>					
Purchase of short-term investments	(88,234)	(2,715)	(6,501)		
Proceeds from sale or maturity of short-term investments	101,275	36,672	6,912	1,098	
Proceeds from disposition of acquired assets		200	1,450	1,050	
Proceeds from disposal of fixed assets					30
Proceeds from sale of assets held for sale					1,109
Purchase of property and equipment	(3,279)	(4,006)	(15,255)	(2,078)	(5,164)
Change in prepaid deposit for equipment	(479)				
Acquisition of certain assets, net		(700)	(4,675)		
<b>Net cash provided by (used in) investing activities</b>	<b>9,283</b>	<b>29,451</b>	<b>(18,069)</b>	<b>70</b>	<b>(4,025)</b>

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

**Table of Contents****INFINERA CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

(In thousands)

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
<b>Cash Flows from Financing Activities:</b>					
Principal payments on loan obligation	(11,362)	(12,629)	(21,520)	(5,129)	(1,605)
Cash payments for debt issuance costs		(185)	(14)		
Proceeds from loans	7,127	27,244	21,628	12,071	7,119
Proceeds from issuance of common stock	731	1,009	4,377	270	1,644
Proceeds from issuance of convertible preferred stock, net of issuance costs	55,112	42,627	74,055	8,440	
Proceeds from non-recourse notes			261		
Repurchase of common stock		(7)	(7)		(20)
<b>Net cash provided by financing activities</b>	<b>51,608</b>	<b>58,059</b>	<b>78,780</b>	<b>15,652</b>	<b>7,138</b>
Effect of exchange rate changes	\$ 12	\$ (79)	\$ (65)	\$ (11)	\$ 10
<b>Net change in cash and cash equivalents</b>	<b>(1,319)</b>	<b>30,982</b>	<b>(7,129)</b>	<b>(5,914)</b>	<b>10,086</b>
Cash and cash equivalents at beginning of period	6,350	5,031	36,013	36,016	28,884
<b>Cash and cash equivalents at end of period</b>	<b>\$ 5,031</b>	<b>\$ 36,013</b>	<b>\$ 28,884</b>	<b>\$ 30,102</b>	<b>\$ 38,970</b>
<b>Supplemental disclosures of cash flow information:</b>					
Cash paid for interest	\$ 1,944	\$ 1,629	\$ 3,585	\$ 560	\$ 1,042
Cash paid for income taxes	\$	\$ 5	\$ 28	\$ 7	\$ 47
<b>Supplemental schedules of non-cash investing and financing activities</b>					
Issuance of warrants in connection with debt arrangements	\$ 368	\$ 179	\$	\$	\$
Debt assumed in connection with acquisition of certain assets of Big Bear Networks, Inc.	\$	\$ 2,000	\$	\$	\$
Debt assumed in connection with acquisition of certain assets of Little Optics, Inc.	\$	\$	\$ 4,500	\$	\$
Issuance of convertible preferred stock warrants in connection with Series G financing and the acquisition of certain assets of Little Optics, Inc.	\$	\$ 660	\$ 902	\$	\$
Issuance of common stock for notes receivables	\$ 183	\$	\$	\$	\$
Debt placement fees	\$	\$ 800	\$	\$	\$

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

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Significant Accounting Policies**

**Organization**

Infinera Corporation (the Company) was founded in December 2000 and has developed a digital optical communications system called the Infinera DTN System. The Company began commercial shipment of its DTN System in November 2004.

**Significant Accounting Policies**

***Basis of Financial Statements***

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

On February 16, 2007, the Board of Directors approved a 1-for-4 reverse stock split of the Company's outstanding shares of common stock and convertible preferred stock that was effected on May 15, 2007. All issued and outstanding common stock, convertible preferred stock and per share amounts contained in the financial statements have been retroactively adjusted to reflect this reverse stock split.

The accompanying unaudited interim consolidated financial statements as of March 31, 2007 and for the three months ended March 31, 2006 and 2007 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations.

In the opinion of management, the unaudited interim consolidated financial statements as of March 31, 2007 and for the three months ended March 31, 2006 and 2007 have been prepared on the same basis as the audited consolidated statements and reflect all adjustments, which are normal recurring adjustments, necessary for the fair presentation of our statement of financial position, results of operations and cash flows. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

***Fiscal Calendar***

Commencing in 2007, the Company operates and reports financial results on a fiscal year of 52 or 53 weeks ending on the last Saturday of December in each year. In previous years, the Company operated and reported financial results on a calendar year basis. Accordingly, the three-month periods ended March 31, 2006 and 2007 each comprised of 13 weeks. The current fiscal year ends on December 29, 2007 and is comprised of 52 weeks.

***Unaudited Pro Forma Stockholders' Equity***

The Company has filed a registration statement with the U.S. Securities and Exchange Commission to sell shares of its common stock to the public. If the initial public offering is completed under the terms presently anticipated, all of the Series A, B, C, D, E, F and G convertible preferred stock outstanding at March 31, 2007 will be converted into 59,427,606 shares of common stock. Unaudited pro forma stockholders' deficit, as adjusted for the assumed conversion of all Series A, B, C, D, E, F and G convertible preferred stock, is set forth in the accompanying consolidated balance sheets. In addition, the convertible preferred and common stock warrant liability of \$7.9 million at March 31, 2007 will be



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**INFINERA CORPORATION**

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

reclassified to common stock and additional paid-in-capital. Pro forma stockholders' equity, as adjusted for the assumed conversion of the convertible preferred stock and convertible preferred stock warrants, is set forth on the consolidated balance sheet.

***Use of Estimates***

The consolidated financial statements are prepared in accordance with generally accepted accounting principles (GAAP) in the United States. These accounting principles require the Company to make certain estimates, assumptions and judgments that can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates, assumptions and judgments made by management include revenue recognition, inventory valuation and the determination of the fair value of stock awards and warrants issued. Management believes that the estimates and judgments upon which they rely are reasonable based upon information available to them at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, the Company's consolidated financial statements will be affected.

***Revenue Recognition***

The Company's networking products are generally integrated with software that is more than incidental to the functionality of the equipment. Accordingly, the Company accounts for revenue in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. The Company recognizes product revenue when all of the following have occurred: (1) it has entered into a legally binding arrangement with a customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed or determinable; and (4) collectibility is reasonably assured. Revenue is recognized net of cash discounts.

Substantially all of the Company's product sales have been sold in combination with training and product support services, which consist of software warranty, updates and product support.

Software updates provide customers with rights to unspecified software product upgrades and to maintenance releases and patches released during the term of the support period. Product support includes internet access to technical content, telephone and internet access to technical support personnel. Training services include the right to a specified number of training classes over the term of the arrangement.

Vendor specific objective evidence (VSOE) of fair value for training and product support services is determined by reference to the price the customer will be required to pay when training and product support services are sold separately. To date, the Company has not established VSOE of fair value for training and product support services. Assuming all other revenue recognition criteria have been met and the only undelivered element is training or product support services, revenue is deferred and recognized ratably over the longest undelivered service period. The undelivered service periods range from one to five years. Revenue related to these arrangements is included in ratable product and related support and services revenue in the accompanying consolidated statements of operations.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify

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

delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product is specified by the customer, revenue is deferred until all acceptance criteria have been met. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 90 days from product acceptance. In the event payment terms are provided that differ from the Company's standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is deferred until the fees become fixed or determinable which the Company believes is when they are legally due and payable. The Company assesses the ability to collect from its customers based primarily on the creditworthiness of the customer and past payment history of the customer.

Revenue for products that does not require significant customization, and with respect to which any software is considered incidental, is recognized under Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104). Under SAB 104, revenue is recognized only when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable and collectibility is reasonably assured. Revenue related to these arrangements is included in product revenue in the accompanying consolidated statements of operations.

Shipping charges billed to customers are included in product revenue and in ratable product and related support and services revenue. The related shipping costs are included in cost of product sales and cost of ratable product and related support and services in the accompanying consolidated statements of operations.

***Stock-Based Compensation***

Prior to January 1, 2006, the Company accounted for employee stock options using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB No. 25) and Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25*. The intrinsic value represents the difference between the per share market price of the stock on the date of grant and the per share exercise price of the related stock option. The Company grants stock options to employees for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. Under APB Opinion No. 25, no compensation expense is recorded for employee stock options granted at an exercise price equal to the market price of the underlying stock on the date of grant. The Company recognizes compensation expense for any stock options granted with an exercise price that is less than the fair value of the underlying stock on the date of grant on a straight-line basis over the vesting period.

On January 1, 2006, the Company adopted the provisions of the Statement of Accounting Standards (SFAS) No. 123(R) *Share-Based Payments* (SFAS 123(R)). Under SFAS 123(R), stock-based compensation costs for employees is measured at the grant date, based on the estimated fair value of the award at that date, and is recognized as expense over the employee's requisite service period, which is generally over the vesting period, on a straight-line basis. The Company adopted the provisions of SFAS 123(R) using the prospective transition method. Under this transition method, non-vested option awards outstanding at January 1, 2006 continue to be accounted for under the minimum value method under SFAS No. 123, *Accounting for Stock-Based Compensation*. All awards granted, modified or settled after the date of adoption are accounted for using the measurement, recognition and attribution provisions of SFAS 123(R).

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the effects of stock-based compensation related to employees, non-recourse notes and non-employees for 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006 (Unaudited)	2007 (Unaudited)
Cost of revenue	\$	\$	\$ 151	\$ 14	\$ 88
Sales and marketing		36	198	12	87
Research and development	180	99	411	27	822
General and administrative	34	7	335	19	216
<b>Total stock-based compensation effects in loss before taxes</b>	<b>\$ 214</b>	<b>\$ 142</b>	<b>\$ 1,095</b>	<b>\$ 72</b>	<b>\$ 1,213</b>

During 2006, the Company granted options to employees to purchase a total of 4.7 million shares of common stock at exercise prices ranging from \$1.32 to \$2.00 per share at a weighted average price of \$1.96. During the three months ended March 31, 2007, the Company granted options to employees to purchase a total of 1.1 million shares of common stock at exercise prices of \$4.04 and \$7.68 per share at a weighted average price of \$4.64. These options have exercise prices equal to the deemed market value of the Company's common stock on the dates these options were granted.

The Company makes a number of estimates and assumptions related to SFAS 123(R). The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from the Company's estimates, such amounts will be recorded as an adjustment in the period estimates are revised. Actual results may differ substantially from these estimates. In valuing share-based awards under SFAS 123(R), significant judgment is required in determining the expected volatility of common stock and the expected term individuals will hold their share-based awards prior to exercising. Expected volatility of the stock is based on the Company's peer group in the industry in which the Company does business because the Company does not have sufficient historical volatility data for its own stock. The expected term of options granted represents the period of time that options granted are expected to be outstanding and was calculated based on historical information. In the future, as the Company gains historical data for volatility in its own stock and more data on the actual term employees hold their options, the expected volatility and expected term may change, which could substantially change the grant-date fair value of future awards of stock options and ultimately the expense the Company records.

For 2006, the total compensation cost related to stock-based awards granted under SFAS 123(R) to employees and directors but not yet amortized was approximately \$5.2 million, net of estimated forfeitures of \$0.4 million. These costs will be amortized on a straight-line basis over a weighted average period of approximately 1.1 years. Amortization of stock-based compensation in 2006 was approximately \$0.9 million. Basic and diluted loss per share for 2006 were \$0.15 higher than if the Company had continued to account for stock-based compensation under APB No. 25.

For the three months ended March 31, 2007, the total compensation cost related to stock-based awards granted under SFAS 123(R) to employees and directors but not yet amortized was approximately \$7.4 million, net of estimated forfeitures of \$0.6 million. Amortization of stock-based compensation in the three months ended March 31, 2007 was approximately \$0.5 million.

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

The fair value of each option grant is estimated on the date of grant using the following weighted-average assumptions used for grants in 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007:

	Years Ended December 31,			Three Months Ended March 31,	
	2004	2005	2006	2006	2007
				(Unaudited)	
Dividend					
Volatility	0%	0%	72% - 83%	77% - 83%	62% - 71%
Risk-free interest rate	3.00%	4.05%	4.57% - 5.08%	4.81% - 4.82%	4.50% - 4.51%
Weighted-average expected life	4 years	4 years	4.2 - 5.4 years	4.2 - 5.4 years	4.3 - 5.1 years
Weighted-average fair value of common stock	\$0.15	\$0.15	\$0.81 - \$1.35	\$0.80 - \$0.92	\$2.12 - \$4.80

The Company accounts for stock options granted to non-employees in accordance with Emerging Issues Task Force (EITF) No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, Goods or Services* (EITF No. 96-18) and related interpretations. The Company grants stock options to certain consultants and non-employee advisory board members for a fixed number of shares with an exercise price equal to the fair value of the Company's common stock at the date of grant. Under EITF No. 96-18, compensation expense on non-employee stock options is calculated using the Black Scholes option-pricing model and is recorded using the straight-line method over the vesting period, which approximates the service period. Total compensation expense related to options granted to consultants was not material for 2004, 2005, 2006, and the three months ended March 31, 2006 and 2007, respectively.

***Inventory Valuation***

Inventories consist of raw materials, work-in-process and finished goods and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing for our products and technological obsolescence of the Company's products.

Inventory that is obsolete or in excess of the Company's forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand.

The Company recorded total inventory write-downs for lower of cost or market (LCM) adjustments in 2004, 2005 and 2006 of \$1.6 million, \$9.7 million and \$21.7 million, respectively, and in the three months ended March 31, 2006 and 2007 of \$4.3 million and \$1.1 million, respectively. These adjustments related to the Company's inventory and firm purchase commitments with suppliers and are reflected as costs of product and cost of ratable product and related support and services. In addition, the Company recorded inventory write-downs for excess and obsolete inventory in 2004, 2005 and 2006 of \$2.2 million, \$(0.7) million and \$1.7 million, respectively, and in the three months ended March 31, 2006 and 2007 of \$1.1 million and \$1.4 million, respectively. These write-downs for excess and obsolete inventory were reflected as cost of product and cost of ratable product and related support and services.

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

In valuing its deferred inventory costs, the Company considered the valuation of inventory using the guidance of Accounting Research Bulletin 43 *Restatement and Revision of Accounting Research Bulletins* ( ARB 43 ). In particular, the Company considered ARB 43, Chapter 4, Statement 5 and whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. The Company concluded that, in the instances where the utility of the products delivered or expected to be delivered were less than cost, it was appropriate to value the deferred inventory costs and inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. The Company has, therefore, recorded inventory write-downs as necessary in each period in order to reflect common equipment inventory at the lower of cost or market. In addition, the Company considered the guidance provided in ARB 43, Chapter 4, Statement 10 relating to losses on firm purchase commitments related to inventory items. Given that the expected selling price of common equipment in the future remains below cost, the Company has also recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

***Allowances for Doubtful Accounts***

Management makes judgments as to its ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices. At December 31, 2005, December 31, 2006 and March 31, 2007, management has not reserved any of the Company's accounts receivable as they were deemed fully collectible.

***Warranty Reserve***

Upon delivery of the Company's products, it provides for the estimated cost to repair or replace products or the related components that maybe returned under warranty. In general, the Company's hardware warranty periods range from 2 to 5 years. Hardware product warranties provide the customer with protection in the event that the product does not perform to product specifications. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. Warranty reserves amounted to \$1.7 million, \$2.7 million and \$6.8 million at December 31, 2005, December 31, 2006 and March 31, 2007, respectively. There was no warranty activity in 2004.

***Cash Equivalents and Short-term Investments***

The Company considers all liquid instruments with an original maturity at the date of purchase of 90 days or less to be cash equivalents. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

The Company considers all instruments with remaining time to maturity of one year or less to be short-term investments. At December 31, 2005 and 2006 and at March 31, 2007, cash equivalents and short-term investments consisted primarily of money market funds, commercial paper and municipal bonds. The Company's cash equivalents and short-term investments are classified as available-for-

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

sale in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

All cash equivalents and short-term investments are stated at fair market value based on quoted market prices with unrealized gains and losses reported in accumulated comprehensive loss as a separate component of stockholders' equity (deficit). The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Realized gains and losses, and declines in value judged to be other-than-temporary, which were insignificant, are recorded as a component of interest income using the specific-identification method.

***Fair Values of Financial Instruments***

The carrying value of cash and cash equivalents approximates fair value due to the short of time to maturity. Fair values of short-term investments are based on quoted market prices. The fair values of the Company's obligations under lines of credit and term loans are based on current rates offered to the Company for similar debt instruments of the same remaining maturities. The carrying value of the Company's lines of credit and term loans approximated fair value at December 31, 2005 and 2006 and at March 31, 2007. The fair value of the convertible preferred stock warrant liabilities was estimated using a combination of both the Black-Scholes and Lattice models.

***Property, Plant and Equipment***

Property, plant and equipment is stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. An assumption of lease renewal where a renewal option exists is used only when the renewal has been determined to be reasonably assured. Repair and maintenance costs are expensed as incurred. The estimated useful life for each asset category is as follows:

	<b>Estimated Useful lives</b>
Laboratory and manufacturing equipment	1.5 to 10 years
Furniture and fixtures	5 years
Computer hardware and software	1.5 to 3 years
Leasehold improvements	1 to 7 years

The Company regularly reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable or that the useful life is shorter than originally estimated. If impairment indicators are present and the projected future undiscounted cash flows are less than the carrying value of the assets, the carrying values are reduced to the estimated fair value. If assets are determined to be recoverable, but the useful lives are shorter than originally estimated, the carrying value of the assets is depreciated over the newly determined remaining useful lives. No impairment losses have been recognized through March 31, 2007.

***Valuation of Intangibles***

The Company tests for asset impairment of amortizing intangible assets using the guidance of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, where recoverability

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**INFINERA CORPORATION**

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

of these assets is assessed only when events have occurred that may give rise to impairment. When events or circumstances indicate that a potential impairment may have occurred, future undiscounted net cash flows associated with the related asset or group of assets over their remaining lives are compared to the current carrying amounts of such assets. When projected cash flows are less than the carrying amounts of the intangibles, an impairment loss would be recognized by comparing the discounted present value of future cash flows to carrying amounts and writing down the excess of the carrying amounts to their respective fair values. No impairment losses have been recognized through March 31, 2007.

***Deferred Inventory Costs***

When the Company's products have been delivered, but the product revenue associated with the arrangement has been deferred as a result of not meeting the revenue recognition criteria in SOP 97-2, the Company also defers the related inventory costs for the delivered items in accordance with ARB 43.

***Accounting for Income Taxes***

As part of the process of preparing the Company's consolidated financial statements, the Company is required to estimate its taxes in each of the jurisdictions in which it operates. The Company estimates actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in the Company's consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carry-forwards are utilized. Accordingly, realization of the Company's deferred tax assets is dependent on future taxable income against which these deductions, losses and credits can be utilized.

The Company must assess the likelihood that the Company's deferred tax assets will be recovered from future taxable income, and to the extent the Company believes that recovery is not likely the Company must establish a valuation allowance. Management judgment is required in determining the Company's provision for income taxes, the Company's deferred tax assets and liabilities and any valuation allowance recorded against the Company's net deferred tax assets. The Company recorded a full valuation allowance as of December 31, 2006 because, based on the available evidence, the Company believed at that time it was more likely than not that it would not be able to utilize all of its deferred tax assets in the future. The Company intends to maintain the full valuation allowances until sufficient evidence exists to support the reversal of the valuation allowances. The Company makes estimates and judgments about its future taxable income that are based on assumptions that are consistent with its plans and estimates. Should the actual amounts differ from the Company's estimates, the amount of the Company's valuation allowance could be materially impacted.

***Concentration of Credit Risk***

Financial instruments that are potentially subject to concentrations of credit risk consist primarily of cash, cash equivalents, short-term investments and trade receivables. Investment policies have been implemented that limit investments to investment grade securities. Credit risk with respect to

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

trade receivables is mitigated by credit evaluations the Company performs on its customers and by the financial strength of the Company's customer base. Collateral is not required for trade receivables. In 2004, the Company had one customer that represented 100% of revenues. Level 3 and Broadwing, which Level 3 acquired in January 2007, together accounted for approximately 28%, 75%, 59% and 57% of the Company's revenue in 2005, 2006 and the three months ended March 31, 2006 and 2007, respectively. In 2005, the Company had four other customers that each represented over 10% of the Company's revenue. In 2006, the Company had no other customer that represented more than 10% of revenue. In the three months ended March 31, 2006, the Company had one other customer that represented approximately 18% of revenue. In the three months ended March 31, 2007, the Company had one other customer that represented approximately 13% of revenue.

The Company depends on a single or limited number of suppliers for components and raw materials. The Company generally purchases these single or limited source components and materials through standard purchase orders and has no long-term guarantee supply agreements with its suppliers. While the Company seeks to maintain sufficient reserve stock of such products, the Company's business and results of operations could be adversely affected by a stoppage or delay in receiving such components and materials, the receipt of defective parts, an increase in price of such components and materials or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures.

***Foreign Currency Translation and Transactions***

The Company considers the functional currencies of its foreign subsidiaries to be the local currency. Assets and liabilities recorded in foreign currencies are translated at the exchange rate as of the balance sheet date, and costs and expenses are translated at average exchange rates in effect during the year. Equity transactions are translated using historical exchange rates. The effects of foreign currency translation adjustments are recorded as a separate component of stockholders' equity (deficit) in the accompanying consolidated balance sheet. Foreign denominated monetary accounts have been remeasured to the U.S. dollar. Aggregate foreign currency transaction gains (losses) recorded were not material in 2004, 2005, 2006 and the three months ended March 31, 2006 and 2007, respectively.

***Other Accumulated Comprehensive Loss***

Comprehensive loss consists of other comprehensive loss and net loss. Other comprehensive loss includes certain changes in equity that are excluded from net loss. Specifically, cumulative foreign currency translation adjustments are included in other accumulated comprehensive loss. Comprehensive loss has been reflected in the consolidated statements of convertible preferred stock and stockholders' equity (deficit).

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

	December 31,		Three Months Ended March 31,	
	2005	2006	2006	2007
			(Unaudited)	
Accumulated net unrealized loss on foreign currency translation adjustment	\$ (87)	\$ (153)	\$ (98)	\$ (142)
Net unrealized holding gain (loss) on available-for-sale investments	1		1	(1)
Other accumulated comprehensive loss	\$ (86)	\$ (153)	\$ (97)	\$ (143)



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**INFINERA CORPORATION**

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

***Advertising***

All advertising costs are expensed as incurred. Advertising expenses were approximately \$63,000, \$56,000, and \$0.2 million in 2004, 2005 and 2006, respectively, and approximately \$21,000 and \$84,000 for the three months ended March 31, 2006 and 2007, respectively.

***Research and Development***

All costs to develop the Company's hardware products are expensed as incurred. Software development costs are capitalized beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers. Generally, the Company's products are released soon after technological feasibility has been established. As a result, costs subsequent to achieving technological feasibility have not been significant and all software development costs have been expensed as incurred.

***Freestanding Convertible Preferred Stock Warrants***

Freestanding warrants and other similar instruments related to shares that are redeemable are accounted for in accordance with FASB Staff Position (FSP) No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (FSP 150-5). Under FSP 150-5, the freestanding warrants that are related to the Company's convertible preferred stock and common stock are classified as liabilities on the consolidated balance sheet. The warrants will be subject to re-measurement at each balance sheet date and any change in fair value will be recognized as a component of other income (expense), net. The Company will continue to adjust the liability for changes in fair value until the earlier of the exercise of the warrants or the completion of a liquidation event, including the completion of an initial public offering, at which time the liability will be reclassified as common stock and additional paid-in-capital.

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. Cumulative Effect of Change in Accounting Principle**

On June 29, 2005, the FASB issued FSP 150-5. This Staff Position affirms that such warrants are subject to the requirements in FSP 150-1, regardless of the timing of the redemption feature or the redemption price. Therefore, under FSP 150-5, the freestanding warrants that are related to the Company's convertible preferred stock and common stock are liabilities that should be recorded at fair value. The Company previously accounted for freestanding warrants for the purchase of the Company's convertible preferred stock under EITF No. 96-18.

Effective July 1, 2005, the Company adopted FSP 150-5 and reclassified the fair value of the warrants from equity to liability and recorded a cumulative effect of \$1.1 million. In addition, the Company recorded charges of \$0.2 million to reflect the increase in fair value between July 1, 2005 and December 31, 2005. In 2006, the Company recorded \$2.4 million of charges in other loss, net to reflect the increase in fair value between January 1, 2006 and December 31, 2006. In the three months ended March 31, 2006, the Company recorded \$(0.1) million of charges in other loss, net to reflect the increase in fair value between January 1, 2006 and March 31, 2006. In the three months ended March 31, 2007, the Company recorded \$2.5 million of charges in other loss, net to reflect the increase in fair value between January 1, 2007 and March 31, 2007. The calculation of fair value requires the input of highly subjective assumptions and changes in those assumptions could materially affect the fair value estimates.

## December 31, 2005

Warrants	Per Exercise Share			Change of Control Scenario Expected			Per Share			IPO Scenario			Per Share Value
	Price	Value	Probability	Term (yrs)	Interest Rate	Volatility	Value	Probability	Remaining Contractual Term (yrs)	Interest Rate	Volatility		
Series A	\$ 10.00	\$ 0.56	100%	0.3	4.08%	60%	0.57	0%	0.3	4.08%	60%	\$ 0.57	
Series A	10.00	0.88	100%	0.5	4.14%	60%	0.89	0%	0.5	4.14%	60%	0.89	
Series A	10.00	2.88	90%	1.9	4.40%	70%	2.82	10%	2.5	4.39%	75%	3.40	
Series B	13.96	3.60	90%	1.9	4.40%	70%	3.47	10%	3.2	4.38%	80%	4.90	
Series E	2.40	2.24	90%	1.9	4.40%	70%	2.20	10%	6.0	4.36%	85%	2.63	
Series F	3.80	2.20	90%	1.9	4.40%	70%	2.11	10%	6.5	4.36%	85%	2.79	
Series G	5.40	2.48	90%	1.9	4.40%	65%	2.39	10%	4.9	4.36%	80%	3.26	
Series G	5.40	2.48	90%	1.9	4.40%	65%	2.39	10%	5.0	4.36%	80%	3.27	
Common Stock	8.96	0.08	90%	1.9	4.40%	75%	0.05	10%	7.5	4.37%	95%	0.44	
Common Stock	8.96	0.08	90%	1.9	4.40%	75%	0.05	10%	8.5	4.38%	95%	0.44	

## December 31, 2006

Warrants	Per Exercise Share			Change of Control Scenario Expected			Per Share			IPO Scenario			Per Share Value
	Price	Value	Probability	Term (yrs)	Interest Rate	Volatility	Value	Probability	Remaining Contractual Term (yrs)	Interest Rate	Volatility		
Series A	\$ 10.00	\$ 3.28	40%	0.9	5.01%	60%	\$ 2.85	60%	1.5	4.91%	65%	\$ 3.60	
Series B	13.96	3.72	40%	0.9	5.01%	60%	2.68	60%	2.2	4.81%	70%	4.43	
Series E	2.40	5.36	40%	0.9	5.01%	60%	5.28	60%	5.0	4.70%	75%	5.44	
Series F	3.80	4.72	40%	0.9	5.01%	60%	4.40	60%	5.5	4.70%	75%	4.91	
Series G	5.40	3.88	40%	0.9	5.01%	55%	3.41	60%	3.9	4.71%	70%	4.20	
Series G	5.40	3.88	40%	0.9	5.01%	55%	3.41	60%	4.0	4.71%	70%	4.19	
Series G	5.40	3.88	40%	0.9	5.01%	55%	3.41	60%	4.4	4.71%	70%	4.22	
Series G	5.40	3.88	40%	0.9	5.01%	55%	3.41	60%	4.5	4.71%	70%	4.21	
Series G	5.40	3.88	40%	0.9	5.01%	55%	3.41	60%	4.6	4.71%	70%	4.23	
Common Stock	8.96	0.92	40%	0.9	5.01%	65%	0.19	60%	6.5	4.70%	85%	1.44	
	8.96	0.88	40%	0.9	5.01%	65%	0.19	60%	7.5	4.70%	85%	1.36	

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Common Stock												
Common Stock	8.96	1.00	40%	0.9	5.01%	65%	0.19	60%	8.5	4.71%	85%	1.53

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Warrants	Per		Change of Control Scenario				March 31, 2007 (Unaudited)			IPO Scenario			Per Share Value
	Exercise Price	Share Value	Probability	Expected Term (yrs)	Interest Rate	Volatility	Per Share Value	Probability	Remaining Contractual Term (yrs)	Interest Rate	Volatility		
Series A	\$ 10.00	\$ 3.60	10%	0.3	4.97%	55%	\$ 2.49	90%	1.3	4.89%	60%	\$ 3.72	
Series B	13.96	3.48	10%	0.3	4.97%	55%	1.27	90%	2.0	4.57%	65%	3.73	
Series E	2.40	8.36	10%	0.3	4.97%	55%	8.35	90%	4.8	4.52%	70%	8.34	
Series F	3.80	7.04	10%	0.3	4.97%	55%	7.01	90%	5.2	4.52%	70%	7.03	
Series G	5.40	5.60	10%	0.3	4.97%	50%	5.43	90%	3.6	4.52%	65%	5.64	
Series G	5.40	5.64	10%	0.3	4.97%	50%	5.43	90%	3.8	4.52%	65%	5.64	
Series G	5.40	5.64	10%	0.3	4.97%	50%	5.43	90%	3.9	4.52%	65%	5.65	
Series G	5.40	5.60	10%	0.3	4.97%	50%	5.43	90%	4.1	4.52%	65%	5.62	
Series G	5.40	5.60	10%	0.3	4.97%	50%	5.43	90%	4.3	4.52%	65%	5.63	
Series G	5.40	5.60	10%	0.3	4.97%	50%	5.43	90%	4.4	4.52%	65%	5.63	
Common Stock	8.96	4.04	10%	0.3	4.97%	60%	2.33	90%	6.3	4.55%	80%	4.22	
Common Stock	8.96	4.20	10%	0.3	4.97%	60%	2.33	90%	7.3	4.59%	80%	4.40	
Common Stock	8.96	4.24	10%	0.3	4.97%	60%	2.33	90%	8.3	4.61%	80%	4.44	
Common Stock	8.96	4.32	10%	0.3	4.97%	60%	2.33	90%	9.1	4.61%	80%	4.55	

The Company will continue to adjust the liabilities for changes in fair value until the earlier of the exercise of the warrants or the completion of a liquidation event, including the completion of an initial public offering, at which time the liabilities will be reclassified to stockholders equity (deficit).

The Company estimated the fair value of these warrants using the Black-Scholes model for change of control scenario and the Lattice model for a successful initial public offering scenario. The Company then used a probability weighted average of per-share values under the different scenarios to determine the fair value of these warrants at the respective balance sheet dates.

Both models require the Company to make highly subjective assumptions, and a change in the Company's assumptions could materially affect the fair value estimates.

The impact of the cumulative effect of change in accounting principle on net loss per common share was as follows:

	2004	December 31, 2005	2006	Three Months Ended March 31, 2006 2007 (Unaudited)	
	(In thousands, except per share data)				
Net loss per common share, basic and diluted:					
Loss before cumulative effect of change in accounting principle	\$ (17.94)	\$ (14.33)	\$ (14.90)	\$ (3.63)	\$ (2.62)
Cumulative effect of change in accounting principle		0.25			
Net loss	\$ (17.94)	\$ (14.08)	\$ (14.90)	\$ (3.63)	\$ (2.62)
Shares used in computing basic and diluted net loss per common share	3,705	4,605	6,036	5,010	7,560



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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the pro forma effect of the adoption of FSP 150-5 on results of operations for 2004 and 2005, if applied retroactively, assuming FSP 150-5 had been adopted in those years.

	December 31,	
	2004	2005
	(In thousands, except per share data)	
Net loss, as reported	\$ (66,480)	\$ (64,826)
Add: Cumulative effect of change in accounting principle included in net loss		(1,137)
Change in fair value of warrants	1,029	(229)
Pro forma net loss	\$ (65,451)	\$ (66,192)
Pro forma loss per common share, basic and diluted	\$ (17.67)	\$ (14.37)
Shares used in computing basic and diluted net loss per common share	3,705	4,605

**3. Balance Sheet Components**

	December 31,		March 31,
	2005	2006	2007
	(In thousands)		
	(Unaudited)		
Property, plant and equipment			
Computer hardware	\$ 1,404	\$ 2,148	\$ 2,236
Computer software	1,846	2,892	2,928
Laboratory and manufacturing equipment	23,156	36,262	40,715
Furniture and fixtures	434	559	704
Leasehold improvements	6,832	10,918	11,100
	\$ 33,672	\$ 52,779	\$ 57,683
Less accumulated depreciation and amortization	(19,138)	(26,114)	(28,199)
Property, plant and equipment, net(1)	\$ 14,534	\$ 26,665	\$ 29,484
Inventory:			
Raw materials	\$ 3,617	\$ 6,700	\$ 7,385
Work in process	16,715	38,104	31,588
Finished goods(2)	4,321	13,465	18,356
	\$ 24,653	\$ 58,269	\$ 57,329
Accrued expenses:			
Loss contingency related to purchase commitments	\$ 1,299	\$ 3,518	\$ 1,083
Customer prepay liability		2,855	1,214

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Professional and other consulting fees	435	2,063	2,965
Other accrued expenses	4,305	8,138	11,347
	\$ 6,039	\$ 16,574	\$ 16,609

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- (1) Property, plant and equipment, net includes approximately \$0.4 million, \$0.8 million and \$0.8 million in asset retirement obligations recorded as of December 31, 2005 and 2006 and at March 31, 2007, respectively. These asset retirement obligations are related to various office leases in California and Maryland.
- (2) Included in finished goods inventory at December 31, 2005 and 2006 and at March 31, 2007, were \$3.6 million, \$6.8 million and \$8.5 million, respectively, of inventory at customer locations where the sales transaction did not meet the Company's revenue recognition criteria.

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**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. Acquired Assets**

On November 9, 2005, the Company purchased certain assets of Big Bear Networks, Inc. (BBN) for a net consideration of \$1.1 million. The purchase price consisted of \$2.0 million in an assumed note payable, \$0.6 million in cash and \$0.1 million in transaction fees. An additional \$25,000 was retained in an escrow account, which is payable to BBN's former shareholders and subject to any indemnification claims at the end of the applicable escrow period. This was offset by net proceeds of \$1.7 million from the sale of certain non-strategic assets acquired from BBN to a third party purchaser and a \$50,000 write-off of an accounts payable balance due to BBN. The purchase of these assets was accounted for under the guidance of SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), for intangible assets acquired with a group of other assets not part of a business combination.

Based on the assessment of fair value of the acquired assets performed by an independent third party valuation firm, the Company allocated \$60,000 to tangible equipment, \$0.2 million to inventory and the remaining \$0.8 million to intangible assets. The intangible assets represent purchased technologies and will be amortized on a straight-line basis over an estimated useful life of seven years. The amortization is recorded in cost of ratable product and related support and services. The accumulated amortization for intangible assets as of December 31, 2005 and 2006 and March 31, 2007 was \$19,230, \$0.1 million and \$0.2 million, respectively. The carrying value of these intangibles at December 31, 2005, December 31, 2006 and March 31, 2007, was \$0.8 million, \$0.7 million and \$0.6 million, respectively. Based on identified intangible assets recorded at December 31, 2006, the annual amortization expense for each period is expected to be approximately \$0.1 million for the remainder of 2007 and for each year beginning 2008 through 2012, at which time the intangible assets will be fully amortized.

On July 13, 2006, the Company entered into a supply and services agreement with Broadwing Corporation (Broadwing) whereby the Company agreed to provide manufacturing and support for certain of Broadwing's product divisions. The manufacturing is based on Broadwing's specifications using its technology, former manufacturing facility and equipment, and intellectual property underlying the manufacture of such products and owned or licensed by Broadwing. In connection with the agreement, the Company issued 92,592 warrants to Broadwing to purchase Series G convertible preferred stock at a price of \$5.40 per share. The fair value of the warrants of \$189,000 was recorded as a reduction to product revenue. In addition, the Company hired certain Broadwing employees.

On August 16, 2006, the Company purchased certain assets of Little Optics, Inc. for net consideration of \$9.5 million. The purchase price consisted of \$4.7 million in cash, \$4.5 million in an assumed note payable, \$251,000 in fair value of a warrant to purchase 0.1 million shares of Series G convertible preferred stock, and \$90,000 in net liabilities assumed. The purchase of these assets was accounted for under the guidance of SFAS 142 for intangible assets acquired with a group of assets not part of a business combination.

Based on the assessment of fair value of the acquired assets performed by an independent third party valuation firm, the Company allocated \$4.5 million to in-process research and development, \$3.8 million to tangible equipment and the remaining \$1.2 million to intangible assets. The in-process research and development was written off on the acquisition date because technological feasibility had not been established and no alternative future uses existed. The intangible assets represent patents, assembled workforce and customer contracts. The fair values of the intangibles on the date of acquisition will be amortized on a straight-line basis over their estimated useful lives ranging from three to fifteen years. The amortization is recorded in amortization of intangible assets on the statement of



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

operations. The accumulated amortization for these intangible assets was approximately \$56,000 and \$93,500 as of December 31, 2006 and March 31, 2007, respectively. The carrying value of these intangibles at December 31, 2006 and March 31, 2007 was \$1.1 million. Based on identified intangible assets recorded at December 31, 2006, the annual amortization expense for each period is expected to be approximately \$0.1 million for the remainder of 2007 and for each year beginning 2008 through 2012, \$55,000 in 2013 through 2020 and \$34,000 in 2021, at which time the intangible assets will be fully amortized. The in-process research and development charge of \$4.5 million was recorded in research and development expense in 2006.

On January 23, 2007, the Company entered into an asset purchase agreement with a customer, whereby the Company would purchase various assets consisting primarily of test and manufacturing equipment for an amount of \$1.2 million. Based on an assessment by management of the fair value of the assets, \$0.7 million of the acquisition cost was allocated to equipment retained by the Company for internal use and \$0.5 million was allocated to assets held for sale. At March 31, 2007, the Company had generated proceeds of \$1.1 million from the sale of a portion of the assets held for sale, resulting in a gain for the period of \$0.9 million. The balance of the assets held for sale amounted to \$0.3 million at March 31, 2007. The equipment retained for internal use was redeployed and depreciation commenced in accordance with the Company's depreciation policy.

**5. Intangible Assets**

Purchased other intangible assets are carried at cost less accumulated amortization. Amortization expenses are recorded to the appropriate cost and expense categories. The Company expects amortization expense on purchased intangible assets to be approximately \$0.2 million for the remainder of 2007 and for each year from 2008 through 2012, approximately \$55,000 for each year from 2013 through 2020, and approximately \$34,000 in 2021, at which time purchased intangible assets will be fully amortized. The weighted average amortization period as of December 31, 2005 was 7 years and as of December 31, 2006 and March 31, 2007 were each 10 years. Amortization of intangible assets was \$0, approximately \$19,000 and \$0.2 million in 2004, 2005 and 2006, respectively, and \$29,000 and \$66,000 for the three months ended March 31, 2006 and 2007, respectively.

	December 31, 2005			December 31, 2006		
	Gross Carrying Amount	Accumulated Amortization (In thousands)	Net	Gross Carrying Amount	Accumulated Amortization (In thousands)	Net
Patents & developed technology	\$ 808	\$ (19)	\$ 789	\$ 1,628	\$ (155)	\$ 1,473
Assembled workforce and other				370	(36)	334
<b>Total intangible assets</b>	<b>\$ 808</b>	<b>\$ (19)</b>	<b>\$ 789</b>	<b>\$ 1,998</b>	<b>\$ (191)</b>	<b>\$ 1,807</b>

	March 31, 2007		
	Gross Carrying Amount	Accumulated Amortization (In thousands) (Unaudited)	Net
Patents & developed technology	\$ 1,628	\$ (197)	\$ 1,431
Assembled workforce and other	370	(60)	310
<b>Total intangible assets</b>	<b>\$ 1,998</b>	<b>\$ (257)</b>	<b>\$ 1,741</b>



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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**6. Net Loss Per Common Share**

Basic net loss per common share is computed by dividing net loss by the weighted average number of vested common shares outstanding during the period. Diluted net loss per common share is computed by giving effect to all potential dilutive common shares, including options, restricted common stock, common stock subject to repurchase, warrants to purchase common and convertible preferred stock and convertible preferred stock.

Pro forma basic and diluted net loss per common share have been computed to give effect to the conversion of the Company's convertible preferred stock (using the if-converted method) into common stock as though the conversion had occurred on the original dates of issuance.

The following table sets forth the computation of net loss per share:

	Year Ended December 31,			Three Months Ended	
	2004	2005	2006	2006	2007
	(In thousands, except per share data)				
Net loss	\$ (66,480)	\$ (64,826)	\$ (89,935)	\$ (18,193)	\$ (19,813)
Weighted average common shares outstanding net of weighted-average common shares subject to repurchase	3,705	4,605	6,036	5,010	7,560
Basic and diluted net loss per common share	\$ (17.94)	\$ (14.08)	\$ (14.90)	\$ (3.63)	\$ (2.62)
Basic and diluted weighted-average shares used above	3,705	4,605	6,036	5,010	7,560
Pro forma adjustments to reflect assumed conversion of convertible preferred stock (unaudited)			54,353	45,752	59,428
Shares used in computing pro forma net loss per common share (unaudited)			60,389	50,762	66,988
Pro forma net loss per common share, basic and diluted (unaudited)			\$ (1.49)	\$ (0.36)	\$ (0.30)

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following outstanding options, restricted common stock, common stock subject to repurchase, warrants to purchase common and convertible preferred stock were excluded from the computation of diluted net loss per common share for the periods presented because including them would have had an antidilutive effect:

	Year Ended December 31,			Three Months Ended	
	2004	2005	2006	2006	2007
	(In thousands)				
Restricted common stock	21				
Options to purchase common stock	5,190	6,696	7,872	6,504	8,221
Common stock subject to repurchase	186	739	1,513	689	1,813
Options outstanding related to non-recourse notes	331	331	114	331	114
Convertible preferred stock (as converted basis)	36,270	45,297	59,428	48,109	59,428
Convertible preferred stock and common stock warrants (as converted basis)	444	867	1,333	876	1,333

**7. Cash, Cash Equivalents and Short-term Investments**

The following is a summary of cash and cash equivalents and short-term investments as of December 31, 2005 and 2006 (in thousands):

	December 31, 2005			Estimated Fair Value	December 31, 2006			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Cash in banks	\$ 11,310	\$	\$	\$ 11,310	\$ 13,791	\$	\$	\$ 13,791
Money market	19,813			19,813	16			16
Commercial paper	5,988	1		5,989	15,075	2		15,077
Corporate bonds					690		(2)	688
Total cash, cash equivalents and short-term investments	\$ 37,111	\$ 1	\$	\$ 37,112	\$ 29,572	\$ 2	\$ (2)	\$ 29,572
Classified as cash and cash equivalents				\$ 36,013				\$ 28,884
Classified as short term investments				1,099				688
Total cash, cash equivalents and short-term investments				\$ 37,112				\$ 29,572

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	March 31, 2007 (Unaudited)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash in banks	\$ 33,055	\$	\$	\$ 33,055
Money market	4,917			4,917
Commercial paper	998			998
Corporate bonds	693		(1)	692
<b>Total cash, cash equivalents and short-term investments</b>	<b>\$ 39,663</b>	<b>\$</b>	<b>\$ (1)</b>	<b>\$ 39,662</b>
Classified as cash and cash equivalents				\$ 38,970
Classified as short term investments				692
<b>Total cash, cash equivalents and short-term investments</b>				<b>\$ 39,662</b>

Under a loan arrangement with a financial institution, the Company maintains on deposit with the financial institution an unrestricted compensating balance of \$4.0 million. Commercial paper and corporate bond investments have a contractual maturity term of less than one year. Realized gains (losses) on short-term investments were not material for 2004, 2005, 2006 and for the three months ended March 31, 2007.

**8. Deferred Revenue and Deferred Inventory Costs**

Deferred revenue and deferred inventory costs consist of the following:

	December 31, 2005	December 31, 2006	March 31, 2007 (Unaudited)
	(In thousands)		
Deferred ratable product and related support and services, current	\$ 6,636	\$ 101,080	\$ 121,099
Deferred ratable product and related support and services, non-current	16,564	9,873	7,321
<b>Total deferred revenue</b>	<b>\$ 23,200</b>	<b>\$ 110,953</b>	<b>\$ 128,420</b>
Deferred inventory costs, current	\$ 5,084	\$ 62,936	\$ 70,127
Deferred inventory costs, non-current	11,603	4,317	3,331
<b>Total deferred inventory costs</b>	<b>\$ 16,687</b>	<b>\$ 67,253</b>	<b>\$ 73,458</b>

Deferred ratable product and related support and services revenue consists of revenue on transactions where VSOE of fair value of support and other services has not been established and the entire arrangement is being recognized ratably over the longest bundled support or service period. In the fourth quarter of 2006, the Company amended several of its significant sales contracts to shorten the contractual software warranty periods to between 90 days and one year, which management believes is more typical in the industry. This contractual change in the software warranty period resulted in the reduction of the average recognition period for ratable revenue from 3.7 years in the third quarter 2006 to 1.3 years in the fourth quarter of 2006.



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**INFINERA CORPORATION**

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

**9. Commitment and Contingencies**

***Leases***

The Company leases facilities under non-cancelable operating lease agreements. The Company had four primary lease agreements at December 31, 2006 covering its headquarters, research and development (R&D) and manufacturing facility in Sunnyvale, California, its R&D and manufacturing facility in Allentown, Pennsylvania, and its software development facility in Bangalore, India. Terms of the leases are from one to seven years. The Sunnyvale, California lease on the R&D and manufacturing facility was terminated ten months early on December 31, 2005 due to the sale of the property. A new seven year lease on the same facility expiring on December 31, 2012 was entered into with the new landlord. The Company recognizes lease payments on its facilities on a straight-line basis. Both leases at the Sunnyvale facility have annual rent escalation clauses, which resulted in a deferred rent balance of \$45,999, \$0.8 million and \$1.1 million at December 31, 2005, December 31, 2006 and March 31, 2007, respectively. The unamortized deferred rent balance of \$0.1 million that was related to the terminated lease with the predecessor landlord was charged to expense upon termination of the lease in 2005.

On August 31, 2005, the Company entered into a 15-month lease for office space adjacent to its manufacturing facility in Sunnyvale, California, expiring on December 31, 2006. On July 24, 2006, this lease was extended for an additional year and expires on December 31, 2007.

On July 17, 2006, the Company entered into a five year lease expiring on August 31, 2011 for additional office space adjacent to its existing Sunnyvale, California facility. This new space serves as the Company's administrative headquarters. On November 2, 2006, this lease was amended to include warehouse space.

Rent expense for all leases was \$1.6 million, \$1.4 million and \$1.7 million for 2004, 2005 and 2006, respectively. Rent expense for all leases was \$0.3 million and \$0.9 million for the three months ended March 31, 2006 and 2007, respectively.

On July 13, 2006, the Company entered into a supply and services agreement with Broadwing, whereby the Company agreed to manufacture, sell and support for certain of its division products. In connection with the agreement, the Company assumed a sublease for a manufacturing facility in Maryland, where the manufacture of the products would continue. The sublease expires on October 31, 2007. Total expense for this lease was \$0.3 million and \$0.2 million for 2006 and the three months ended March 31, 2007, respectively.

***Purchase Commitments***

The Company has service agreements with its major production suppliers, where the Company is committed to purchase certain parts. As of December 31, 2006 and March 31, 2007, these purchase commitments were \$39.2 million and \$30.5 million, respectively.

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of the Company's contractual obligations as of December 31, 2006:

	Years Ended December 31,					2011 and beyond
	Total	2007	2008	2009	2010	
	(In thousands)					
<b>Contractual obligations:</b>						
Purchase obligations	\$ 39,176	\$ 39,176	\$	\$	\$	\$
Operating leases	14,987	3,119	2,940	2,929	2,650	3,349
Total contractual obligations	\$ 54,163	\$ 42,295	\$ 2,940	\$ 2,929	\$ 2,650	\$ 3,349

The following is a summary of the Company's contractual obligations as of March 31, 2007:

	Years Ended December 31,					2011 and beyond
	Total	Remainder of 2007	2008	2009	2010	
	(Unaudited)					
	(In thousands)					
<b>Contractual obligations:</b>						
Purchase obligations	\$ 30,502	\$ 30,502	\$	\$	\$	\$
Operating leases	14,335	2,394	2,913	2,996	2,675	3,357
Total contractual obligations	\$ 44,837	\$ 32,896	\$ 2,913	\$ 2,996	\$ 2,675	\$ 3,357

**Indemnification Obligations**

From time to time, the Company enters into certain types of contracts that contingently require it to indemnify parties against third-party claims. These contracts primarily relate to: (i) certain real estate leases under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company's use of the applicable premises; (ii) certain agreements with the Company's officers and directors, under which the Company may be required to indemnify such persons for liabilities; and (iii) certain provisions in the Company's customer agreements that may require the Company to indemnify their customers and their affiliated parties against liabilities if the Company's products infringe a third party's intellectual property rights.

The terms of such obligations vary. Because the maximum obligated amounts under these agreements generally are not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated.

To date, the Company has not incurred any material costs as a result of the indemnification obligations and have not accrued any liabilities related to such obligations in the Company's consolidated financial statements.



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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**10. Debt Obligations**

Debt consisted of the following:

	December 31, 2005	December 31, 2006	March 31, 2007 (Unaudited)
	(In thousands)		
Bank loans due 2007-2009	\$ 21,452	\$ 23,481	\$ 28,964
Assumed debt from acquisition of assets due 2006-2007	2,000	4,500	4,500
Other debt due 2007-2013	321	401	432
<b>Total debt</b>	<b>23,773</b>	<b>28,382</b>	<b>33,896</b>
<b>Less current maturities</b>	<b>12,422</b>	<b>20,025</b>	<b>22,860</b>
<b>Long-term debt</b>	<b>\$ 11,351</b>	<b>\$ 8,357</b>	<b>\$ 11,036</b>

On July 31, 2003, the Company entered into a loan agreement with a financial institution that allows for borrowings of up to \$0.1 million. The agreement was amended on March 18, 2004 to allow for an additional borrowing amount of \$30,000. In August 2004, the agreement was amended and an additional \$0.2 million was made available and subsequently, an additional \$0.2 million was borrowed under the same arrangement. The weighted average interest rate under this credit facility as of December 31, 2005 and 2006 was 5.7% and 8.1%, respectively. Under the agreements, warrants to purchase 5,049 shares of common stock at \$8.96 per share were issued. The fair value of these warrants on the date of grant was estimated to be \$5,854. For the years ended December 31, 2004, 2005 and 2006, the amounts recorded as interest expense were not material. The principal balance outstanding and classified as non-current was \$0.3 million at December 31, 2005 and 2006. The principal balance outstanding and classified as current was \$0.4 million at March 31, 2007.

On December 29, 2004, the Company entered into a growth capital loan agreement with two co-lender financial institutions. The agreement allowed for borrowings of up to \$10.0 million. The loan is secured by, among other things, a lien on the Company's intellectual property. The terms of the loan were interest only through June 30, 2005, and then the higher of 11% or prime plus 6.25% thereafter over three years. Additionally, when the loan matures, the Company must make an additional payment equal to 8% of the original principal amount. In January 2005, the Company borrowed \$3.0 million under this line. Under this agreement, warrants to purchase 0.1 million shares of Series E convertible preferred stock at \$2.40 per share were issued. The fair value of these warrants at the date of grant was estimated to be \$0.2 million. In March 2005, the Company issued additional warrants to purchase 0.1 million shares of Series E convertible preferred stock at \$2.40 per share when we borrowed the remaining \$7.0 million under this line. The fair value of these warrants on the date of grant was estimated to be \$0.1 million. The weighted average interest rate under this credit facility as of December 31, 2005 and 2006 was 12.7% and 16.7%, respectively. The amounts recorded as interest expense for both warrant issuances were not material for 2004 and were \$99,875 and \$111,634 for 2005 and 2006, respectively. The amounts recorded as interest expense for both warrant issuances was \$27,908 for each of the three months ended March 31, 2006 and 2007, respectively. The principal balance outstanding was \$6.2 million, of which \$3.5 million and \$2.7 million were classified as current and non-current, respectively, at December 31, 2006. The principal balance outstanding was \$5.4 million, of which \$3.6 million and \$1.8 million were classified as current and non-current, respectively, at March 31, 2007.

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

On December 29, 2004, the Company entered into a borrowing arrangement with a financial institution. This arrangement provided for two facilities, an operating line of credit and a revolving line of credit. The operating line of credit allowed for borrowings secured by approved accounts receivable and purchase orders. The revolving line allowed for borrowing subject to the Company maintaining certain minimum cash balances. Total borrowings under the arrangement could not exceed \$20.0 million and bore interest at various rates of interest depending on the facility. The total available credit under the agreement was reduced by, among other things, any stand-by letters of credit outstanding. Under this agreement, warrants to purchase 62,500 shares of Series E convertible preferred stock at \$2.40 per share and 9,259 shares of Series G convertible preferred stock at \$5.40 per share were issued. The fair value of these warrants on the date of grant was estimated to be \$0.1 million. For the years ended December 31, 2004, 2005 and 2006, the amounts recorded as interest expense were not material for 2004 and \$74,460 and \$36,507, for 2005 and 2006, respectively. The amounts recorded as interest expense for the three months ended March 31, 2006 and 2007 was \$18,615 and \$20,712, respectively. The arrangement was scheduled to expire on June 28, 2006 but was amended a number of times in 2006 by mutual consent to, among other things, extend the maturity date, extend the deadline for providing audited financial statements and waive the deadline for certain other management reports. On October 6, 2006, the arrangement was amended to allow the Company to borrow against its accounts receivable, to increase the facility amount to \$25.0 million, to reduce the interest rate on the revolving line to the greater of prime or 6.25% and to extend the maturity date to September 27, 2007. The weighted average interest rate under all sub-facilities as of December 31, 2005 and 2006 was 7.7% and 10.1%, respectively. As of December 31, 2006 and March 31, 2007, there were no outstanding balances on the operating line of credit. As of December 31, 2006 and March 31, 2007, the principal balance outstanding under the revolving loan was \$9.5 million, which is classified as current.

On June 21, 2005, the Company entered into a loan arrangement with a financial institution. This arrangement provides for two separate sub-facilities, a term loan and a revolving facility. Under the arrangement, the maximum term advance shall not exceed \$5.5 million and the maximum revolving advance shall not exceed \$6.0 million; provided, however, that at no time may the total outstanding loan obligations under the arrangement exceed \$10.0 million. Under the arrangement, the Company maintains on deposit with the bank an unrestricted compensating balance of \$4.0 million. The arrangement is secured by, among other things, the Company's equipment and certain intellectual property. The term facility is repayable over a three-year period and the revolving facility is repayable over a period of twelve months. The interest rate for the arrangement is at a variable rate of 0.50% above the prime interest rate. In connection with the loan arrangement, the Company granted warrants to purchase 19,824 shares of Series F convertible preferred stock at an exercise price of \$3.78 per share. The fair value of these warrants on the date of grant was estimated at \$35,599. For 2004, 2005 and 2006, the amounts recorded as interest expense were not material and at December 31, 2006, the value of the warrant was fully amortized. During 2006, the loan arrangement was amended at various times by mutual consent to extend the maturity date, amend certain definitions in the agreement, permit the acquisition of the assets of Little Optics, Inc. and waive specified management reports. On October 31, 2006, the arrangement was amended and restated to terminate the term loan and revolving facility, replace them with a new three-year variable rate term facility and the amount borrowed previously under the term loan and revolving facility was repaid from the proceeds of this new facility. Total borrowings under this new facility may not exceed \$15.0 million. In February and March 2007, the Company borrowed approximately \$7.0 million under this facility. As a result, borrowings under the facility were fully utilized. The interest rate on this new facility is set at the bank's prime rate and the Company is required to comply with certain information reporting requirements. The weighted average borrowing rate under this facility was 9.0% and 8.3% at December 31, 2005 and 2006, respectively. The

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principal balance outstanding under this facility was \$7.8 million, of which \$2.5 million and \$5.3 million were classified as current and non-current, respectively, at December 31, 2006. The principal balance outstanding under this facility was \$14.1 million, of which \$4.8 million and \$9.3 million were classified as current and non-current, respectively, at March 31, 2007.

On June 26, 2006, the Company entered into a premium financing agreement with a financial institution for \$0.2 million. The loan is repayable over ten months and bears interest at a rate of 6.0% per annum. The principal balance outstanding under this loan was approximately \$86,000 and \$21,000 at December 31, 2006 and March 31, 2007, respectively, which is classified as current.

The above agreements require the Company to maintain compliance with certain covenants and prohibit the Company from paying dividends. As of December 31, 2006 and March 31, 2007, the Company had satisfied all the requirements set forth by the Company's financial institutions and had access to an additional \$19.5 million and \$12.3 million, respectively, of incremental funds under the existing credit facilities described above.

At December 31, 2006, the Company's payments under debt arrangements are due as follows (in thousands):

<b>Year</b>	
2007	\$ 21,834
2008	5,825
2009	2,780
2010	19
2011	163
Thereafter	172
<b>Total minimum payments</b>	<b>30,793</b>
Less amount representing interest	(2,411)
<b>Present value of future minimum payments</b>	<b>28,382</b>
Less current portion of debt obligation	(20,025)
<b>Long-term portion of debt obligation</b>	<b>\$ 8,357</b>

At March 31, 2007, the Company's payments under debt arrangements are due as follows (in thousands) (unaudited):

<b>Year</b>	
2007	\$ 22,331
2008	8,621
2009	5,592
2010	
2011	
Thereafter	
<b>Total minimum payments</b>	<b>36,544</b>
Less amount representing interest	(2,648)
<b>Present value of future minimum payments</b>	<b>33,896</b>
Less current portion of debt obligation	(22,860)

Long-term portion of debt obligation	\$ 11,036
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**INFINERA CORPORATION**

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

**11. Founders' Stock, Restricted Stock, Convertible Preferred Stock and Stockholders' Equity (Deficit)**

**Founders' Stock**

In December 2000, the Company issued 1.4 million shares of common stock at \$0.004 per share to a founder of the Company for cash proceeds of \$5,500. In March 2001, the Company repurchased 0.4 million of these shares at the original issuance price of \$0.004 per share for a total of \$1,500. In March 2001, the Company issued 2.0 million shares, at \$0.10 per share, to the other founders of the Company for cash proceeds of \$0.2 million. The founders' shares are subject to adjustment for certain events, including mergers, stock dividends, stock splits, and other events. The founders' shares vested over four years: 20% immediately, and 1.667% per month for 48 months thereafter. At December 31, 2006, all of the shares of the founders' common stock were fully vested.

One of the founders who received a grant of 1.0 million shares of common stock in March 2001 was an advisor to the Company from March 2001 to May 2001. Accordingly, the Company recorded a compensation charge of \$9,000, which was calculated using the Black-Scholes option-pricing model. This founder became an employee of the Company in May 2001, whereupon his stock grant was remeasured due to a change in employment status. The intrinsic value of the unvested shares of common stock as of the change of employment status was \$0.7 million. This amount was recognized over the remaining vesting period. For 2004 and 2005, the Company recorded a compensation charge of \$0.2 million and \$45,000, respectively. At December 31, 2006, the common stock was fully vested.

**Restricted Stock**

In March 2001, the Company issued 0.2 million and 0.1 million shares of restricted common stock at \$0.10 per share to a member of the Board of Directors and an employee of the Company, respectively, for total cash proceeds of \$30,000. The 0.1 million shares of restricted common stock issued to the employee are under the Company's 2000 Stock Option Plan. In November 2001, the Company issued 42,500 shares of restricted common stock at \$1.40 per share to another member of the Board of Directors of the Company for cash proceeds totaling \$59,500. These restricted shares are subject to adjustment for certain events, including mergers, stock dividends, stock splits and other events. These restricted shares vest over four years. In connection with a software license agreement in June 2004, the Company issued 7,500 shares of restricted common stock at \$1.84 per share for cash proceeds of \$13,800. These restricted shares vested over one year. At December 31, 2006, 0.3 million shares of restricted common stock were fully vested.

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Convertible Preferred Stock**

The following is a schedule of authorized, issued and outstanding shares of each series of convertible preferred stock (in thousands):

	Authorized Shares	Shares Issued and Outstanding		
		December 31, 2005	2006	March 31, 2007 (Unaudited)
Series A	3,919	3,691	3,691	3,691
Series B	2,128	2,112	2,112	2,112
Series C	1,335	1,335	1,335	1,335
Series D	7,143	6,920	6,920	6,920
Series E	22,975	21,590	21,590	21,590
Series F	3,000	2,723	2,723	2,723
Series G	21,500	6,304	20,435	20,435
Total convertible preferred stock	62,000	44,675	58,806	58,806

In October 2004, the Company issued shares of Series E convertible preferred stock at a price that was significantly less than the price of the previously issued Series D convertible preferred stock. On July 30, 2004, the Company issued 0.5 million shares of Series D convertible preferred stock at a price of \$8.96 per share to two investors who were also customers of the Company. Because of the close proximity of the time of the sale of the shares of Series D convertible preferred stock and the Series E convertible preferred stock and the decline in the price of the convertible preferred stock from \$8.96 to \$2.40 per share, on September 29, 2004, a dispute arose regarding the price paid for the Series D convertible preferred stock. As a result of this dispute, the Company entered into a settlement agreement and mutual release with both investors to repurchase 0.2 million shares of the Series D convertible preferred stock at the investor's original price of \$8.96 per share, or \$2 million. As part of the agreement, the Company agreed to sell 0.8 million shares of the Series E convertible preferred stock to the same investors at a price of \$2.40 per share. The \$2.40 per share price represented the fair market value of the Series E convertible preferred stock and was the same price that the Company sold \$51.8 million worth of shares of Series E convertible preferred stock to other stockholders. The difference of \$1.5 million between the repurchase price and the fair market value of the repurchased shares was charged to other loss, net in 2004. The net amount of \$0.5 million recorded to stockholder's equity represents the fair value of the treasury stock repurchased by the Company.

In June 2005, the Company issued 2.7 million shares of Series F convertible preferred stock at \$3.78 per share for net proceeds of \$10.3 million, net of issuance costs, to fund its current operations. Of the shares of Series F convertible preferred stock sold in June 2005, 2.6 million were sold to a customer of the Company and the remaining 0.1 million shares were sold to an employee of the Company, each on substantially the same terms and conditions. The Company determined that the Series F convertible preferred stock was issued at fair value and, therefore, no contra revenue charges or employee compensation charges were recorded as part of these sales of Series F convertible preferred stock.

During the fourth quarter of 2005, the Company issued 6.3 million shares of Series G convertible preferred stock at \$5.40 per share for \$31.1 million, net of issuance costs, to various investors.

In January, March, May, July and October of 2006, the Company issued a total of 14.1 million shares of Series G convertible preferred stock for \$73.4 million, net of issuance costs. The purchase



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

price for these issuances was \$5.40 per share, with the exception of a board member's purchase of 67,934 shares at \$7.36 per share in October 2006. These issuances completed the sale of Series G convertible preferred stock which began in October of 2005. Total Series G convertible preferred stock issued was 20.4 million shares for \$105.1 million, net of issuance costs.

The significant rights and obligations of the Company's convertible preferred stock are as follows:

*Voting Rights* Each holder of Series A, B, C, D, E, F and G convertible preferred stock is entitled to the number of votes equal to the number of shares of common stock into which such preferred stock are convertible.

*Dividends* Series A, B, C, D, E, F and G convertible preferred stockholders are entitled to receive non-cumulative dividends at the rate of \$0.70, \$0.98, \$1.28, \$0.63, \$0.17, \$0.26, and \$0.38 per annum, respectively, for each share of Series A, B, C, D, E, F, and G convertible preferred stock outstanding, when, as and if declared by the Board of Directors. These dividends are payable in preference to common stock dividends. To date, the Company has not declared or paid any dividends.

*Liquidation* In the event of any liquidation, dissolution or winding up of the Company, the holders of Series G convertible preferred stock shall be entitled to receive, prior and in preference to the other stockholders, \$2.70 per share for each share of Series G convertible preferred stock then held by them, plus declared but unpaid dividends. In the event that the available funds and assets are insufficient for full payment to the holders of Series G convertible preferred stock on a per-share basis as outlined above, the entire assets and funds of the Company legally available for distribution shall be distributed ratably among the holders of Series G convertible preferred stock in proportion to the liquidation preference amount each such holder is otherwise entitled to receive.

The holders of Series A through G convertible preferred stock shall then be entitled to receive, prior and in preference to any payment or distribution of available funds and assets to shares of common stock, \$10.00 for each share of Series A convertible preferred stock, \$13.94 for each share of Series B convertible preferred stock, \$18.28 for each share of Series C convertible preferred stock, \$8.96 for each share of Series D convertible preferred stock, \$2.40 for each share of Series E convertible preferred stock, \$3.78 for each share of Series F convertible preferred stock, and \$5.40 for each share of Series G convertible preferred stock, including the Series G liquidation amount of \$2.70 for each share described above, held by them, plus all declared but unpaid dividends on the preferred shares. In the event that the available funds and assets are insufficient for full payment to the convertible preferred stockholders on a per-share basis as outlined above, the entire assets and funds of the Company legally available for distribution shall be distributed ratably among holders of Series A, B, C, D, E, F and G convertible preferred stock in proportion to the liquidation preference amount each such holder is otherwise entitled to receive.

After all payments have been made to the holders of Series A, B, C, D, E, F and G convertible preferred stock, the remaining assets of the Company available for distribution to stockholders shall be distributed among the holders of Series A, B, C, D, E, F and G convertible preferred stock and common stock pro rata based on the number of shares of common stock held by each (assuming conversion of all Series A, B, C, D, E, F and G convertible preferred stock) until the holders of Series A, B, C, D, E, F and G convertible preferred stock shall have received up to an additional 20% of the Series A, B, C, D, E, F and G convertible preferred stock purchase price for each year the Series A, B, C, D, E, F and G convertible preferred stock is outstanding, respectively; provided, however, that no holder of Series A, B, C, D, E, F or G convertible preferred stock shall receive an aggregate amount



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

greater than the Series A, B, C, D, E, F or G convertible preferred stock original purchase price per share, as applicable; provided further, that the Series E and Series F convertible preferred stock shall be deemed for these purposes to have been outstanding for two years prior to their issuance dates.

Upon completion of the above distributions, the remaining assets available for distribution to stockholders shall be distributed to the holders of common stock pro rata based on the number of shares of common stock held by each.

Upon liquidation or winding up of the Company, a transfer of greater than 50% of the Company's voting power or a sale of substantially all of the Company's assets would constitute a redemption event. As the redemption event of the convertible preferred stock is outside of the Company's control, all shares of convertible preferred stock have been presented outside of permanent equity. The carrying value will remain the same, as EITF Topic D-98: *Classification and Measurement of Redeemable Securities* states that the initial carrying amount should be the price paid on the issuance date until the redemption is considered probable.

*Conversion* Each share of convertible preferred stock is convertible at the option of the holder into fully paid and non-assessable shares of common stock. In connection with the issuance of Series D convertible preferred stock, an anti-dilution adjustment was triggered for Series A convertible preferred stock, Series B convertible preferred stock and Series C convertible preferred stock. Under the terms of Article IV, Section 4(d)(i) of the Company's restated certificate of incorporation, the new conversion prices of the Series A Convertible preferred stock, Series B convertible preferred stock and Series C convertible preferred stock, respectively, were modified as follows:

Conversion price of Series A convertible preferred stock changed from \$2.50 to \$2.42;

Conversion price of Series B convertible preferred stock changed from \$3.486 to \$3.11; and

Conversion price of Series C convertible preferred stock changed from \$4.57 to \$3.86.

Each share of Series A, B, C, D, E, F and G convertible preferred stock is convertible into the number of shares of common stock that result from dividing the original issue price (\$2.50, \$3.486, \$4.57, \$2.24, \$0.60, \$0.9458, \$1.35 and \$1.84, respectively) by the conversion price of the Series A, B, C, D, E, F and G convertible preferred stock (\$2.42, \$3.11, \$3.86, \$2.24, \$0.60, \$0.9458, \$1.35 and \$1.84, respectively) at December 31, 2006. Accordingly, the conversion ratios for the Series A, B, C, D, E, F and G convertible preferred stock to common stock are (1:1.0330, 1:1.1209, 1:1.1839, 1:1, 1:1, 1:1, and 1:1, respectively).

Conversion of each series of convertible preferred stock into common stock is automatic upon the earlier of: (i) the closing of an initial public offering, registered under the Securities Act of 1933, which results in aggregate proceeds equal to or exceeding \$30.0 million, net of underwriting discounts, to the Company or (ii) at any time upon the affirmative election of the holders of at least a majority of the then-outstanding shares of Series A, B, C, D, E, F and G convertible preferred stock voting together as a single class.

*Special Mandatory Conversion* If the Company's Board of Directors approves a subsequent financing and determines that the holders of the Company's convertible preferred stock are entitled to participate on a pro rata basis in such qualified financing (Qualified Financing), then each holder of the Company's convertible preferred stock shall have the right to participate in such Qualified Financing on a pro rata basis. If any holder of convertible preferred stock does not participate in such Qualified Financing up to its full pro rata share, then all or a portion of such holder's preferred stock shall be

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converted into fully paid and non-assessable shares of the Company's common stock upon the closing of such Qualified Financing, based upon the percentage of such holder's pro rata share that was not purchased by such holder in the Qualified Financing.

**Convertible Preferred and Common Stock Warrant Liabilities**

The Company had the following unexercised convertible preferred and common stock warrants (in thousands, except per share data):

Stock	Expiration Date(1)	Exercise Price per Share	Shares as of			Fair Value as of		
			December 31, 2005	March 31, 2006	March 31, 2007 (Unaudited)	December 31, 2005	March 31, 2006	March 31, 2007 (Unaudited)
Series A convertible preferred	Apr 2006 to Jul 2008	\$ 10.00	197	135	135	\$ 444	\$ 445	\$ 485
Series B convertible preferred	Mar 2009	13.96	16	16	16	58	59	55
Series E convertible preferred	Dec 2011	2.40	292	292	292	654	1,568	2,434
Series F convertible preferred	Jun 2012	3.80	20	20	20	43	93	139
Series G convertible preferred	Nov 2010 to Aug 2011	5.40	298	828	828	739	3,212	4,644
Common stock	July 2013 to May 2016	8.96	35	36	36	3	32	152
<b>Total</b>			<b>858</b>	<b>1,327</b>	<b>1,327</b>	<b>\$ 1,941</b>	<b>\$ 5,409</b>	<b>\$ 7,909</b>

(1) All convertible preferred stock warrants will convert into warrants to purchase shares of common stock at the applicable conversion rate for the related convertible preferred stock immediately prior to the closing of this offering. In 2006, warrants to purchase 62,500 shares of Series A convertible preferred stock expired unexercised.

The fair value of these warrants was estimated at the date of grant using a probability weighted average of per-share values using the Black-Scholes and Lattice models.

**Non-recourse Notes Receivable from Employee Stockholders**

The Company had issued non-recourse notes receivables to non-executive officers to finance the purchase of 0.3 million shares of common stock of the Company. Principal and interest were due four years from the original issuance date or upon the occurrence of certain events. Because these employee notes were deemed to be non-recourse, the equity awards are subject to variable accounting. Accordingly, stock compensation expense of \$0.0 million, \$0.1 million and \$0.2 million, calculated based on the change of intrinsic value, was recorded in 2004, 2005 and 2006, respectively, and \$0.0 million and \$0.6 million for the three months ended March 31, 2006 and 2007, respectively.

**12. 2000 Stock Option Plan**

On December 6, 2000, the Company adopted the 2000 Stock Option Plan (2000 Plan), which allows the Company to grant incentive stock options or non-statutory stock options. Under the terms of the 2000 Plan, the exercise price of incentive stock options may not be less than 100% of the fair market value of the shares on the date of grant, and the exercise price of non-statutory stock options may not be less than 85% of the fair market value of the shares on the date of grant. The exercise price of incentive stock options and non-statutory stock options granted to an employee or a service provider who, at the time of grant, owns stock representing more than 10% of the total combined voting



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power of all classes of the stock of the Company may be no less than 110% of the fair market value of the common stock on the date of grant. The exercise price of non-statutory stock options granted to an executive officer of the Company may be no less than 100% of the fair market value of the common stock on the date of grant if such option is intended to qualify as performance-based compensation. Options granted to date generally vest over a four year period.

The maximum aggregate number of shares reserved for future issuance under the 2000 Plan is 9.9 million shares and 9.3 million shares of common stock as of December 31, 2006 and March 31, 2007, respectively. The shares may be authorized but unissued or reacquired common stock. The term of each option shall be the term stated in the option agreement, provided that the term shall be no more than ten years from the date of grant. Any option granted is exercisable at the rate of at least 20% per year over five years from the date the option is granted.

Terms of the 2000 Plan permit option holders to exercise stock options before they are vested, subject to certain limitations. Common stock issued in connection with such exercises is subject to repurchase at the exercise price if vesting does not occur. Of the total common shares outstanding at December 31, 2005, December 31, 2006 and March 31, 2007, 0.8 million, 1.5 million shares and 1.8 million shares, respectively, are subject to repurchase by the Company at the original exercise price. During 2005 and 2006, the Company repurchased and retired 3,750 and 12,156 unvested shares granted under the 2000 Plan, respectively. During the three months ended March 31, 2007, the Company repurchased and retired 10,000 shares subject to repurchase that were granted under the 2000 Plan and did not vest.

A summary of activity under the 2000 Plan is as follows:

	Shares Available for Grant	Options Outstanding (In thousands, except per share amounts)	Weighted- Average Exercise Price Per Share	Aggregate Intrinsic Value
Balance at December 31, 2003	646	3,234	\$ 1.65	
Additional options authorized	2,599			
Granted	(2,737)	2,737	\$ 1.31	
Exercised		(559)	\$ 1.62	
Canceled	222	(222)	\$ 1.76	
Balance at December 31, 2004	730	5,190	\$ 1.47	
Additional options authorized	2,500			
Granted	(2,767)	2,767	\$ 1.16	
Exercised		(1,162)	\$ 0.86	
Canceled	99	(99)	\$ 1.82	
Balance at December 31, 2005	562	6,696	\$ 1.44	
Additional options authorized	5,750			
Granted	(4,670)	4,670	\$ 1.96	
Exercised		(3,066)	\$ 1.43	\$ 759
Canceled	428	(428)	\$ 1.21	
Balance at December 31, 2006	2,070	7,872	\$ 1.77	\$ 1,927
Additional options authorized (Unaudited)				
Granted (Unaudited)	(1,086)	1,086	\$ 4.64	
Exercised (Unaudited)		(665)	\$ 2.47	\$ 2,338

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Canceled (Unaudited)	72	(72)	\$	2.05	
Balance at March 31, 2007 (Unaudited)	1,056	8,221	\$	2.09	\$ 45,947

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Options outstanding that have vested and are expected to vest as of December 31, 2006 are as follows:

	Number of shares (In thousands)	Weighted average price	Weighted average remaining contractual term (In years)	Aggregate intrinsic value(1) (In thousands)
Vested	2,466	\$ 1.69	7.17	\$ 842
Expected to vest	5,028	1.81	9.30	1,009
<b>Total</b>	<b>7,494</b>	<b>\$ 1.77</b>	<b>8.63</b>	<b>\$ 1,851</b>

(1) These amounts represent the difference between the exercise price and the fair market value of common stock for all in-the-money options outstanding on December 31, 2006.

Options outstanding that have vested and are expected to vest as of March 31, 2007 are as follows (unaudited):

	Number of shares (In thousands)	Weighted average price	Weighted average remaining contractual term (In years)	Aggregate intrinsic value(1) (In thousands)
Vested	2,614	\$ 1.70	8.08	\$ 15,634
Expected to vest	5,379	2.27	8.76	29,101
<b>Total vested and expected to vest</b>	<b>7,993</b>	<b>\$ 2.09</b>	<b>8.52</b>	<b>\$ 44,735</b>
Not expected to vest	228			
	<b>8,221</b>			

(1) These amounts represent the difference between the exercise price and the fair market value of common stock for all in-the-money options outstanding on March 31, 2007.

Options outstanding that are expected to vest are net of estimated future option forfeitures in accordance with the provisions of SFAS No. 123(R).

The following table summarizes information about options outstanding at December 31, 2006:

Exercise Price	Number of	Options Outstanding Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Exercisable Options(1) Number of	Options(1) Weighted-Average Exercise
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	Shares (In thousands)	(In Years)		Shares (In thousands)	Price
\$0.76	570	8.12	\$	228	0.76
\$1.00	81	4.50	\$	81	1.00
\$1.32	1,345	8.94	\$	395	1.32
\$1.40	65	5.08	\$	52	1.4
\$1.84	1,159	5.99	\$	1,114	1.84
\$2.00	4,125	9.62	\$	274	2.0
\$2.24	527	7.55	\$	322	2.24
	7,872	8.63	\$	2,466	1.69

(1) All options under the 2000 Plan may be exercised prior to vesting but are subject to repurchase at the original issuance price in the event the optionees' employment is terminated.

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes information about options outstanding at March 31, 2007 (unaudited):

Exercise Price	Options Outstanding			Exercisable Options(1)	
	Number	Weighted-Average Remaining Contractual Life (In Years)	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
	of Shares (In thousands)			of Shares (In thousands)	Price
\$0.76	508	7.85	\$ 0.76	228	\$ 0.76
\$1.00	77	4.25	\$ 1.00	77	\$ 1.00
\$1.32	1,291	8.70	\$ 1.32	470	\$ 1.32
\$1.40	57	4.83	\$ 1.40	44	\$ 1.40
\$1.84	1,117	5.73	\$ 1.84	1,090	\$ 1.84
\$2.00	3,707	9.38	\$ 2.00	361	\$ 2.00
\$2.24	504	7.31	\$ 2.24	337	\$ 2.24
\$4.04	832	9.76	\$ 4.04	7	\$ 4.04
\$7.68	128	9.87	\$ 7.68		\$
	8,221	8.52	\$ 2.09	2,614	\$ 1.70

(1) All options under the 2000 Plan may be exercised prior to vesting but are subject to repurchase at the original issuance price in the event the optionee's employment is terminated.

**13. Shares Reserved for Future Issuances**

Common stock reserved for future issuance was as follows (in thousands):

	At December 31, 2006	At March 31, 2007 (Unaudited)
2000 Plan:		
Outstanding stock options	7,872	8,221
Reserved for future option grants	2,070	1,056
Total common stock reserved for stock options	9,942	9,277
Warrants to purchase convertible preferred stock	1,297	1,297
Warrants to purchase common stock	36	36
Convertible preferred stock:		
Series A	3,812	3,812
Series B	2,368	2,368
Series C	1,580	1,580
Series D	6,920	6,920



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Series E	21,590	21,590
Series F	2,723	2,723
Series G	20,435	20,435
<b>Total convertible preferred stock</b>	<b>59,428</b>	<b>59,428</b>
Total common stock reserved for future issuances	70,703	70,038

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The following is a geographic breakdown of the provision for income taxes (in thousands):

	2004	December 31, 2005	2006	March 31, 2007 (Unaudited)
Domestic	\$	\$ 7	\$ 5	\$ 1
Foreign		5	67	28
<b>Total</b>	<b>\$</b>	<b>\$ 12</b>	<b>\$ 72</b>	<b>\$ 29</b>

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows (in thousands):

	December 31, 2005	December 31, 2006	March 31, 2007 (Unaudited)
<b>Deferred tax assets:</b>			
Net operating losses	\$ 61,755	\$ 82,550	\$ 84,786
Research credits	7,901	8,070	8,700
Nondeductible	4,205	8,321	9,423
Capitalized software	565	1,979	2,187
Intangibles	19,771	27,635	30,360
<b>Total deferred tax assets</b>	<b>94,197</b>	<b>128,555</b>	<b>135,456</b>
Valuation allowance	(94,197)	(128,555)	(135,456)
<b>Net deferred tax assets</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>

Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance. The valuation allowance increased by \$29.1 million, \$23.5 million and \$34.4 million for 2004, 2005 and 2006, respectively. The net change in the total valuation allowance for the three months ended March 31, 2007 was an increase of \$6.9 million.

Since inception, the Company has incurred operating losses and, accordingly, have not recorded a provision for income taxes for any periods presented. As of December 31, 2006, the Company had net operating loss carry-forwards for federal income tax purposes of \$205.7 million, which expire beginning in the year 2021 if not utilized. The Company also has state net operating loss carry-forwards of \$193.6 million, which expire beginning in the year 2013. The Company has federal and California research and development credits of approximately \$5.6 million and \$3.7 million, respectively. The federal research credits will begin to expire in the year 2021, and the California research credits have no expiration date. \$0.1 million of federal net operating losses relate to stock option deductions, for which a full valuation allowance has been recorded.

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As of March 31, 2007, the Company had net operating loss carry-forwards for federal income tax purposes of \$211.3 million, which expire beginning in the year 2021 if not utilized. The Company also has state net operating loss carry-forwards of \$199.1 million, which expire beginning in the year 2013.

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**INFINERA CORPORATION**

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

The Company has federal and California research and development credits of approximately \$6.0 million and \$4.0 million, respectively. The federal research credits will begin to expire in the year 2021, and the California research credits have no expiration date. \$1.0 million of federal net operating losses relate to stock option deductions, for which a full valuation allowance has been recorded.

Utilization of the Company's net operating losses and credit carry-forwards may be subject to a substantial annual limitation due to the ownership change limitations under the Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration of the net operating losses and credit carry-forwards before the Company can utilize them.

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), at the beginning of 2007. At the adoption date of January 1, 2007, the cumulative unrecognized tax benefit was \$6.4 million which was netted against deferred tax assets with a full valuation allowance or other fully reserved amounts, and if recognized there would be no effect on the Company's effective tax rate. Upon adoption of FIN 48, the Company recognized no adjustment in the liability for unrecognized income tax benefits.

At March 31, 2007, the cumulative unrecognized tax benefit was \$6.9 million that was substantially netted against deferred tax assets with a full valuation allowance. Included in the \$6.9 million of cumulative unrecognized tax benefit, approximately \$10,000 impacted the Company's effective tax rate in the current quarter. At March 31, 2007, the Company had no liability for unrecognized tax benefits nor any accrued interest and penalties related to uncertain tax positions. Tax returns for all years after 2002 are subject to future examination by the major taxing jurisdictions to which the Company is subject.

The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2003 through 2006. The Company and its subsidiaries' state income tax returns are open to audit under the statute of limitations for the years ended December 31, 2002 through 2006.

For FIN 48 purposes, the Company recognizes interest and penalties related to uncertain tax positions as part of its provision for federal, state and foreign income taxes.

**15. Segment Information**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Company's chief executive officer. The Company's chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue by geographic region is based on the shipping address of the customer. The following table sets forth revenue and long-lived assets by geographic region:

**Revenue**

	As of December 31,			Three Months Ended	
	2004	2005	2006	2006	2007
	(In thousands)				
United States	\$	\$ 2,660	\$ 49,901	\$ 2,082	\$ 39,945
Europe, Middle East and Africa		776	7,565	409	8,844
Asia Pacific and Japan	599	691	770	162	403
Total revenue	\$ 599	\$ 4,127	\$ 58,236	\$ 2,653	\$ 49,192

**Property, plant and equipment, net**

	As of December 31,			March 31,	
	2004	2005	2006	2007	(Unaudited)
	(In thousands)				
United States	\$ 16,356	\$ 14,155	\$ 26,030	\$	28,832
Europe, Middle East and Africa			3		3
Asia Pacific and Japan	290	379	632		649
Total property, plant and equipment, net	\$ 16,646	\$ 14,534	\$ 26,665	\$	29,484

**16. Employee Benefit Plan**

In July 2001, the Company's Board of Directors approved the adoption of a savings plan under Section 401(k) of the Internal Revenue Code. Expenses related to the Company's 401(k) plan were immaterial for 2004, 2005 and 2006.

**17. Legal Matters**

On May 9, 2006, the Company and Level 3 were sued by Cheetah Omni LLC for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under patent No. 6,795,605 and asserting that the claims of the patent are invalid and that the DTN System does not infringe the patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under patent No. 7,142,347 and the Company and Level 3 asserted counterclaims

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against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

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

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office for inter partes reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347 asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

On April 11, 2007, the Company and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit.

From time to time, the Company may be subject to other legal proceedings and claims in the ordinary course of its business.

**18. Guarantees****Product Warranties**

Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under the hardware warranty. In general, hardware warranty periods range from two to five years. Hardware product warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the warranty period, the purchaser's sole and exclusive remedy in the event of such defect or failure to perform is expressly limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company's sole option and expense. The Company estimates the fair value of the Company's hardware warranty obligations based on the Company's historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company's recorded warranty liabilities and adjusts the amounts as necessary. Changes in product warranty liability in 2005, 2006 and March 31, 2007 are summarized below.

	For the Years Ended		
	December 31, 2005	December 31, 2006	March 31, 2007 (Unaudited)
	(In thousands)		
Balance at the beginning of the period	\$	\$ 1,692	\$ 2,717
Charges to operations	2,079	4,166	2,319
Utilization	(407)	(2,090)	(720)
Change in estimate	20	(1,051)(1)	2,492(2)
Balance at the end of the period	\$ 1,692	\$ 2,717	\$ 6,808





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**INFINERA CORPORATION**

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

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- (1) Change in estimate represents overall improvement in average return rates and lower than expected cost of repair.
- (2) Change in estimate includes an increase in the expected future returns related to a component quality issue on one specific product that ceased shipping in June 2006. In addition, the Company increased its expected cost of replacing defective units due to a reduction in the expected volume of repaired units available to satisfy customer warranty claims.

The Company's agreements with customers, as well as its reseller agreements, generally include certain provisions for indemnifying customers and resellers and their affiliated parties against liabilities if the Company's products infringe a third party's intellectual property rights. To date, the Company has not incurred any material costs as a result of such indemnification obligations and has not accrued any liabilities related to such obligations in the Company's consolidated financial statements.

***Letters of Credit***

The Company had \$3.2 million of stand-by letters of credit outstanding as of December 31, 2006 and March 31, 2007, of which \$1.0 million related to property leases, \$1.2 million related to a vendor credit line and \$1.0 million related to a valued added tax license for Europe.

**19. New Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). The purpose of SFAS No. 157 is to define fair value, establish a framework for measuring fair value and enhance disclosures about fair value measurements. The measurement and disclosure requirements are effective for the Company beginning in the first quarter of 2008. The Company is currently evaluating the impact that SFAS No. 157 will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 is effective for the Company beginning in the first quarter of 2008, although earlier adoption is permitted. The Company is currently evaluating the impact that SFAS No. 159 will have on its consolidated financial statements.

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No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus. You must not rely on any unauthorized information or representations. This prospectus is an offer to sell only the shares offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus is current only as of its date.

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Through and including July 1, 2007 (the 25th day after the date of this prospectus), all dealers effecting transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to a dealer's obligation to deliver a prospectus when acting as an underwriter and with respect to an unsold allotment or subscription.

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14,000,000 Shares

**Infinera Corporation**

Common Stock

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**Goldman, Sachs & Co.**

**Citi**

**JPMorgan**

**Lehman Brothers**

**Thomas Weisel Partners LLC**

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