Fabrinet
Form 10-Q
November 09, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2016

OR

¨ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
Commission File Number: 001-34775

FABRINET

(Exact name of registrant as specified in its charter)

Cayman Islands	**Not Applicable**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

c/o Intertrust Corporate Services (Cayman) Limited

190 Elgin Avenue

George Town

Grand Cayman

Cayman Islands	**KY1-9005**
(Address of principal executive offices)	**(Zip Code)**

+66 2-524-9600

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act) 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 x 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 x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if 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 x No

As of November 4, 2016, the registrant had 36,856,532 ordinary shares, $0.01 par value, outstanding.

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FORM 10-Q

QUARTER ENDED SEPTEMBER 30, 2016

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PART I: FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

FABRINET

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands of U.S. dollars, except share data)	**September 30, 2016**	**June 24, 2016**
Assets		
Current assets		
Cash and cash equivalents	$ 105,860	$ 142,804
Marketable securities	147,702	141,709
Trade accounts receivable, net	212,684	196,145
Inventory, net	205,484	181,499
Deferred tax assets		1,358
Prepaid expenses	3,511	3,114
Other current assets	5,210	6,662
Total current assets	680,451	673,291
Non-current assets		
Restricted cash in connection with business acquisition	3,379	
Property, plant and equipment, net	205,845	178,410
Intangibles, net	5,091	499
Goodwill	2,994	
Deferred tax assets	2,503	1,806
Deferred debt issuance costs on revolving loan and other non-current assets	1,040	1,851
Total non-current assets	220,852	182,566
Total Assets	$ 901,303	$ 855,857
Liabilities and Shareholders Equity		
Current liabilities		
Bank borrowings, net of unamortized debt issuance costs	$ 37,516	$ 24,307
Trade accounts payable	179,741	172,052
Fixed assets payable	19,694	20,628
Capital lease liability, current portion	122	
Income tax payable	3,077	2,010
Accrued payroll, bonus and related expenses	12,417	12,300
Accrued expenses	6,462	8,072
Other payables	10,214	16,356

Total current liabilities		269,243	255,725
Non-current liabilities			
Long-term loan from bank, non-current portion, net of unamortized debt issuance costs		32,759	36,100
Deferred tax liability			854
Capital lease liability, non-current portion		1,556	
Deferred liability in connection with business acquisition		3,379	
Severance liabilities		7,154	6,684
Other non-current liabilities		2,179	2,075
Total non-current liabilities		47,027	45,713
Total Liabilities		316,270	301,438
Commitments and contingencies (Note 16)			
Shareholders equity			
Preferred shares (5,000,000 shares authorized, $0.01 par value; no shares issued and outstanding as of September 30, 2016 and June 24, 2016)			
Ordinary shares (500,000,000 shares authorized, $0.01 par value; 36,700,468 shares and 36,156,446 shares issued and outstanding as of September 30, 2016 and June 24, 2016, respectively)		367	362
Additional paid-in capital		109,772	102,325
Accumulated other comprehensive income		987	591
Retained earnings		473,907	451,141
Total Shareholders Equity		585,033	554,419
Total Liabilities and Shareholders Equity	$	901,303	$ 855,857

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

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UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(in thousands of U.S. dollars, except per share amounts)	Three Months Ended September 30, 2016	Three Months Ended September 25, 2015
Revenues	$ 332,043	$ 216,433
Cost of revenues	(292,435)	(190,422)
Gross profit	39,608	26,011
Selling, general and administrative expenses	(15,832)	(11,900)
Other expense related to flooding		(864)
Operating income	23,776	13,247
Interest income	437	442
Interest expense	(1,322)	(402)
Foreign exchange gain (loss), net	1,657	(10,492)
Other income	143	103
Income before income taxes	24,691	2,898
Income tax expense	(1,925)	(1,295)
Net income	22,766	1,603
Other comprehensive income, net of tax:		
Change in net unrealized (loss) gains on marketable securities	(187)	87
Change in net unrealized loss on derivative instruments	(158)	
Change in foreign currency translation adjustment	741	
Total other comprehensive income, net of tax	396	87
Net comprehensive income	$ 23,162	$ 1,690
Earnings per share		
Basic	$ 0.63	$ 0.05
Diluted	$ 0.61	$ 0.04
Weighted-average number of ordinary shares outstanding (thousands of shares)		
Basic	36,404	35,579
Diluted	37,330	36,315

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

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UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands of U.S. dollars)	Three Months Ended September 30, 2016	Three Months Ended September 25, 2015
Cash flows from operating activities		
Net income for the period	$ 22,766	$ 1,603
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	5,113	4,063
Gain on disposal of property, plant and equipment	(40)	(26)
Loss from sales and maturities of available-for-sale securities	100	92
Amortization of investment premium	166	298
Amortization of deferred debt issuance costs	908	171
Allowance for doubtful accounts (reversal of)	3	(4)
Unrealized (gain) loss on exchange rate and fair value of derivative instruments	(1,913)	10,855
Share-based compensation	5,611	2,673
Deferred income tax	311	157
Other non-cash expenses	453	386
(Reversal of) inventory obsolescence	(62)	150
Loss from written-off inventory due to flood loss		233
Changes in operating assets and liabilities		
Trade accounts receivable	(11,876)	(4,948)
Inventory	(21,290)	(13,150)
Other current assets and non-current assets	3,285	(668)
Trade accounts payable	3,103	3,053
Income tax payable	1,035	707
Other current liabilities and non-current liabilities	(8,675)	(1,106)
Net cash (used in) provided by operating activities	(1,002)	4,539
Cash flows from investing activities		
Purchase of marketable securities	(32,737)	(38,773)
Proceeds from sales of marketable securities	13,061	16,687
Proceeds from maturities of marketable securities	13,230	12,528
Payments in connection with business acquisition, net of cash acquired	(9,664)	
Restricted cash in connection with business acquisition	(3,379)	
Purchase of property, plant and equipment	(27,090)	(8,452)
Purchase of intangibles	(178)	(68)
Deposits for land purchase		(2,352)
Proceeds from disposal of property, plant and equipment	107	28
Net cash used in investing activities	(46,650)	(20,402)

Cash flows from financing activities		
Payment of debt issuance costs		(353)
Proceeds from revolving loans	13,500	
Repayment of long-term loans from bank	(4,900)	(1,500)
Proceeds from issuance of ordinary shares under employee share option plans	2,708	1,547
Withholding tax related to net share settlement of restricted share units	(867)	(878)
Net cash provided by (used in) financing activities	10,441	(1,184)
Net decrease in cash and cash equivalents	(37,211)	(17,047)
Movement in cash and cash equivalents		
Cash and cash equivalents at beginning of period	142,804	112,978
Decrease in cash and cash equivalents	(37,211)	(17,047)
Effect of exchange rate on cash and cash equivalents	267	(466)
Cash and cash equivalents at end of period	$ 105,860	$ 95,465
Non-cash investing and financing activities		
Construction and equipment-related payables	$ 19,694	$ 5,123

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(in thousands of U.S. dollars unless otherwise noted)

1. Business and organization

General

Fabrinet (Fabrinet or the Parent Company) was incorporated on August 12, 1999, and commenced operations on January 1, 2000. The Parent Company is an exempted company incorporated in the Cayman Islands, British West Indies. The Company refers to Fabrinet and its subsidiaries as a group.

The Company provides advanced optical packaging and precision optical, electro-mechanical and electronic manufacturing services to original equipment manufacturers (OEMs) of complex products, such as optical communication components, modules and sub-systems, industrial lasers, medical devices and sensors. The Company offers a broad range of advanced optical and electro-mechanical capabilities across the entire manufacturing process, including process design and engineering, supply chain management, manufacturing, complex printed circuit board assembly, advanced packaging, integration, final assembly and testing. The Company focuses primarily on the production of low-volume, high-mix products. The principal subsidiaries of Fabrinet include Fabrinet Co., Ltd. (Fabrinet Thailand), Casix, Inc. (Casix) and Fabrinet West, Inc. (Fabrinet West).

2. Accounting policies

Basis of presentation

The accompanying unaudited condensed consolidated financial statements for Fabrinet as of September 30, 2016 and for the three months ended September 30, 2016 and September 25, 2015 includes normal recurring adjustments, necessary for a fair presentation of the financial statements set forth herein, in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, such information does not include all of the information and footnotes required by U.S. GAAP for annual financial statements. For further information, please refer to the consolidated financial statements and footnotes thereto included in Fabrinet s Annual Report on Form 10-K for the year ended June 24, 2016.

The balance sheet as of June 24, 2016 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The results for the three months ended September 30, 2016 may not be indicative of results for the year ending June 30, 2017 or any future periods.

Where necessary, comparative figures have been reclassified to conform to the current period accounting policies and presentation adopted.

On September 14, 2016, the Company acquired 100% of the shares of Global CEM Solutions, Ltd. and all of its subsidiaries, a privately-held group located in Wiltshire, United Kingdom (Exception EMS). The unaudited condensed

consolidated financial statements of the Company include the financial position, results of operations and the cash flows of Exception EMS commencing as of the acquisition date. See Note 8 - Business acquisitions for further details on the accounting for this transaction.

Use of Estimates

The preparation of the Company s condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, and the reported amount of total revenues and expenses during the year. The Company bases estimates on historical experience and various assumptions about the future that are believed to be reasonable based on available information. The Company s reported financial position or results of operations may be materially different under different conditions or when using different estimates and assumptions, particularly with respect to significant accounting policies, which are discussed below. Significant assumptions are used in accounting for share-based compensation, allowance for doubtful accounts, income taxes, inventory obsolescence and valuation of intangible assets related to business acquisition, among others. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be different from these estimates. In the event that estimates or assumptions prove to differ from actual results, adjustments will be made in subsequent periods to reflect more current information.

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Fiscal years

The Company utilizes a 52-53 week fiscal year ending on the Friday in June closest to June 30. The three months ended September 30, 2016 and September 25, 2015 each consisted of 14 weeks and 13 weeks, respectively. Fiscal year 2017 will be comprised of 53 weeks and will end on June 30, 2017.

Concentration of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents, marketable securities, derivatives, and accounts receivable.

Cash, cash equivalents, and marketable securities are maintained with several financial institutions. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and are maintained with financial institutions with reputable credit and therefore bear minimal credit risk. The Company seeks to mitigate its credit risks by spreading such risks across multiple counterparties and monitoring the risk profiles of these counterparties. The Company limits its investments in marketable securities to securities with a maturity not in excess of three years, and all marketable securities that the Company invests in are rated A1, P-1, F1, or better.

The Company performs ongoing credit evaluations for credit worthiness of its customers and usually does not require collateral from its customers. Management has implemented a program to closely monitor near term cash collection and credit exposures to mitigate any material losses.

Derivatives

The derivatives assets and liabilities are recognized on the consolidated balance sheets as other current assets or accrued expenses measured at fair value.

The Company applies hedge accounting to arrangements that qualify and are designated for cash flow hedge accounting treatment. Hedge accounting is discontinued prospectively if the hedging relationship ceases to be effective or the hedging or hedged items cease to exist as a result of maturity, sale, termination or cancellation.

Derivatives designated and qualifying as hedges of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges which include forward currency contracts. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative is initially recorded in accumulated other comprehensive income (loss) (AOCI), while any ineffective portion is recognized directly in earnings, as a component of other income (expense). The portion of gain or loss on the derivative instrument remains in AOCI until the forecasted transaction is recognized in earnings.

The Company also enters into derivative contracts that are intended to economically hedge certain of the Company s risks. The changes in the fair value of the derivatives are recorded directly in earnings as a component of other income (expense), net. In accordance with the fair value measurement guidance, the Company s accounting policy is to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio. The Company executes derivative instruments with financial institutions that are credit-worthy, defined as institutions that hold an investment grade credit rating.

Business acquisition

For the acquisition of Exception EMS, the Company allocated the fair value of purchase consideration to the assets acquired and liability assumed based on their fair values at the acquisition date. The total consideration and the allocation of consideration to the individual net assets is preliminary, as there are remaining uncertainties to be resolved, including the settlement of the final net working capital adjustment and the finalization of the estimated fair value attributable to the acquired intangible assets.

The acquired intangible assets include customer relationships and backlog and are recorded as intangibles in the unaudited condensed consolidated balance sheets. The fair value of the acquired intangible assets was determined based on the multi-period excess earnings method. The Company reviews intangibles for impairment annually or whenever changes or circumstances indicate the carrying amount may not be recoverable.

In connection with the business acquisition, $3.4 million of cash for deferred consideration was placed into an escrow account which is under the Company controls. However, the Company has contractually agreed to remit this deferred consideration to the sellers of Exception EMS, subject to the resolution of claims that the Company may make against the funds with respect to indemnification and other claims within 24 months from the closing date of the transaction. The cash is presented as restricted cash in the unaudited condensed consolidated balance sheets and the related liability is presented within non-current liabilities for the deferred consideration.

Goodwill

Goodwill arising from the acquisition is primarily attributable to the ability to expand future products and services and the assembled workforce. Goodwill is reviewed annually for impairment or more frequently whenever changes or circumstances indicate the carrying amount of goodwill may not be recoverable.

Capital lease

Certain machine and equipment held under capital leases are classified as property, plant and equipment and amortized using the straight-line method over the terms of the lease contracts. The related obligations from the capital lease are recorded as liabilities in the unaudited condensed consolidated balance sheets.

New Accounting Pronouncements not yet adopted by the Company

In October 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-16, Income Taxes (Topic 740) Intra-Entity Transfers of Assets Other Than Inventory, which eliminates the exception for an intra-entity transfer of an asset other than inventory that prohibits the recognition of current and deferred income taxes until the asset has been sold to an outside party. The entity should recognize income tax consequences of an intra-entity transfer of assets other than inventory when the transfer occurs. For public entities, this update is effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements have not been issued or made available for issuance. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force). The amendments in this ASU provide guidance on the presentation of certain cash receipts and cash payments in the statement of cash flows in order to reduce diversity in existing practice. The amendments in ASU 2016-15 are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The amendments in this ASU replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASU simplifies several aspects of the accounting for share-based payment award transactions, including, the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. The amendments in this update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods, for public companies. Early adoption is permitted for any entity in any interim or annual period. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

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In March 2016, the FASB issued ASU 2016-05, Derivatives and Hedging (Topic 815), to clarify that a change in the counterparty to a derivative instrument that has been designated as a hedging instrument under Topic 815, does not, in and of itself, require designation of the hedging relationship, provided that all other hedge accounting criteria continue to be met. This guidance is effective for public entities for financial statements issued for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Lease (Topic 842). The core principle of Topic 842 is that a lessee should recognize the lease assets and liabilities that arise from leases in the statement of financial position. For public business entities, this update is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This new guidance requires certain equity investments to be measured at fair value, use of the exit price notion and separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. The ASU on recognition and measurement will take effect for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. The update provides the guidance that an entity, that measured inventory by using first-in, first-out or average cost, should measure inventory at the lower of cost and net realizable value. Subsequent measurement is unchanged for inventory measured using last-in, first-out or the retail inventory method. The update is effective for fiscal years beginning after December 15, 2016, including interim periods within these fiscal years. This update should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting date. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity s Ability to Continue as a Going Concern. The amendments require management to evaluate, for each annual and interim reporting period, an entity s ability to continue as a going concern when relevant conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations that become due within one year after the date that the financial statements are issued (or available to be issued). This ASU is effective for annual periods and interim reporting periods beginning after December 15, 2016. The Company does not expect that the adoption of this update will have an effect on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), issued as a new Topic, Accounting Standards Codification. The core principle of this amendment is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update is effective for public companies, as amended by ASU 2015-14, for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application of this guidance is permitted, but not before the original date of December 15, 2016, which can be adopted either retrospectively to each prior reporting period presented or as a cumulative-effect adjustment as of the date of adoption. Subsequently, in March 2016 and April 2016, the FASB issued ASU 2016-08 and ASU 2016-10, to clarify the implementation guidance on principle versus agent considerations and address the potential diversity in practice at initial application and cost; and the complexity

of applying Topic 606, both at transition and on an ongoing basis related to identification of performance obligations and licensing arrangements; and ASU 2016-12, in May 2016, to improve in certain aspects of Topic 606, with the same effective date as ASU 2015-14. The Company will adopt this standard during its fiscal year ending June 28, 2018. In the current period, the Company is assessing the contracts with its customers to identify the impact to its consolidated financial statements. The process is still ongoing and the Company expects to make significant progress in the coming quarters.

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New Accounting Pronouncements adopted by the Company

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes, which will require entities to present deferred tax assets (DTAs) and deferred tax liabilities (DTLs) as non-current in a classified balance sheet. The ASU simplifies the current guidance, which requires entities to separately present DTAs and DTLs as current and non-current in a classified balance sheet. The Company adopted of this update early. Accordingly, as of September 30, 2016, DTAs of $1.2 million were classified to non-current in the unaudited condensed consolidated balance sheets. The Company adopted this update on a prospective basis and did not change the presentation of the comparative period.

In September 2015, the FASB issued ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments which require an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The Company has adopted of this update and applied it on a prospective basis.

In April 2015, the FASB issued ASU 2015-03, Interest Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The update requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability instead of being presented as an asset. Debt disclosures will include the face amount of the debt liability and the effective interest rate. The update requires retrospective application and represents a change in accounting principle. Additionally, in August 2015, the FASB issued ASU 2015-15, Interest Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements to amend ASU 2015-03. The Company has adopted this amendment retrospectively. As of September 30, 2016 and June 24, 2016, debt issuance costs of $0.5 million and $0.6 million, respectively, related to a recognized debt liability are presented in the balance sheet as a direct reduction of the carrying amount of the related debts.

In February 2015, the FASB issued ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis. ASU No. 2015-02 amended the process that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The Company has adopted this update with no impact to the unaudited condensed consolidated financial statements.

In January 2015, the FASB issued ASU 2015-01, Income Statement Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items. The objective of this amendment is to reduce the complexity in accounting standards by eliminating the concept of extraordinary items from U.S. GAAP. To meet for extraordinary classification the underlying event or transaction should (a) possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity and (b) not reasonably be expected to recur in the foreseeable future. The Company has adopted this update with no impact to the unaudited condensed consolidated financial statements.

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3. Earnings per ordinary share

Basic earnings per ordinary share is computed by dividing reported net income by the weighted-average number of ordinary shares outstanding during each period. Diluted earnings per ordinary share is computed by calculating the effect of potential dilutive ordinary shares outstanding during the period using the treasury stock method. Dilutive ordinary equivalent shares consist of share options, restricted share units and performance share units. Earnings per ordinary share was calculated as follows:

(amount in thousands except per share amounts)	Three Months Ended September 30, 2016	September 25, 2015
Net income attributable to shareholders	$ 22,766	$ 1,603
Weighted-average number of ordinary shares outstanding (thousands of shares)	36,404	35,579
Incremental shares arising from the assumed exercise of share options and vesting of restricted share units (thousands of shares)	926	736
Weighted-average number of ordinary shares for diluted earnings per ordinary share (thousands of shares)	37,330	36,315
Basic earnings per ordinary share	$ 0.63	$ 0.05
Diluted earnings per ordinary share	$ 0.61	$ 0.04
Outstanding share options excluded in the computation of diluted earnings per ordinary share [(1)]		62,304

(1) These share options were not included in the computation of diluted earnings per ordinary share because the exercise price of the options was greater than the average market price of the underlying shares.

4. Cash, cash equivalents and marketable securities

The Company s cash, cash equivalents, and marketable securities can be analyzed as follows:

			Fair Value	
(amount in thousands)	Carrying Cost	Unrealized Gain/(Loss)	Cash and Cash Equivalents	Marketable Securities
As of September 30, 2016				
Cash	$ 105,675	$	$ 105,675	$

Cash equivalents	185		185	
Corporate bonds and commercial papers	116,926	235		117,161
U.S. agency and U.S. treasury securities	29,411	(23)		29,388
Sovereign and municipal securities	1,153			1,153
Total	$ 253,350	$ 212	$ 105,860	$ 147,702

			Fair Value	
(amount in thousands)	**Carrying Cost**	**Unrealized Gain**	**Cash and Cash Equivalents**	**Marketable Securities**
As of June 24, 2016				
Cash	$ 136,754	$	$ 136,754	$
Cash equivalents	6,050		6,050	
Corporate bonds and commercial papers	112,128	394		112,522
U.S. agency and U.S. treasury securities	28,028	2		28,030
Sovereign and municipal securities	1,154	3		1,157
Total	$ 284,114	$ 399	$ 142,804	$ 141,709

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All highly liquid investments with original maturities of three months or less at the date of purchase are classified as cash equivalents. Management determines the appropriate classification of its investments at the time of purchase and reevaluates the designations at each balance sheet date. The Company may sell certain of its marketable securities prior to their stated maturities for strategic reasons including, but not limited to, anticipation of credit deterioration and duration management. The maturities of the Company s marketable securities generally range from three months to three years. The Company s investments in marketable securities consist of investments in U.S. Treasuries and fixed income securities and have been classified and accounted for as available-for-sale.

The following table summarizes the cost and estimated fair value of marketable securities classified as available-for-sale securities based on stated effective maturities as of September 30, 2016:

(amount in thousands)	**Carrying Cost**	**Fair Value**
Due within one year	$ 16,828	$ 16,830
Due between one to three years	130,662	130,872
Total	$ 147,490	$ 147,702

During the three months ended September 30, 2016, the Company recognized a realized loss of $0.1 million from sales and maturities of available-for-sale securities.

As of September 30, 2016, the Company considered the declines in market value of its marketable securities investment portfolio to be temporary in nature and did not consider any of its securities other-than-temporarily impaired. The Company typically invests in highly-rated securities, and its investment policy generally limits the amount of credit exposure to any one issuer. The policy requires investments generally to be investment grade, with the primary objective of minimizing the potential risk of principal loss. Fair values were determined for each individual security in the investment portfolio. When evaluating an investment for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below its cost basis, the financial condition of the issuer and any changes thereto, changes in market interest rates, and the Company s intent to sell, or whether it is more likely than not it will be required to sell, the investment before recovery of the investment s cost basis. No impairment losses were recorded for the three months ended September 30, 2016.

As of September 30, 2016, cash, cash equivalents, and marketable securities included bank deposits of $40.0 million held in various financial institutions located in the United States in order to support the availability of the Facility Agreement (as defined in Note 11) and comply with covenants. As discussed in Note 11, under the terms and conditions of the Facility Agreement, the Company shall maintain cash, cash equivalents and/or marketable securities in an aggregate amount not less than $40.0 million in unencumbered deposits, and/or securities in accounts located in the United States at all times during the term of the Facility Agreement. The Company must comply with the covenant from and after the effective date of the Facility Agreement.

5. Fair value of financial instruments

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is established which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs for the valuation of an asset or liability as of

measurement date. The three levels of inputs that may be used to measure fair value are defined as follows:

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for assets or liabilities, either directly or indirectly. If the assets or liabilities have a specified (contractual) term, Level 2 inputs must be observable for substantially the full term of assets or liabilities.

Level 3 inputs are unobservable inputs for assets or liabilities, which require the reporting entity to develop its own valuation techniques and assumptions.

The Company utilizes the market approach to measure fair value for its financial assets and liabilities. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

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The following table provides details of the financial instruments measured at fair value on a recurring basis, including:

	Fair Value Measurements at Reporting Date Using			
(amount in thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**
As of September 30, 2016				
Assets				
Cash equivalents	$	$ 185	$	$ 185
Corporate bonds and commercial papers		117,161		117,161
U.S. agency and U.S. treasury securities		29,388		29,388
Sovereign and municipal securities		1,153		1,153
Total	$	$ 147,887	$	$ 147,887
Liabilities				
Derivative liabilities	$	$ 49 [(1)]	$	$ 49
Total	$	$ 49	$	$ 49

	Fair Value Measurements at Reporting Date Using			
(amount in thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**
As of June 24, 2016				
Assets				
Cash equivalents	$	$ 6,050	$	$ 6,050
Corporate bonds and commercial papers		112,522		112,522
U.S. agency and U.S. treasury securities		28,030		28,030
Sovereign and municipal securities		1,157		1,157
Derivative assets		158[(2)]		158
Total	$	$ 147,917	$	$ 147,917
Liabilities				
Derivative liabilities	$	$ 1,754[(3)]	$	$ 1,754
Total	$	$ 1,754	$	$ 1,754

(1) Foreign currency forward contracts with notional amount of $42.5 million and Canadian dollars 0.4 million.
(2) Foreign currency forward contracts with notional amount of $7.0 million.
(3) Foreign currency forward contracts with notional amount of $77.5 million and Canadian dollars 0.6 million.

Derivative Financial Instruments

As a result of foreign currency rate fluctuations, the U.S. dollar equivalent values of the Company s foreign currency denominated assets and liabilities change. The Company uses foreign currency contracts to manage the foreign

exchange risk associated with certain foreign currency denominated assets and liabilities and other foreign currency transactions. The Company minimizes the credit risk in derivative instruments by limiting its exposure to any single counterparty and by entering into derivative instruments only with counterparties that meet the Company s minimum credit quality standard. As of September 30, 2016, the Company recognized the fair value of foreign currency forward contracts of $0.05 million as derivative liabilities in the unaudited condensed consolidated balance sheet. As of June 24, 2016, the Company recognized the fair value of foreign currency forward contracts of $0.2 million as derivative assets and $1.7 million as derivative liabilities in the unaudited condensed consolidated balance sheets.

As of September 30, 2016, the Company had no foreign currency forward contract, designated as cash flow hedges. During the three months ended September 30, 2016, the Company discontinued cash flow hedges and recognized a gain from unwinding these forward contracts of $0.3 million in the unaudited condensed consolidated statements of operations and comprehensive income. A gain of $0.01 million in AOCI for the three months ended September 30, 2016 is expected to be reclassified into the earnings within the next 12 months.

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As of September 30, 2016, the Company had nine outstanding foreign currency forward contracts with notional amount of $42.5 million and Canadian dollars 0.4 million, maturing during October to December 2016. These foreign currency forward contracts were not designated for hedge accounting and were used to hedge fluctuations in the U.S. dollar value of forecasted transactions denominated in Thai baht and Canadian dollar. During the three months ended September 30, 2016, the Company included unrealized loss of $0.05 million from changes in the fair value of foreign currency contracts in earnings in the unaudited condensed consolidated statements of operations and comprehensive income.

As of September 25, 2015, the Company had 42 outstanding foreign currency options with notional amount of $11.0 million and forward contracts with notional amount of $169.5 million, Canadian dollars 1.0 million and Japanese yen of 0.1 million, maturing during September 2015 to December 2016. These foreign currency forward contracts and options were not designated for hedge accounting and were used to hedge fluctuations in the U.S. dollar value of forecasted transactions denominated in Thai baht and Canadian dollar. During the three months ended September 25, 2015, the Company included unrealized gain of $12.1 million from changes in the fair value of foreign currency contracts in earnings in the unaudited condensed consolidated statements of operations and comprehensive income.

6. Trade accounts receivable, net

(amount in thousands)	**As of September 30, 2016**	**As of June 24, 2016**
Trade accounts receivable	$ 212,774	$ 196,178
Less: Allowance for doubtful account	(90)	(33)
Trade accounts receivable, net	$ 212,684	$ 196,145

As of September 30, 2016, trade accounts receivable of $1.7 million were secured to short-term loans from bank (see Note 11).

7. Inventory

(amount in thousands)	**As of September 30, 2016**	**As of June 24, 2016**
Raw materials	$ 66,759	$ 58,199
Work in progress	106,702	94,762
Finished goods	23,007	21,593
Goods in transit	12,491	9,381
	208,959	183,935
Less: Inventory obsolescence	(3,475)	(2,436)

Inventory, net	$ 205,484	$ 181,499

8. Business acquisition

On September 14, 2016, the Company acquired 100% of the shares of Exception EMS, a privately-held group located in Wiltshire, United Kingdom, for cash consideration of approximately $13.0 million, net of $0.5 million cash acquired. Exception EMS provides contract electronics manufacturing services to the global electronics industry with innovative solutions, adding value to the design, manufacture and testing of printed circuit board assemblies. Pursuant to the acquisition agreement, the Company has placed $3.4 million of cash for deferred consideration in an escrow account which is under the Company controls. However, the Company has contractually agreed to remit this deferred consideration to the sellers of Exception EMS, subject to the resolution of claims that the Company may make against the funds with respect to indemnification and other claims, within 24 months from the closing date of the transaction.

The Company has concluded it is the accounting acquirer for in the transaction and accounted for the acquisition under the provisions of business combinations accounting, in accordance with Accounting Standards Codification Topic 805 Business Combinations. Accordingly, the estimated fair value of the acquisition consideration was allocated to the assets acquired and the liabilities assumed based on their respective fair values on the acquisition date. The Company has made certain estimates and assumptions in determining the allocation of the acquisition consideration.

The total consideration and the allocation of consideration to the individual Exception EMS net assets is preliminary, as there are remaining uncertainties to be resolved, including the settlement of the final net working capital adjustment and the finalization of the estimated fair value attributable to the acquired intangible assets. As the functional currency of Exception EMS is Pound sterling, as of September 30, 2016, the Company recognized $0.7 million of foreign exchange currency translation adjustment in its unaudited condensed consolidated statements of operations and comprehensive income.

The Company s preliminary allocation of the total purchase price for the acquisition is summarized below:

(amount in thousands)		**Purchase price allocation**
Cash	$	474
Accounts receivable		4,698
Inventory		2,633
Other current assets		425
Property, plant and equipment		5,660
Intangibles		4,472
Goodwill		2,994
Other non-current assets		509
Current liabilities		(6,792)
Other non-current liabilities		(1,556)
Total fair value of assets acquired and liabilities assumed	$	13,517
Total purchase price, net of cash acquired	$	13,043

In connection with the Company s acquisition of Exception EMS, the Company assumed lease agreements for certain machine and equipment, which are accounted for as capital leases. As of September 30, 2016, the Company included approximately $2.2 million of capital lease assets and $1.7 million of capital lease liability in the unaudited condensed consolidated balance sheets associated with these acquired lease agreements.

During the three months ended September 30, 2016, the Company incurred approximately $1.1 million, in transaction costs related to the acquisition, which primarily consisted of legal, accounting and valuation-related expenses. These expenses were recorded in selling, general and administrative expense in the accompanying unaudited condensed consolidated statements of operations and comprehensive income.

Pro forma results of operations for the acquisition have not been presented as they were not material to the Company s results of operations.

Identifiable intangibles

The acquired intangible assets include customer relationships and backlog. The fair value of the identified intangible assets was determined based on the multi-period excess earnings method.

Customer relationships represent the fair value of future projected revenues that was derived from the sale of products to existing customers of the acquired company. The fair value $4.4 million of customer relationships will be amortized over the respective estimated remaining useful life of ten years.

Backlog represents the fair value of sales orders backlog as of the valuation date. The fair value $0.1 million of backlog will be amortized over the respective estimated remaining useful life of three years.

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Goodwill

Goodwill arising from the acquisition is primarily attributable to the ability to expand future products and services and the assembled workforce. Goodwill is not deductible for tax purposes.

9. Intangibles

The following tables present details of the Company s intangibles:

(amount in thousands)	Gross Carrying Amount	Accumulated Amortization	Net
As of September 30, 2016			
Software	$ 3,915	$ (3,296)	$ 619
Customer relationships	4,372		4,372
Backlog	100		100
Total intangibles	$ 8,387	$ (3,296)	$ 5,091

(amount in thousands)	Gross Carrying Amount	Accumulated Amortization	Net
As of June 24, 2016			
Software	$ 3,786	$ (3,287)	$ 499
Customer relationships			
Backlog			
Total intangibles	$ 3,786	$ (3,287)	$ 499

In connection with the acquisition of Exception EMS, the Company recorded $4.4 million of customer relationships and $0.1 million of backlog with the weighted-average life of 7.6 years and 2.3 years, respectively.

The Company recorded amortization expense relating to intangibles of $0.03 million and $0.01 million for the three months ended September 30, 2016 and September 25, 2015, respectively.

Based on the carrying amount of intangibles as of September 30, 2016, and assuming no future impairment of the underlying assets, the estimated future amortization during each fiscal year was as follows:

(amount in thousands)	
2017 (remaining nine months)	$ 461
2018	614
2019	614
2020	585
2021	517

Thereafter	2,300
Total	$ 5,091

10. Goodwill

In connection with the acquisition of Exception EMS, the Company recorded $3.0 million of goodwill in the unaudited condensed consolidated balance sheets.

The changes in the carrying amount of goodwill were as follows;

(amount in thousands)	**Goodwill**
Balance as of June 24, 2016	$
Addition in connection with business acquisition	2,994
Balance as of September 30, 2016	$ 2,994

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Goodwill is not deductible for tax purposes. Goodwill will not be amortized but is reviewed annually for impairment or more frequently whenever changes or circumstances indicate the carrying amount of goodwill may not be recoverable.

11. Borrowings

The Company s total borrowings, including short-term and long-term borrowings, consisted of the following:

(amount in thousands)

Rate [1]	Conditions	Maturity	As of September 30, 2016	As of June 24, 2016
Short-term borrowing:				
Revolving borrowing:				
LIBOR + 1.75% per annum	Repayable in 1 to 6 months	October 2016 [2]	$ 20,000	$ 6,500
Short-term loans from bank:				
Bank Base rate +1.85% per annum	Repayable based on credit term of secured accounts receivables		1,182	
Current portion of long-term borrowing			16,600	18,100
			37,782	24,600
Less: Unamortized debt issuance costs			(266)	(293)
			$ 37,516	$ 24,307
Long-term borrowing:				
LIBOR + 2.8% per annum	Repayable in quarterly installments	March 2017	$ 3,000	$ 4,500
Term loan borrowing:				
LIBOR +1.75% per annum	Repayable in quarterly installments	May 2019	46,600	50,000
			49,600	54,500
Less: Current portion			(16,600)	(18,100)

Unamortized debt issuance costs	(241)	(300)
Non-current portion	$ 32,759	$ 36,100

(1) LIBOR is London Interbank Offered Rate.
(2) In October 2016, the maturity date was extended to November 2016.

Under the long-term borrowing contract of a subsidiary, the loan is secured by certain property, plant and equipment of the subsidiary. The carrying amount of assets secured and pledged as collateral to such loan as of September 30, 2016 and June 24, 2016 was $47.0 million and $47.7 million, respectively. This subsidiary is also required to comply with maximum ratios of debt to equity and minimum levels of debt service coverage ratios, and Fabrinet must maintain an effective shareholding ratio. The carrying amounts of bank borrowings approximate their fair value.

As of September 30, 2016 and June 24, 2016, the Company was in compliance with its bank borrowing agreements. In addition to financial ratios, certain of the Company s credit facilities include customary events of default.

The movements of long-term loans were as follows for the three months ended September 30, 2016 and September 25, 2015:

	Three Months Ended	
(amount in thousands)	**September 30, 2016**	**September 25, 2015**
Opening balance	$ 54,500	$ 10,500
Repayments during the period	(4,900)	(1,500)
Closing balance	$ 49,600	$ 9,000

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As of September 30, 2016, future maturities of long-term debt during each fiscal year were as follows:

(amount in thousands)	
2017 (remaining nine months)	$ 13,200
2018	13,600
2019	22,800
Total	$ 49,600

Credit facilities:

Fabrinet entered into a syndicated senior credit facility agreement (the Facility Agreement) with a consortium of banks on May 22, 2014. The Facility Agreement, led by Bank of America, provides for a $200.0 million credit line, comprised of a $150.0 million revolving loan facility and a $50.0 million delayed draw term loan facility. The revolving loan facility contains an accordion feature permitting Fabrinet to request an increase in the facility up to $100.0 million subject to customary terms and conditions and provided that no default or event of default exists at the time of request. The revolving loan facility terminates and all amounts outstanding are due and payable in full on May 22, 2019. The principal amount of any drawn term loans must be repaid according to scheduled quarterly amortization payments, with final payment of all amounts outstanding, plus accrued interest, being due May 22, 2019.

On February 26, 2015, the Company entered into the Second Amendment to the Facility Agreement. The amendment extended the availability period for draws on the term loan facility from May 21, 2015 to July 31, 2015. It also allowed the Company, upon the satisfaction of certain conditions, to designate from time to time one or more of its subsidiaries as borrowers under the Facility Agreement. On July 31, 2015, the Company entered into the Third Amendment to the Facility Agreement. The amendment extended the availability period for draws on the term loan facility from July 31, 2015 to July 31, 2016. As of September 30, 2016, there were $20.0 million of the revolving borrowing and $46.6 million of the term loan borrowing outstanding under the Facility Agreement, resulting in available credit facilities of $133.4 million. Borrowings under the revolving credit facility are classified as current liabilities in the unaudited condensed consolidated balance sheets as the Company has the periodic option to renew or pay, all or a portion of, the outstanding balance at the end of the maturity date, which is in the range of one to six months, without premium or penalty, upon notice to the administrative agent. During October 2016, the Company sent notices to the bank to renew the maturity date of its revolving borrowings. The bank approved the notices and extended the maturity to November 2016.

Loans under the Facility Agreement bear interest, at Fabrinet s option, at a rate per annum equal to a LIBOR rate plus a spread of 1.75% to 2.50%, or a base rate plus a spread of 0.75% to 1.50%, determined in accordance with the Facility Agreement in each case with such spread determined based on Fabrinet s consolidated total leverage ratio for the preceding four fiscal quarter period. Interest is due and payable quarterly in arrears for loans bearing interest at the base rate and at the end of an interest period (or at each three-month interval in the case of loans with interest periods greater than three months) in the case of loans bearing interest at the LIBOR rate.

Fabrinet s obligations under the Facility Agreement are guaranteed by certain of its existing and future direct material subsidiaries. In addition, the Facility Agreement is secured by Fabrinet s present and future accounts receivable, deposit accounts and cash, and a pledge of the capital stock of certain of Fabrinet s direct subsidiaries. Fabrinet is required to maintain at least $40.0 million of cash, cash equivalents, and marketable securities at financial institutions located in the United States. Further, Fabrinet is required to maintain any of its deposits accounts or securities

accounts with balances in excess of $10.0 million in a jurisdiction where a control agreement, or the equivalent under the local law, can be effected.

The Facility Agreement contains customary affirmative and negative covenants. Negative covenants include, among other things, limitations on liens, indebtedness, investments, mergers, sales of assets, changes in the nature of the business, dividends and distributions, affiliate transactions and capital expenditures. The Facility Agreement contains financial covenants requiring Fabrinet to maintain: (1) a minimum tangible net worth of not less than $200.0 million plus 50% of quarterly net income, exclusive of quarterly losses; (2) a minimum debt service coverage ratio of not less than 1.50:1.00; (3) a maximum senior leverage ratio of not more than 2.50:1.00; and (4) a minimum quick ratio of not less than 1.10:1.00. Each of these financial covenants is calculated on a consolidated basis for the consecutive four fiscal quarter period then ended. As of September 30, 2016, the Company was in compliance with all covenants under the Facility Agreement.

The Facility Agreement also contains customary events of default including, among other things, payment defaults, breaches of covenants or representations and warranties, cross-defaults with certain other indebtedness, bankruptcy and insolvency events and change in control of Fabrinet, subject to grace periods in certain instances. Upon an event of default, the lenders may terminate their commitments, declare all or a portion of the outstanding obligations payable by Fabrinet to be immediately due and payable and exercise other rights and remedies provided for under the Facility Agreement.

Fabrinet intends to use the proceeds of the credit line to finance its future manufacturing buildings in the United States and Thailand, and for general corporate purposes including mergers and acquisitions of complementary manufacturing businesses or technology, although Fabrinet has no current commitments with respect to any such acquisitions.

Short-term loans from bank

In connection with the business acquisition, the Company assumed a secured borrowing agreement. The loans are secured by trade accounts receivable and the way of chattels mortgage over the plant and machine of Exception EMS. As of September 30, 2016, the carrying amount of trade accounts receivable and plant and machine secured to such loans were $5.5 million and $4.9 million, respectively The secured borrowing agreement contains certain covenants that the Company is required to comply with: (1) the value of credit notes may not exceed 4% of the value of assigned debts measured on a monthly basis, and (2) rolling cash flow must be provided with monthly management information. As of September 30, 2016, the Company was in compliance with all covenants under the secured borrowing agreement.

As of September 30, 2016, the Company drew down from this facility of $1.2 million which is recorded as short-term loans in the unaudited condensed consolidated balance sheets. The agreement bears interest for discount charge at 1.85% per annum above based rate.

Undrawn available credit facilities classified by availability period of future borrowing as of September 30, 2016 and June 24, 2016 were as follows:

(amount in thousands)	**September 30, 2016**	**June 24, 2016**
Short-term	$ 2,999	$ 1,414
Long-term	$ 133,400	$ 143,500

12. Income taxes

As of September 30, 2016 and June 24, 2016, the liability for uncertain tax positions including accrued interest and penalties was $1.9 million and $1.8 million, respectively. The Company expects the estimated amount of liability associated with its uncertain tax positions to decrease within the next 12 months due to the lapse of the applicable statute of limitations in foreign tax jurisdictions.

The Company files income tax returns in the United States and foreign tax jurisdictions. The tax years from 2012 to 2016 remain open to examination by U.S. federal and state tax authorities, and foreign tax authorities. The Company s income tax is recognized based on the best estimate of the expected annual effective tax rate for the full financial year of each entity in the Company, adjusted for discrete items arising in that quarter. If the Company s estimated annual

effective tax rate changes, the Company makes a cumulative adjustment in that quarter.

The effective tax rate for the Company for the three months ended September 30, 2016 and September 25, 2015 remained flat at 6.7% of net income. The Company s taxable income and income tax expenses for the three months ended September 30, 2016 increased proportionately on an absolute dollars basis, compared with the three months ended September 25, 2015.

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13. Share-based compensation

Share-based compensation

In determining the grant date fair value of equity awards, the Company is required to make estimates of the fair value of Fabrinet s ordinary shares, expected dividends to be issued, expected volatility of Fabrinet s ordinary shares, expected forfeitures of the awards, risk free interest rates for the expected term of the awards, expected terms of the awards, and the vesting period of the respective awards. Forfeitures are estimated at the time of grant and revised if necessary in subsequent periods if actual forfeitures differ from those estimates.

The effect of recording share-based compensation expense for the three months ended September 30, 2016 and September 25, 2015 was as follows:

	Three Months Ended	
(amount in thousands)	**September 30, 2016**	**September 25, 2015**
Share-based compensation expense by type of award:		
Share options	$	$ 16
Restricted share units	4,820	2,657
Performance share units	791	
Total share-based compensation expense	5,611	2,673
Tax effect on share-based compensation expense		
Net effect on share-based compensation expense	$ 5,611	$ 2,673

Share-based compensation expense was recorded in the unaudited condensed consolidated statements of operations and comprehensive income as follows:

	Three Months Ended	
(amount in thousands)	**September 30, 2016**	**September 25, 2015**
Cost of revenue	$ 1,014	$ 537
Selling, general and administrative expense	4,597	2,136
Total share-based compensation expense	$ 5,611	$ 2,673

The Company did not capitalize any share-based compensation expense as part of any asset costs during the three months ended September 30, 2016 and September 25, 2015.

Share-based award activity

Share options have been granted to directors and employees. As of September 30, 2016, there were 5 share options outstanding under Fabrinet s Amended and Restated 1999 Share Option Plan (the 1999 Plan). Additional option grants may not be made under the 1999 Plan.

As of September 30, 2016, there were an aggregate of 306,012 share options outstanding, 1,321,464 restricted share units outstanding and 234,678 performance share units outstanding under Fabrinet s 2010 Performance Incentive Plan (the 2010 Plan). As of September 30, 2016, there were 1,404,646 ordinary shares available for future grant under the 2010 Plan. The 1999 Plan and 2010 Plan are collectively referred to as the Share Option Plans.

Share options

Fabrinet s board of directors has the authority to determine the type of option and the number of shares subject to an option. Options generally vest and become exercisable over four years and expire, if not exercised, within seven years of the grant date. In the case of a grantee s first grant, 25 percent of the underlying shares vest 12 months after the vesting commencement date and 1/48 of the underlying shares vest monthly over each of the subsequent 36 months. In the case of any additional grants to a grantee, 1/48 of the underlying shares vest monthly over four years, commencing one month after the vesting commencement date.

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The following summarizes share option activity:

	Number of Shares	Number of Exercisable Options	Weighted-Average Exercise Price Per Share	Weighted-Average Grant Date Fair Value Per Share
Balance as of June 24, 2016	464,334	464,334	$ 15.95	
Granted				
Exercised	(158,317)		$ 17.10	
Forfeited				
Expired				
Balance as of September 30, 2016	306,017	306,017	$ 15.36	

	Number of Shares	Number of Exercisable Options	Weighted-Average Exercise Price Per Share	Weighted-Average Grant Date Fair Value Per Share
Balance as of June 26, 2015	792,019	758,451	$ 16.33	
Granted				
Exercised	(98,759)		$ 15.67	
Forfeited	(213)		$ 14.43	
Expired				
Balance as of September 25, 2015	693,047	680,798	$ 16.42	

The following summarizes information for share options outstanding as of September 30, 2016 under the Share Option Plans:

	Range of Exercise Price		Number of Shares Underlying Options	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value *(amount in thousands)*
	$5.75	$15.05	185,092	1.94	
	$15.16	$16.83	112,375	1.09	
	$18.60	$26.16	8,550	2.02	
Options outstanding			306,017	1.63	$ 8,945
Options exercisable			306,017	1.63	$ 8,945

As of September 30, 2016, there was no unrecognized compensation cost under the Share Option Plan.

Restricted share units and performance share units

Restricted share units and performance share units are types of share-based awards that may be granted under the 2010 Plan. Restricted share units granted to non-employee directors generally cliff vest 100% on the first of January, approximately one year from the grant date, provided the director continues to serve through such date. Restricted share units granted to employees generally vest in equal installments over three or four years on each anniversary of the vesting commencement date.

Performance share units granted to executives will vest at the end of a two-year performance period based on the Company s achievement of pre-defined performance criteria, which consist of revenue and gross margin targets. The actual number of performance share units that may vest at the end of the performance period ranges from 0% to 100% of the award grant.

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The Company has entered into an employment agreement, as amended on August 12, 2016, with an executive of the Company that provides for accelerated vesting of equity awards under certain circumstances, including upon termination of employment. In addition, if the executive s employment with the Company continues through and including February 20, 2017, (1) any outstanding equity awards granted to the executive prior to August 2016 will become 100% vested and (2) certain restricted share units granted to the executive in August 2016 will become 100% vested.

The following summarizes restricted share unit activity under the 2010 Plan:

	Number of Shares	Weighted-Average Grant Date Fair Value Per Share
Balance as of June 24, 2016	1,181,402	$ 18.34
Granted	568,283	$ 39.53
Issued	(408,874)[1]	$ 16.23
Forfeited	(19,347)	$ 19.12
Balance as of September 30, 2016	1,321,464	$ 28.10

	Number of Shares	Weighted-Average Grant Date Fair Value Per Share
Balance as of June 26, 2015	1,140,927	$ 16.02
Granted	499,896	$ 19.34
Issued	(286,374)	$ 14.69
Forfeited	(6,587)	$ 18.11
Balance as of September 26, 2015	1,347,862	$ 17.09

(1) Includes 875 shares vested on September 30, 2016, but not settled.

The following summarizes performance share unit activity under the 2010 Plan:

	Number of Shares	Weighted-Average Grant Date Fair Value Per Share
Balance as of June 24, 2016		

Granted	234,678	$	40.48
Issued			
Forfeited			
Balance as of September 30, 2016	234,678	$	40.48

As of September 30, 2016, there was $35.3 million of unrecognized share-based compensation expense related to restricted share units under the 2010 Plan that is expected to be recorded over a weighted-average period of 2.77 years.

For the three months ended September 30, 2016 and September 25, 2015, the Company withheld an aggregate of 22,294 shares and 46,016 shares, respectively, upon the vesting of restricted share units, based upon the closing share price on the vesting date to settle the employees minimum statutory obligation for the applicable income and other employment taxes. For the three months ended September 30, 2016 and September 25 2015, the Company then remitted cash of $0.9 million and $0.9 million, respectively, to the appropriate taxing authorities, and presented it in a financing activity within the unaudited condensed consolidated statements of cash flows. The payment had the effect on shares issued by the Company as it reduced the number of shares that would have been issued on the vesting date and was recorded as a reduction of additional paid-in capital.

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14. Shareholders equity

Share capital

Fabrinet s authorized share capital is 500,000,000 ordinary shares, par value of $0.01 per ordinary share, and 5,000,000 preferred shares, par value of $0.01 per preferred share.

For the three months ended September 30, 2016, Fabrinet issued 158,317 ordinary shares upon the exercise of options, for cash consideration at a weighted-average exercise price of $17.10 per share, and 385,705 ordinary shares upon the vesting of restricted share units, net of shares withheld.

All such issued shares are fully paid.

15. Accumulated other comprehensive income

The changes in AOCI for the three months ended September 30, 2016 were as follows:

(amount in thousands)	Unrealized net Gains (Losses) on Marketable Securities	Unrealized net Gains (Losses) on Derivative Instruments	Foreign Currency Translation Adjustment	Total
Balance as of June 24, 2016	$ 399	$ 192	$	$ 591
Other comprehensive income before reclassification adjustment	(87)		741	654
Amounts reclassified out of AOCI to foreign exchange loss in the unaudited condensed consolidated statement of operations and comprehensive income	(100)	(158)		(258)
Tax effects				
Other comprehensive loss	$ (187)	$ (158)	741	$ 396
Balance as of September 30, 2016	$ 212	$ 34	$ 741	$ 987

16. Commitments and contingencies

Bank guarantees

As of September 30, 2016 and June 24, 2016, there were outstanding bank guarantees given by banks on behalf of Fabrinet Thailand for electricity usage and other normal business amounting to $0.8 million and $0.8 million, respectively.

Operating lease commitments

The Company leases a portion of its office, capital equipment, and certain land and buildings for its facilities in the Cayman Islands, China, New Jersey and the United Kingdom under operating lease arrangements that expire in various calendar years through 2023. Rental expense under these operating leases amounted to $0.4 million and $0.3 million for the three months ended September 30, 2016 and September 25, 2015, respectively.

As of September 30, 2016, the future minimum lease payments due under non-cancelable operating leases during each fiscal year were as follows:

(amount in thousands)	
2017 (remaining nine months)	$ 1,338
2018	1,685
2019	1,131
2020	922
2021	525
Thereafter	897
Total minimum operating lease payments	$ 6,498

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Capital lease commitments

In connection with the acquisition of Exception EMS, the Company assumed the capital lease commitments of certain machine and equipment, with various expiration dates until September 2020. The equipment can be purchased at the determined price upon expiration.

As of September 30, 2016, the future minimum lease payments due under non-cancelable capital leases during each fiscal year were as follows:

(amount in thousands)	
2017 (remaining nine months)	$ 301
2018	416
2019	429
2020	376
2021	156
Total minimum capital lease payments	$ 1,678

Purchase obligations

Purchase obligations represent legally-binding commitments to purchase inventory and other commitments made in the normal course of business to meet operational requirements. Although open purchase orders are considered enforceable and legally binding, their terms generally give the Company the option to cancel, reschedule and/or adjust its requirements based on its business needs prior to the delivery of goods or performance of services. Obligations to purchase inventory and other commitments are generally expected to be fulfilled within one year.

As of September 30, 2016, the Company had an outstanding commitment to third parties of approximately $30.1 million, mainly related to the construction of a new manufacturing building at the Company s Chonburi campus.

Indemnification of directors and officers

Cayman Islands law does not limit the extent to which a company s memorandum and articles of association may provide for indemnification of directors and officers, except to the extent any such provision may be held by the Cayman Islands courts to be contrary to public policy, such as to provide indemnification against civil fraud or the consequences of committing a crime. Fabrinet s amended and restated memorandum and articles of association provide for indemnification of directors and officers for actions, costs, charges, losses, damages and expenses incurred in their capacities as such, except that such indemnification does not extend to any matter in respect of any fraud or dishonesty that may attach to any of them.

In accordance with Fabrinet s form of indemnification agreement for its directors and officers, Fabrinet has agreed to indemnify its directors and officers against certain liabilities and expenses incurred by such persons in connection with claims by reason of their being such a director or officer. Fabrinet maintains a director and officer liability insurance policy that may enable it to recover a portion of any future amounts paid under the indemnification agreements.

17. Business segments and geographic information

Operating segments are defined as components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company s chief operating decision maker is Fabrinet s chief executive officer. As of September 30, 2016, the Company operated and internally managed a single operating segment. Accordingly, the Company does not accumulate discrete information with respect to separate product lines and does not have separate reportable segments.

Total revenues are attributed to a particular geographic area based on the bill-to-location of the customers. The Company operates primarily in three geographic regions: North America, Asia-Pacific and Europe. The following table presents total revenues by geographic regions:

(amount in thousands)	Three Months Ended September 30, 2016	Three Months Ended September 25, 2015
North America	$ 165,995	$ 106,443
Asia-Pacific	114,745	83,890
Europe	51,303	26,100
	$ 332,043	$ 216,433

As of September 30, 2016 and September 25, 2015, the Company had approximately $36.4 million and $33.9 million of long-lived assets based in North America, with the substantial remainder of assets based in Asia-Pacific and Europe.

Significant customers

The Company had one and two customers that each contributed to 10% or more of its total account receivable as of September 30, 2016 and June 24, 2016, respectively.

18. Other expense related to flooding

During the week of August 10, 2015, the Company s subsidiary in China temporarily suspended production in its manufacturing facility due to flooding caused by Typhoon Soudelor and resumed operations on August 15, 2015. During the three months ended September 25, 2015, the Company recognized $0.9 million of losses incurred from the event in the unaudited condensed consolidated statements of operations and comprehensive income. The Company received a final payment of $0.8 million from an insurer against the Company s claim for flood damage during the three months ended March 25, 2016.

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

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements relate to future events or to our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our or our industry s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Forward-looking statements include, but are not limited to, statements about:

our goals and strategies;

our and our customers estimates regarding future revenues, operating results, expenses, capital requirements and liquidity;

our expectation that the portion of our future revenues attributable to customers in regions outside of North America will continue to decrease compared with the portion of those revenues for the three months ended September 30, 2016;

our expectation that we will incur incremental costs of revenue as a result of our planned expansion of our business into new geographic markets;

our expectation that our fiscal year 2017 selling, general and administrative (SG&A) expenses will increase on an absolute dollar basis and decrease as a percentage of revenue compared to fiscal year 2016;

our expectation that our employee costs will increase in Thailand and the People s Republic of China (PRC);

our future capital expenditures and our needs for additional financing;

the expansion of our manufacturing capacity, including into new geographies;

the growth rates of our existing markets and potential new markets;

our ability, and the ability of our customers and suppliers, to respond successfully to technological or industry developments;

our suppliers estimates regarding future costs;

our ability to increase our penetration of existing markets and to penetrate new markets;

our plans to diversify our sources of revenues;

our plans to execute acquisitions;

trends in the optical communications, industrial lasers, and sensors markets, including trends to outsource the production of components used in those markets;

our ability to attract and retain a qualified management team and other qualified personnel and advisors; and

competition in our existing and new markets.

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These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q, in particular, the risks discussed under the heading Risk Factors in Part II, Item 1A as well as those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We, us or our collectively refer to Fabrinet and its subsidiaries.

Overview

We provide advanced optical packaging and precision optical, electro-mechanical and electronic manufacturing services to original equipment manufacturers (OEMs) of complex products such as optical communication components, modules and sub-systems, industrial lasers, medical devices and sensors. We offer a broad range of advanced optical and electro-mechanical capabilities across the entire manufacturing process, including process design and engineering, supply chain management, manufacturing, complex printed circuit board assembly, advanced packaging, integration, final assembly and testing. Although, we focus primarily on low-volume production of a wide variety of high complexity products, which we refer to as low-volume, high-mix, we also have the capability to accommodate high-volume production. Based on our experience with, and positive feedback we have received from our customers, we believe we are a global leader in providing these services to the optical communications, industrial lasers and automotive markets.

Our customer base includes companies in complex industries that require advanced precision manufacturing capabilities such as optical communications, industrial lasers, automotive and sensors. The products that we manufacture for our OEM customers include selective switching products; tunable transponders and transceivers; active optical cables; solid state, diode-pumped, gas and fiber lasers; and sensors. In many cases, we are the sole outsourced manufacturing partner used by our customers for the products that we produce for them.

We also design and fabricate application-specific crystals, lenses, prisms, mirrors, laser components, and substrates (collectively referred to as customized optics) and other custom and standard borosilicate, clear fused quartz, and synthetic fused silica glass products (collectively referred to as customized glass). We incorporate our customized optics and glass into many of the products we manufacture for our OEM customers, and we also sell customized optics and glass in the merchant market.

Business acquisition

On September 14, 2016, we acquired 100% shareholding in Global CEM Solutions, Limited and all of its subsidiaries (Exception EMS), a privately-held group located in Wiltshire, United Kingdom, for cash consideration of approximately $13.0 million, net of cash acquired. This is strategic acquisition involving new geographies, new sectors and new customers. Exception EMS provides contract electronics manufacturing services primarily to the European electronics market with innovative solutions, adding value to the design, manufacture and testing of printed circuit board assemblies. Its customers include industrial, energy, aerospace and defense companies, with approximately 80% of its revenue derived from customers in Europe. See Note 8 - business acquisitions to the unaudited condensed consolidated financial statements for further details.

Flooding

During the week of August 10, 2015, our subsidiary in China temporarily suspended production in its manufacturing facility due to flooding caused by Typhoon Soudelor and resumed operations on August 15, 2015. During the three months ended September 25, 2015, we recognized $0.9 million of losses incurred from the event in the unaudited condensed consolidated statements of operations and comprehensive income. We received a final payment of $0.8 million from an insurer against our claim for flood damage during the three months ended March 25, 2016.

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Revenues

Our total revenues increased by $115.6 million, or 53.4%, to $332.0 million for the three months ended September 30, 2016, compared with $216.4 million for the three months ended September 25, 2015. The increase was primarily due to (1) an increase in our customers demand for both optical and non-optical communications manufacturing services during the three months ended September 30, 2016, (2) the positive impact from an additional week of revenue during the three months ended September 30, 2016 and (3) $0.8 million of revenue from companies we acquired during the three months ended September 30, 2016.

We believe our ability to expand our relationships with existing customers and attract new customers is due to a number of factors, including our broad range of complex engineering and manufacturing service offerings, flexible low-cost manufacturing platform, process optimization capabilities, advanced supply chain management, excellent customer service, and experienced management team. While we expect the prices we charge for our manufactured products to decrease over time (partly as a result of competitive market forces), we still believe we will be able to maintain favorable pricing for our services because of our ability to reduce cycle time, adjust our product mix by focusing on more complicated products, improve product quality and yields, and reduce material costs for the products we manufacture. We believe these capabilities have enabled us to help our OEM customers reduce their manufacturing costs while maintaining or improving the design, quality, reliability, and delivery times for their products.

Revenues by Geography

We generate revenues from three geographic regions: North America, Asia-Pacific and Europe. Revenues are attributed to a particular geographic area based on the bill-to location of our customers, notwithstanding that our customers may ultimately ship their products to end customers in a different geographic region. The majority of our revenues are derived from our manufacturing facilities in Asia-Pacific.

The percentage of our revenues generated from a bill-to location outside of North America decreased from 50.8% in the three months ended September 25, 2015 to 50.0% in the three months ended September 30, 2016, primarily because of a decrease in sales to our customers in Asia-Pacific. We expect that the portion of our future revenues attributable to customers in regions outside North America will continue to decrease as compared with the portion of revenues attributable to such customers during the three months ended September 30, 2016.

The following table presents percentages of total revenues by geographic regions:

	Three Months Ended	
	September 30, 2016	September 25, 2015
North America	50.0%	49.2%
Asia-Pacific	34.6	38.8
Europe	15.4	12.0
	100.0%	100.0%

Our Contracts

We enter into supply agreements with our customers which generally have an initial term of up to three years, subject to automatic renewals for subsequent one-year terms unless expressly terminated. Although there are no minimum purchase requirements in our supply agreements, our customers provide us with rolling forecasts of their demand requirements. Our supply agreements generally include provisions for pricing and periodic review of pricing, consignment of our customer s unique production equipment to us, and the sharing of benefits from cost-savings derived from our efforts. We are generally required to purchase materials, which may include long lead-time materials and materials that are subject to minimum order quantities and/or non-cancelable or non-returnable terms, to meet the stated demands of our customers. After procuring materials, we manufacture products for our customers based on purchase orders that contain terms regarding product quantities, delivery locations and delivery dates. Our customers generally are obligated to purchase finished goods that we have manufactured according to their demand requirements. Materials that are not consumed by our customers within a specified period of time, or are no longer required due to a product s cancellation or end-of-life, are typically designated as excess or obsolete inventory under our contracts. Once materials are designated as either excess or obsolete inventory, our customers are typically required to purchase such inventory from us even if they have chosen to cancel production of the related products.

Cost of Revenues

The key components of our cost of revenues are material costs, employee costs, and infrastructure-related costs. Material costs generally represent the majority of our cost of revenues. Several of the materials we require to manufacture products for our customers are customized for their products and often sourced from a single supplier or in some cases, our own subsidiaries. Shortages from sole-source suppliers due to yield loss, quality concerns and capacity constraints, among other factors, may increase our expenses and negatively impact our gross profit margin or total revenues in a given quarter. Material costs include scrap material. Historically, scrap rate diminishes during a product s life cycle due to process, fixturing and test improvement and optimization.

A second significant element of our cost of revenues is employee costs, including indirect employee costs related to design, configuration and optimization of manufacturing processes for our customers, quality testing, materials testing and other engineering services; and direct costs related to our manufacturing employees. Direct employee costs include employee salaries, insurance and benefits, merit-based bonuses, recruitment, training and retention. Historically, our employee costs have increased primarily due to increases in the number of employees necessary to support our growth and, to a lesser extent, costs to recruit, train and retain employees. Our cost of revenues is significantly impacted by salary levels in Thailand and the PRC, the fluctuation of the Thai baht and Chinese Renminbi (RMB) against our functional currency, the U.S. dollar, and our ability to retain our employees. We expect our employee costs to increase as wages continue to increase in Thailand and the PRC. Wage increases may impact our ability to sustain our competitive advantage and may reduce our profit margin. We seek to mitigate these cost increases through improvements in employee productivity, employee retention and asset utilization.

Our infrastructure costs are comprised of depreciation, utilities, facilities management and overhead costs. Most of our facility leases are long-term agreements. Our depreciation costs include buildings and fixed assets, primarily at our Pinehurst campus in Thailand, and capital equipment located at each of our manufacturing locations.

During the three months ended September 30, 2016 and September 25, 2015, discretionary merit-based bonus awards were made to our non-executive employees. Charges included in cost of revenues for bonus awards to non-executive employees were $0.9 million and $0.7 million for the three months ended September 30, 2016 and September 25, 2015, respectively.

Share-based compensation expense included in cost of revenues was $1.0 million and $0.5 million for the three months ended September 30, 2016 and September 25, 2015, respectively.

We expect to incur incremental costs of revenue as a result of our planned expansion into new geographic markets, though we are not able to determine the amount of these incremental expenses.

Selling, General and Administrative Expenses

Our SG&A expenses primarily consist of corporate employee costs for sales and marketing, general and administrative and other support personnel, including research and development expenses related to the design of customized optics and glass, travel expenses, legal and other professional fees, share-based compensation expense and other general expenses not related to cost of revenues. In fiscal year 2017, we expect our SG&A expenses will increase on an absolute dollar basis and decrease as a percentage of revenue compared with fiscal year 2016, due to the acquisition of Exception EMS and higher share-based compensation expenses as a result of restricted share units and performance share units granted to executives in August 2016.

The compensation committee of our board of directors approved a fiscal year 2017 executive incentive plan with quantitative objectives, based on achieving certain revenue targets and gross margin targets for our fiscal year ending June 30, 2017. Bonuses under our fiscal year 2017 executive incentive plan are payable after the end of fiscal year 2017. In fiscal year 2016, the compensation committee approved a fiscal year 2016 executive incentive plan with quantitative objectives, based on achieving certain revenue and non-GAAP earnings per share targets for our fiscal year ended June 24, 2016, as well as qualitative objectives, based on achieving individual performance goals. In the three months ended September 30, 2016, the compensation committee awarded bonuses to our executive employees for Company and individual achievements of performance under our fiscal 2016 executive incentive plan. Discretionary merit-based bonus awards were also available to our non-executive employees and were payable as of September 30, 2016.

Charges included in SG&A expenses for bonus awards to non-executive and executive employees were $0.9 million and $0.6 million for the three months ended September 30, 2016 and September 25, 2015, respectively.

Share-based compensation expense included in SG&A expenses was $4.6 million and $2.1 million for the three months ended September 30, 2016 and September 25, 2015, respectively.

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Additional Financial Disclosures

Foreign Exchange

As a result of our international operations, we are exposed to foreign exchange risk arising from various currency exposures primarily with respect to the Thai baht. Although a majority of our total revenues is denominated in U.S. dollars, a substantial portion of our payroll plus certain other operating expenses are incurred and paid in Thai baht. The exchange rate between the Thai baht and the U.S. dollar has fluctuated substantially in recent years and may continue to fluctuate substantially in the future. We report our financial results in U.S. dollars and our results of operations have been and may continue to be negatively impacted owing to appreciation of the Thai baht against the U.S. dollar. Smaller portions of our expenses are incurred in a variety of other currencies, including RMB, Pound sterling (GBP), Canadian dollars, Euros, and Japanese yen, the appreciation of which may also negatively impact our financial results.

In addition, we are exposed to foreign exchange risk in connection with the long-term loan and cross currency swap arrangements we entered into with TMB Bank Public Company Limited (the Bank) in May 2011 for the construction of Pinehurst Building 6. The terms of the contract with the Bank provide the following facilities: (1) a term loan facility for up to Thai baht 960 million (equal to $30.0 million) with a fixed interest rate of 5.28% per annum, (2) a hedging facility for currency interest rate swaps with a notional amount of $30.0 million, and (3) a settlement limit of Thai baht 65 million, subject to certain terms and conditions as set forth therein. Borrowings and interest under the term loan have been scheduled to be repaid on a quarterly basis between September 2011 and March 2017. As of September 30, 2016, we had outstanding borrowings under the term loan facility of $3.0 million. Under the terms of the cross currency swap arrangements, amounts drawn in Thai baht were converted to U.S. dollars for repayment by us on a quarterly basis at the floating rate of London Interbank Offered Rate (LIBOR) plus 2.8% per annum.

In order to manage the risks arising from fluctuations in foreign currency exchange rates, we use derivative instruments. We may enter into exchange currency forward or put option contracts to manage foreign currency exposures associated with certain assets and liabilities and other forecasted foreign currency transactions and may designate these instruments as hedging instruments. The forward and put option contracts generally have maturities of up to 12 months. All foreign currency exchange contracts are recognized in the unaudited condensed consolidated balance sheet at fair value. Gain or loss on our forward and put option contracts generally offset the assets, liabilities, and transactions economically hedged.

We had foreign currency denominated assets and liabilities in Thai baht, RMB and GBP as follows:

	As of September 30, 2016			**As of June 24, 2016**		
(amount in thousands, except percentages)	**Currency**	**$**	**%**	**Currency**	**$**	**%**
Assets						
Thai baht	456,782	$ 13,164	68.8	834,536	$ 23,594	91.3
RMB	12,830	1,921	10.0	14,835	2,255	8.7
GBP	3,130	4,057	21.2			
Total		$ 19,142	100.0		$ 25,840	100.0

Liabilities

Thai baht	1,884,630	$ 54,312	87.6	1,517,782	$ 42,912	92.0
RMB	22,241	3,331	5.4	24,654	3,748	8.0
GBP	3,340	4,328	7.0			
Total		$ 61,971	100.0		$ 46,660	100.0

The Thai baht assets represent cash and cash equivalents, trade accounts receivable, deposits and other current assets. The Thai baht liabilities represent trade accounts payable, accrued expenses, income tax payable and other payables. We manage our exposure to fluctuations in foreign exchange rates by the use of foreign currency contracts and offsetting assets and liabilities denominated in the same currency in accordance with management s policy. As of September 30, 2016 and June 24, 2016, there were $42.5 million and $84.5 million in forward contracts, respectively, outstanding against forecasted Thai baht payables.

The RMB assets represent cash and cash equivalents, accounts receivable and other current assets. The RMB liabilities represent trade accounts payable, accrued expenses, income tax payable and other payables. As of September 30, 2016 and June 24, 2016, we did not have any derivative contracts denominated in RMB.

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The GBP assets represent cash and accounts receivable. The GBP liabilities represent trade accounts payable and other payables. As of September 30, 2016, we did not have any derivative contracts denominated in GBP.

For the three months ended September 30, 2016 and September 25, 2015, we recorded loss of $0.1 million and $12.1 million, respectively, related to derivatives that are not designated as hedging instruments in the unaudited condensed consolidated statements of operations and comprehensive income.

Currency Regulation and Dividend Distribution

Foreign exchange regulation in the PRC is primarily governed by the following rules:

- Foreign Currency Administration Rules, as amended on August 5, 2008, or the Exchange Rules;
- Administration Rules of the Settlement, Sale and Payment of Foreign Exchange (1996), or the Administration Rules; and
- Notice on Perfecting Practices Concerning Foreign Exchange Settlement Regarding the Capital Contribution by Foreign-invested Enterprises, as promulgated by the State Administration of Foreign Exchange, or State Administration of Foreign Exchange (SAFE), on August 29, 2008, or Circular 142.

Under the Exchange Rules, RMB is freely convertible into foreign currencies for current account items, including the distribution of dividends, interest payments, trade and service-related foreign exchange transactions. However, conversion of RMB for capital account items, such as direct investments, loans, security investments and repatriation of investments, is still subject to the approval of SAFE.

Under the Administration Rules, foreign-invested enterprises may only buy, sell, or remit foreign currencies at banks authorized to conduct foreign exchange business after providing valid commercial documents and relevant supporting documents and, in the case of capital account item transactions, obtaining approval from SAFE. Capital investments by foreign-invested enterprises outside of the PRC are also subject to limitations, which include approvals by the Ministry of Commerce, SAFE and the State Development and Reform Commission.

Circular 142 regulates the conversion by a foreign-invested company of foreign currency into RMB by restricting how the converted RMB may be used. Circular 142 requires that the registered capital of a foreign-invested enterprise settled in RMB converted from foreign currencies may only be used for purposes within the business scope approved by the applicable governmental authority and may not be used for equity investments within the PRC. In addition, SAFE strengthened its oversight of the flow and use of the registered capital of foreign-invested enterprises settled in RMB converted from foreign currencies. The use of such RMB capital may not be changed without SAFE s approval and may not be used to repay RMB loans if the proceeds of such loans have not been used.

On January 5, 2007, SAFE promulgated the Detailed Rules for Implementing the Measures for the Administration on Individual Foreign Exchange, or the Implementation Rules. Under the Implementation Rules, PRC citizens who are granted share options by an overseas publicly-listed company are required, through a PRC agent or PRC subsidiary of such overseas publicly-listed company, to register with SAFE and complete certain other procedures.

In addition, the General Administration of Taxation has issued circulars concerning employee share options. Under these circulars, our employees working in the PRC who exercise share options will be subject to PRC individual income tax. Our PRC subsidiary has obligations to file documents related to employee share options with relevant tax authorities and withhold individual income taxes of those employees who exercise their share options.

Furthermore, our transfer of funds to our subsidiaries in Thailand and the PRC are each subject to approval by governmental authorities in case of an increase in registered capital, or subject to registration with governmental authorities in case of a shareholder loan. These limitations on the flow of funds between our subsidiaries and us could restrict our ability to act in response to changing market conditions.

Income Tax

Our effective tax rate is a function of the mix of tax rates in the various jurisdictions in which we do business. We are domiciled in the Cayman Islands. Under the current laws of the Cayman Islands, we are not subject to tax in the Cayman Islands on income or capital gains. We have received this undertaking for a 20-year period ending August 24, 2019, and after the expiration date, we may request a renewal with the office of the Clerk of the Cabinet for another twenty years.

Throughout the period of our operations in Thailand, we have generally received income tax and other incentives from the Thailand Board of Investment. Preferential tax treatment from the Thai government in the form of a corporate tax exemption is currently available to us through June 2020 on income generated from projects to manufacture certain products at Pinehurst campus. Such preferential tax treatment is contingent on various factors, including the export of our customers products out of Thailand and our agreement not to move our manufacturing facilities out of our current province in Thailand for at least 15 years from the date on which preferential tax treatment was granted. In March 2016, the Thailand Revenue Department announced a permanent decrease of corporate income tax rates to 20% for tax periods beginning on or after January 1, 2016. As a result, corporate income tax rates for our Thai subsidiary remain at 20% from fiscal year 2017 onward.

Critical Accounting Policies and Use of Estimates

We prepare our condensed consolidated financial statements in conformity with U.S. GAAP, which requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities on the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the financial reporting period. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Because the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. Some of our accounting policies require higher degrees of judgment than others in their application. We consider the policies discussed below to be critical to an understanding of our condensed consolidated financial statements, as their application places the most significant demands on our management s judgment.

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the fiscal year ended June 24, 2016.

Results of Operations

The following table sets forth a summary of our unaudited condensed consolidated statements of operations and comprehensive income. Note that period-to-period comparisons of operating results should not be relied upon as indicative of future performance.

	Three Months Ended	
(amount in thousands)	**September 30, 2016**	**September 25, 2015**
Revenues	$ 332,043	$ 216,433
Cost of revenues	(292,435)	(190,422)
Gross profit	39,608	26,011
Selling, general and administrative expenses	(15,832)	(11,900)
Other expense related to flooding		(864)
Operating income	23,776	13,247
Interest income	437	442

Interest expense		(1,322)		(402)
Foreign exchange gain (loss), net		1,657		(10,492)
Other income		143		103
Income before income taxes		24,691		2,898
Income tax expense		(1,925)		(1,295)
Net income		22,766		1,603
Other comprehensive income, net of tax		396		87
Net comprehensive income	$	23,162	$	1,690

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The following table sets forth a summary of our unaudited condensed consolidated statements of operations and comprehensive income as a percentage of total revenues for the periods indicated.

	Three Months Ended	
	September 30, 2016	September 25, 2015
Revenues	100.0%	100.0%
Cost of revenues	(88.1)	(88.0)
Gross profit	11.9	12.0
Selling, general and administrative expenses	(4.8)	(5.5)
Other expense related to flooding		(0.4)
Operating income	7.1	6.1
Interest income	0.1	0.2
Interest expense	(0.4)	(0.2)
Foreign exchange gain (loss), net	0.5	(4.9)
Other income	0.1	0.1
Income before income taxes	7.4	1.3
Income tax expense	(0.6)	(0.6)
Net income	6.9	0.7
Other comprehensive income, net of tax	0.1	0.1
Net comprehensive income	7.0%	0.8%

The following table sets forth our revenues by end market for the periods indicated.

	Three Months Ended	
(amount in thousands)	September 30, 2016	September 25, 2015
Optical communications	$ 256,807	$ 154,762
Lasers, sensors and other	75,236	61,671
Total	$ 332,043	$ 216,433

We operate and internally manage a single operating segment. As such, discrete information with respect to separate product lines and segments is not accumulated.

Comparison of Three Months Ended September 30, 2016 with Three Months Ended September 25, 2015

Total revenues.

Our total revenues increased by $115.6 million, or 53.4%, to $332.0 million for the three months ended September 30, 2016, compared with $216.4 million for the three months ended September 25, 2015. This increase was primarily due to (1) an increase in our customers demand for both optical and non-optical communications manufacturing services during the three months ended September 30, 2016, (2) the positive impact of an additional week of revenue during the three months ended September 30, 2016 and (3) $0.8 million of revenue from companies which we acquired during the three months ended September 30, 2016. Revenues from optical communications products represented 77.3% of our total revenues for the three months ended September 30, 2016, compared to 71.5% for the three months ended September 25, 2015.

Cost of revenues.

Our cost of revenues increased by $102.0 million, or 53.6%, to $292.4 million, or 88.1% of total revenues, for the three months ended September 30, 2016, compared with $190.4 million, or 88.0% of total revenues, for the three months ended September 25, 2015. This increase in cost of revenues was primarily due to an increase in sales volume, partially offset by a more favorable product mix. Cost of revenues also included share-based compensation expense of $1.0 million for the three months ended September 30, 2016, compared with $0.5 million for the three months ended September 25, 2015.

Gross profit.

Our gross profit increased by $13.6 million, or 52.3%, to $39.6 million, or 11.9% of total revenues, for the three months ended September 30, 2016, compared with $26.0 million, or 12.0% of total revenues, for the three months ended September 25, 2015.

SG&A expenses.

Our SG&A expenses increased by $3.9 million, or 33.0%, to $15.8 million, or 4.8% of total revenues, for the three months ended September 30, 2016, compared with $11.9 million, or 5.5% of total revenues, for the three months ended September 25, 2015. Our SG&A expenses increased in absolute dollars due primarily to an increase in expenses relating to merger and acquisition activities of $1.1 million and severance and related payments of $0.6 million to an executive who left the Company in July 2016. We also recorded share-based compensation charges of $4.6 million for the three months ended September 30, 2016, compared with $2.1 million for the three months ended September 25, 2015.

Other expense related to flooding.

In the three months ended September 30, 2016, we did not have any expenses related to flooding. In the three months ended September 25, 2015, we recognized other expense related to flooding of $0.9 million, which mainly consisted of $0.6 million of repaired cost of equipment and $0.2 million of inventory losses.

Operating income.

Our operating income increased by $10.5 million to $23.8 million, or 7.2% of total revenues, for the three months ended September 30, 2016, compared with $13.2 million, or 6.1% of total revenues, for the three months ended September 25, 2015.

Interest income.

Our interest income remained flat at $0.4 million, or 0.1% of total revenues, for the three months ended September 30, 2016, compared with $0.4 million, or 0.2% of total revenues, for the three months ended September 25, 2015.

Interest expense.

Our interest expense increased by $0.9 million to $1.3 million for the three months ended September 30, 2016, compared with $0.4 million for the three months ended September 25, 2015.

The increase was primarily due to increase in average balance of our bank borrowings.

Foreign exchange gain (loss), net.

Our foreign exchange gain, net, increased by $12.1 million to foreign exchange gain, net, of $1.7 million, or 0.5% of total revenues, for the three months ended September 30, 2016, compared with foreign exchange loss, net, of $10.5 million, or 4.9% of total revenues, for the three months ended September 25, 2015. The increase was due to changes in the fair value of forward contracts as of September 30, 2016 that were not designated as hedging instruments.

Income before income taxes.

We recorded income before income taxes of $24.7 million for the three months ended September 30, 2016, compared with $2.9 million for the three months ended September 25, 2015.

Income tax expense.

Our provision for income tax reflects an effective tax rate of 6.7% for each of the three months ended September 30, 2016 and September 25, 2015. The effective tax rate remained flat, and our taxable income and income tax expenses for the three months ended September 30, 2016 increased proportionately on an absolute dollars basis, compared with the three months ended September 25, 2015.

Net income.

We recorded net income of $22.8 million, or 6.9% of total revenues, for the three months ended September 30, 2016, compared with $1.6 million, or 0.7% of total revenues, for the three months ended September 25, 2015.

Other comprehensive (loss) income.

We recorded other comprehensive loss of $0.3 million, or 0.1% of total revenues, for the three months ended September 30, 2016, compared with other comprehensive income of $0.1 million, or 0.1% of total revenues, for the three months ended September 25, 2015.

Liquidity and Capital Resources

Cash Flows and Working Capital

We primarily finance our operations through cash flow from operations. As of September 30, 2016 and September 25, 2015, we had cash, cash equivalents, and marketable securities of $253.6 million and $247.6 million, respectively, and outstanding debt of $70.8 million and $39.0 million, respectively.

Our cash and cash equivalents, which primarily consist of cash on hand, demand deposits, and liquid investments with original maturities of three months or less, are placed with banks and other financial institutions. The weighted-average interest rate on our cash and cash equivalents for the three months ended September 30, 2016 and September 25, 2015 was 0.5% and 1.0%, respectively.

Our cash investments are made in accordance with an investment policy approved by the Audit Committee of our Board of Directors. In general, our investment policy requires that securities purchased be rated A1, P-1, F1 or better. No security may have an effective maturity that exceeds three years. Our investments in fixed income securities are primarily classified as available-for-sale and are recorded at fair value. The cost of securities sold is based on the specific identification method. Unrealized gains and losses on these securities are recorded as other comprehensive income (loss) and are reported as a separate component of shareholders equity.

During the three months ended September 30, 2016, we borrowed a revolving loan of $13.5 million and repaid a term loan of $3.4 million under our Facility Agreement; as a result, as of September 30, 2016, we had a long-term borrowing of $46.6 million and short-term borrowing of $20.0 million under our Facility Agreement. To better manage our cash on hand, we held investments in short-term marketable securities of $147.7 million as of September 30, 2016.

We believe that our current cash and cash equivalents, marketable securities, cash flow from operations, and funds available through our credit facility will be sufficient to meet our working capital and capital expenditure needs for the next 12 months. Our ability to sustain our working capital position is subject to a number of risks that we discuss in Part II, Item 1A of this Quarterly Report on Form 10-Q.

In December 2015, we began construction of a new manufacturing facility at our Chonburi campus, which we substantially completed in the first quarter of fiscal year 2017. We expect to begin operations at this new facility in the second quarter of fiscal year 2017. We believe that our current manufacturing capacity is sufficient to meet our anticipated production requirements for at least the next few quarters. We maintain a long-term loan associated with construction of production facilities at our Pinehurst campus in Thailand that will come due within the next 12 months. We also have a sufficient credit facility in place to fund the amount needed to construct a new building at our

Chonburi campus. We anticipate that our internally generated working capital, along with our cash and cash equivalents will be adequate to repay these obligations.

The following table shows our cash flows for the periods indicated:

	Three Months Ended	
(amount in thousands)	**September 30, 2016**	**September 25, 2015**
Net cash (used in) provided by operating activities	$ (1,002)	$ 4,539
Net cash used in investing activities	$ (46,650)	$ (20,402)
Net cash provided by (used in) financing activities	$ 10,441	$ (1,184)
Net decrease in cash and cash equivalents	$ (37,211)	$ (17,047)

Operating Activities

Net cash used in operating activities decreased by $5.5 million, or 122.1%, to $1.0 million for the three months ended September 30, 2016, compared with net cash provided by operating activities of $4.5 million for the three months ended September 25, 2015. This decrease was due to a number of factors, including an increase in net income of $22.0 million, offset by increases in accounts receivable of $6.2 million and inventory of $8.7 million due to higher sales and customer demand, the impact of unrealized (gain) loss on the exchange rate and fair value of derivative instruments of $10.6 million and a decrease of other liabilities of $7.8 million, as compared with the three months ended September 25, 2015.

Investing Activities

Net cash used in investing activities increased by $26.2 million, or 128.7%, to $46.6 million for the three months ended September 30, 2016, compared with net cash used in investing activities of $20.4 million for the three months ended September 25, 2015. This increase was primarily due to the payment of $13.0 million for the acquisition of Exception EMS during the three months ended September 30, 2016 and an increase in the purchase of property, plant and equipment of $18.7 million, majority was for the new facility in Thailand, offset by a net decrease in marketable securities of $3.1 million.

Financing Activities

Net cash provided by financing activities increased by $11.6 million, or 981.8%, to $10.4 million for the three months ended September 30, 2016, compared with net cash used in financing activities of $1.2 million for the three months ended September 25, 2015. This increase was primarily due to proceeds from revolving loan from bank of $13.5 million under our Facility Agreement during the three months ended September 30, 2016.

Off-Balance Sheet Commitments and Arrangements

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of any third parties. In addition, we have not entered into any derivative contracts that are not reflected in our condensed consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We also do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

Recent Accounting Pronouncements

See Note 2 of Notes to Unaudited Condensed Consolidated Financial Statements for recent accounting pronouncements that could have an effect on us.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

We had cash, cash equivalents, and marketable securities totaling $253.6 million and $284.5 million as of September 30, 2016 and June 24, 2016, respectively. We have interest rate risk exposure relating to the interest income generated by excess cash invested in highly liquid investments with maturities of three months or less from the original dates of purchase. The cash, cash equivalents, and marketable securities are held for working capital purposes. We have not used derivative financial instruments in our investment portfolio. We have not been exposed nor do we anticipate being exposed to material risks due to changes in market interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates had declined by 10 basis points during the three months ended September 30, 2016 and September 25, 2015, our interest income would have decreased by approximately $0.03 million and $0.02 million, respectively, assuming consistent investment levels.

We also have interest rate risk exposure in movements in interest rates associated with our interest bearing liabilities. The interest bearing liabilities are denominated in U.S. dollars and the interest expense is based on the London Inter-Bank Offered Rate (LIBOR), plus an additional margin, depending on the lending institution. If the LIBOR had increased by 100 basis points during the three months ended September 30, 2016 and September 25, 2015, our interest expense would have increased by approximately $0.1 million and $0.02 million, respectively, assuming consistent borrowing levels.

We maintain an investment portfolio in a variety of financial instruments, including, but not limited to, U.S. government and agency bonds, corporate obligations, money market funds, asset-backed securities, and other investment-grade securities. The majority of these investments pay a fixed rate of interest. The securities in the investment portfolio are subject to market price risk due to changes in interest rates, perceived issuer creditworthiness, marketability, and other factors. These investments are generally classified as available-for-sale and, consequently, are recorded on our consolidated balance sheets at fair value with unrealized gains or losses reported as a separate component of shareholders equity.

Investments in both fixed-rate and floating-rate interest earning instruments carry a degree of interest rate risk. The fair market values of our fixed-rate securities decline if interest rates rise, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may be less than we expect because of changes in interest rates or we may suffer losses in principal if forced to sell securities that have experienced a decline in market value because of changes in interest rates.

Foreign Currency Risk

As a result of our foreign operations, we have significant expenses, assets and liabilities that are denominated in foreign currencies. Substantially all of our employees and most of our facilities are located in Thailand and the PRC. Therefore, a substantial portion of our payroll as well as certain other operating expenses are paid in Thai baht or RMB. The significant majority of our revenues are denominated in U.S. dollars because our customer contracts generally provide that our customers will pay us in U.S. dollars.

As a consequence, our gross profit margins, operating results, profitability and cash flows are adversely impacted when the dollar depreciates relative to the Thai baht or the RMB. We have a particularly significant currency rate exposure to changes in the exchange rate between the Thai baht and the U.S. dollar. We must translate foreign currency-denominated results of operations, assets and liabilities for our foreign subsidiaries to U.S. dollars in our unaudited condensed consolidated financial statements. Consequently, increases and decreases in the value of the U.S.

dollar compared with such foreign currencies will affect our reported results of operations and the value of our assets and liabilities on our unaudited condensed consolidated balance sheets, even if our results of operations or the value of those assets and liabilities has not changed in its original currency. These transactions could significantly affect the comparability of our results between financial periods or result in significant changes to the carrying value of our assets, liabilities and shareholders equity.

In addition, we are exposed to foreign exchange risk in connection with the credit facility and cross currency swap arrangements we entered into with TMB Bank Public Company Limited (the Bank) in May 2011 for the construction of Pinehurst Building 6. The terms of the contract with the Bank provide the following facilities: (1) a term loan facility for up to Thai baht 960 million (equal to $30.0 million) with a fixed interest rate of 5.28% per annum, (2) a hedging facility for currency swaps with a notional amount of $30.0 million, and (3) a settlement limit of Thai baht 65 million, subject to certain terms and conditions as set forth therein. Borrowings and interest under the term loan are scheduled to be repaid on a quarterly basis between September 2011 and March 2017. Under the terms of the cross currency interest rate swap arrangement, all amounts drawn down in Thai baht were converted to U.S. dollars for repayment by us on a quarterly basis at the floating rate of LIBOR plus 2.8% per annum.

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We attempt to hedge against these exchange rate risks by entering into derivative instruments that are typically one to eighteen months in duration, leaving us exposed to longer term changes in exchange rates. During the three months ended September 30, 2016, we discontinued our cash flow hedges which hedged forecasted foreign currency transactions related to the construction cost of a new manufacturing building at the Company s Chonburi campus, which resulted in the recognition of a gain on forward derivative contracts of $0.3 million. We recorded unrealized gain of $1.7 million and $10.5 million related to derivatives that are not designated as hedging instruments, for the three months ended September 30, 2016 and September 25, 2015, respectively. As foreign currency exchange rates fluctuate relative to the U.S. dollar, we expect to incur foreign currency translation adjustments and may incur foreign currency exchange losses. For example, a 10% weakening in the U.S. dollar against the Thai baht and the RMB would have resulted in a decrease in our net dollar position of approximately $4.7 million and $2.3 million as of September 30, 2016 and June 24, 2016, respectively. We cannot give any assurance as to the effect that future changes in foreign currency rates will have on our unaudited condensed consolidated financial position, operating results or cash flows.

Credit Risk

Credit risk refers to our exposures to financial institutions, suppliers and customers that have in the past and may in the future experience financial difficulty, particularly in light of recent conditions in the credit markets and the global economy. As of September 30, 2016, our cash and cash equivalents were held in deposits and highly liquid investment products with maturities of three months or less with banks and other financial institutions having credit ratings of A minus or above. Our marketable securities as of September 30, 2016 are held in various financial institutions with a maturity limit not to exceed 3 years, and all securities are rated A1, P-1, F1 or better. We continue to monitor our surplus cash and consider investment in corporate and U.S. government debt as well as certain available for sale securities in accordance with our investment policy. We generally monitor the financial performance of our suppliers and customers, as well as other factors that may affect their access to capital and liquidity. Presently, we believe that we will not incur material losses due to our exposures to such credit risk.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our chief executive officer and chief financial officer concluded that as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and include controls and procedures designed to ensure that the information required to be disclosed by us in such reports is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosures. Management s assessment of the effectiveness of our internal control over financial reporting is expressed at the level of reasonable assurance because a control system, no matter how well designed and operated, can provide only reasonable, but not absolute, assurance that the control system s objectives will be met.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three months ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we may be involved in litigation relating to claims arising in the ordinary course of our business. There are currently no material claims or actions pending or threatened against us.

ITEM 1A. RISK FACTORS

Investing in our ordinary shares involves a high degree of risk. You should carefully consider the following risks, as well as the other information contained in this Quarterly Report on Form 10-Q, including our condensed consolidated financial statements and the related notes, before investing in our ordinary shares. The risks and uncertainties described below are not the only ones that we may face. Additional risks and uncertainties of which we are unaware, or that we currently deem immaterial, also may become important factors that affect us or our ordinary shares. If any of the following risks actually occur, they may harm our business, financial condition and operating results. In this event, the market price of our ordinary shares could decline and you could lose some or all of your investment.

Risks Related to Our Business

Our sales depend on and will continue to depend on a small number of customers. A reduction in orders from any of these customers, the loss of any of these customers, or a customer exerting significant pricing and margin pressures on us could harm our business, financial condition and operating results.

We have depended, and will continue to depend, upon a small number of customers for a significant percentage of our total revenues. During the three months ended September 30, 2016 and September 25, 2015, we had one customer that contributed 10% or more of our total revenues. This customer accounted for 21% and 18% of our total revenues, respectively, during the periods. Dependence on a small number of customers means that a reduction in orders from, a loss of, or other adverse actions by any one of these customers would reduce our revenues and could have a material adverse effect on our business, operating results and share price.

Further, our customer concentration increases the concentration of our accounts receivable and our exposure to payment default by any of our key customers. Many of our existing and potential customers have substantial debt burdens, have experienced financial distress or have static or declining revenues, all of which may be exacerbated by Brexit, adverse conditions in the credit markets, and the continual uncertainty in the global economies. Certain of our customers have gone out of business, declared bankruptcy, been acquired, or announced their withdrawal from segments of the optics market. We generate significant accounts payable and inventory for the services that we provide to our customers, which could expose us to substantial and potentially unrecoverable costs if we do not receive payment from our customers.

Reliance on a small number of customers gives those customers substantial purchasing power and leverage in negotiating contracts with us. In addition, although we enter into master supply agreements with our customers, the level of business to be transacted under those agreements is not guaranteed. Instead, we are awarded business under those agreements on a project-by-project basis. Some of our customers have at times significantly reduced or delayed the volume of manufacturing services that they order from us. If we are unable to maintain our relationships with our existing significant customers, our business, financial condition and operating results could be harmed.

Natural disasters (like the 2011 flooding in Thailand), epidemics, acts of terrorism and other political and economic developments could harm our business, financial condition, and operating results.

Natural disasters, such as the October and November 2011 flooding in Thailand, where most of our manufacturing operations are located, could severely disrupt our manufacturing operations and increase our supply chain costs. These events, over which we have little or no control, could cause a decrease in demand for our services, make it difficult or impossible for us to manufacture and deliver products and for our suppliers to deliver components allowing us to manufacture those products, require large expenditures to repair or replace our facilities, or create delays and inefficiencies in our supply chain. For example, the October and November 2011 flooding in Thailand forced us to temporarily shut down all of our manufacturing facilities in Thailand and cease production permanently at our Chokchai facility in Thailand, which adversely affected our ability to meet our customers demands during fiscal year 2012. In some countries in which we operate, including the PRC and Thailand, potential outbreaks of infectious diseases such as the H1N1 influenza virus, severe acute respiratory syndrome (SARS) or bird flu could disrupt our manufacturing operations, reduce demand for our customers products and increase our supply chain costs. In addition, increased international political instability, evidenced by the threat or occurrence of terrorist attacks, enhanced national security measures, conflicts in the Middle East and Asia, strained international relations arising from these conflicts and the related decline in consumer confidence and economic weakness, may hinder our ability to do business. Any escalation in

these events or similar future events may disrupt our operations and the operations of our customers and suppliers, and may affect the availability of materials needed for our manufacturing services. Such events may also disrupt the transportation of materials to our manufacturing facilities and finished products to our customers. These events have had, and may continue to have, an adverse impact on the U.S. and world economy in general, and customer confidence and spending in particular, which in turn could adversely affect our total revenues and operating results. The impact of these events on the volatility of the U.S. and world financial markets also could increase the volatility of the market price of our ordinary shares and may limit the capital resources available to us, our customers and our suppliers.

We are not fully insured against all potential losses. Natural disasters or other catastrophes could adversely affect our business, financial condition and results of operations.

Our current property and casualty insurance covers loss or damage to our property and third-party property over which we have custody and control, as well as losses associated with business interruption, subject to specified exclusions and limitations such as coinsurance, facilities location sub-limits and other policy limitations and covenants. Even with insurance coverage, natural disasters or other catastrophic events, including acts of war, could cause us to suffer substantial losses in our operational capacity and could also lead to a loss of opportunity and to a potential adverse impact on our relationships with our existing customers resulting from our inability to produce products for them, for which we would not be compensated by existing insurance. This in turn could have a material adverse effect on our financial condition and results of operations.

If the optical communications market does not expand as we expect, our business may not grow as fast as we expect, which could adversely impact our business, financial condition and operating results.

Our future success as a provider of precision optical, electro-mechanical and electronic manufacturing services for the optical communications market depends on the continued growth of the optics industry and, in particular, the continued expansion of global information networks, particularly those directly or indirectly dependent upon a fiber optic infrastructure. As part of that growth, we anticipate that demand for voice, video, and other data services delivered over high-speed connections (both wired and wireless) will continue to increase. Without network and bandwidth growth, the need for enhanced communications products would be jeopardized. Currently, demand for network services and for high-speed broadband access, in particular, is increasing but growth may be limited by several factors, including, among others: (1) relative strength or weakness of the global economy or certain countries or regions, (2) an uncertain regulatory environment, and (3) uncertainty regarding long-term sustainable business models as multiple industries, such as the cable, traditional telecommunications, wireless and satellite industries, offer competing content delivery solutions. The optical communications market also has experienced periods of overcapacity, some of which have occurred even during periods of relatively high network usage and bandwidth demands. If the factors described above were to slow, stop or reverse the expansion in the optical communications market, our business, financial condition and operating results would be negatively affected.

Our quarterly revenues, gross profit margins and operating results have fluctuated significantly and may continue to do so in the future, which may cause the market price of our ordinary shares to decline or be volatile.

Our quarterly revenues, gross profit margins, and operating results have fluctuated significantly and may continue to fluctuate significantly in the future. For example, any of the risks described in this Risk Factors section and, in particular, the following factors, could cause our quarterly and annual revenues, gross profit margins, and operating results to fluctuate from period to period:

- our ability to acquire new customers and retain our existing customers by delivering superior quality and customer service;
- the cyclicality of the optical communications market, as well as the industrial lasers, medical and sensors markets;
- competition;
- our ability to achieve favorable pricing for our services;
- our ability to manage our headcount and other costs; and
- changes in the relative mix in our revenues.

Therefore, we believe that quarter-to-quarter comparisons of our operating results may not be useful in predicting our future operating results. You should not rely on our results for one quarter as any indication of our future performance. Quarterly variations in our operations could result in significant volatility in the market price of our ordinary shares.

If we are unable to continue diversifying our precision optical and electro-mechanical manufacturing services across other markets within the optics industry, such as the semiconductor processing, biotechnology, metrology and material processing markets, or if these markets do not grow as fast as we expect, our business may not grow as fast as we expect, which could adversely impact our business, financial condition and operating results.

We intend to continue diversifying across other markets within the optics industry, such as the semiconductor processing, biotechnology, metrology, and material processing markets, to reduce our dependence on the optical communications market and to grow our business. Currently, the optical communications market contributes the significant majority of our revenues. There can be no assurance that our efforts to further expand and diversify into other markets within the optics industry will prove successful or that these markets will continue to grow as fast as we expect. In the event that the opportunities presented by these markets prove to be less than anticipated, if we are less successful than expected in diversifying into these markets, or if our margins in these markets prove to be less than expected, our growth may slow or stall, and we may incur costs that are not offset by revenues in these markets, all of which could harm our business, financial condition and operating results.

We face significant competition in our business. If we are unable to compete successfully against our current and future competitors, our business, financial condition and operating results could be harmed.

Our current and prospective customers tend to evaluate our capabilities against the merits of their internal manufacturing as well as the capabilities of other third-party manufacturers. We believe the internal manufacturing capabilities of current and prospective customers are our primary competition. This competition is particularly strong when our customers have excess manufacturing capacity, as was the case when the markets that we serve experienced a significant downturn in 2008 and 2009 that resulted in underutilized capacity. Should our existing and potential customers continue to have excess manufacturing capacity at their facilities, it could adversely affect our business. In addition, as a result of the October and November 2011 flooding in Thailand, some of our customers began manufacturing products internally or using other third-party manufacturers that were not affected by the flooding. If our customers choose to manufacture products internally rather than to outsource production to us, or choose to outsource to a third-party manufacturer, our business, financial condition and operating results could be harmed.

Competitors in the market for optical manufacturing services include Benchmark Electronics, Inc., Celestica Inc., Sanmina-SCI Corporation, Jabil Circuit, Inc., and Venture Corporation Limited. Our customized optics and glass operations face competition from companies such as Browave Corporation, Fujian Castech Crystals, Inc., Photop Technologies, Inc., and Research Electro-Optic, Inc. Other existing contract manufacturing companies, original design manufacturers or outsourced semiconductor assembly and test companies could also enter our target markets. In addition, we may face more competitors as we attempt to penetrate new markets.

Many of our customers and potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater resources than we have. These advantages may allow them to devote greater resources than we can to the development and promotion of service offerings that are similar or superior to our service offerings. These competitors may also engage in more extensive research and development, undertake more far-reaching marketing campaigns, adopt more aggressive pricing policies or offer services that achieve greater market acceptance than ours. These competitors may also compete with us by making more attractive offers to our existing and potential employees, suppliers, and strategic partners. Further, consolidation in the optics industry could lead to larger and more geographically diverse competitors. New and increased competition could result in price reductions for our services, reduced gross profit margins or loss of market share. We may not be able to compete successfully against our current and future competitors, and the competitive pressures we face may harm our business, financial condition and operating results.

Cancellations, delays or reductions of customer orders and the relatively short-term nature of the commitments of our customers could harm our business, financial condition and operating results.

We do not typically obtain firm purchase orders or commitments from our customers that extend beyond 13 weeks. While we work closely with our customers to develop forecasts for periods of up to one year, these forecasts are not fully binding and may be unreliable. Customers may cancel their orders, change production quantities from forecasted volumes or delay production for a number of reasons beyond our control. Any material delay, cancellation or reduction of orders could cause our revenues to decline significantly and could cause us to hold excess materials. Many of our costs and operating expenses are fixed. As a result, a reduction in customer demand could decrease our gross profit and harm our business, financial condition and operating results.

In addition, we make significant decisions, including production schedules, material procurement commitments, personnel needs and other resource requirements, based on our estimate of our customers requirements. The short-term nature of our customers commitments and the possibility of rapid changes in demand for their products reduce our ability to accurately estimate the future requirements of our customers. Inability to forecast the level of customer orders

with certainty makes it difficult to allocate resources to specific customers, order appropriate levels of materials and maximize the use of our manufacturing capacity. This could also lead to an inability to meet a spike in production demand, all of which could harm our business, financial condition and operating results.

Our exposure to financially troubled customers or suppliers could harm our business, financial condition and operating results.

We provide manufacturing services to companies, and rely on suppliers, that have in the past and may in the future experience financial difficulty, particularly in light of recent conditions in the credit markets and the overall economy that affected access to capital and liquidity. As a result, we devote significant resources to monitor receivables and inventory balances with certain of our customers. If our customers experience financial difficulty, we could have difficulty recovering amounts owed to us from these customers, or demand for our services from these customers could decline. If our suppliers experience financial difficulty, we could have trouble sourcing materials necessary to fulfill production requirements and meet scheduled shipments. Any such financial difficulty could adversely affect our operating results and financial condition by resulting in a reduction in our revenues, a charge for inventory write-offs, a provision for doubtful accounts, and an increase in working capital requirements due to increases in days in inventory and in days in accounts receivable. For example, in July 2014, one of our customers filed for bankruptcy protection under the Local Trade Court in France; however, the potential losses from this particular customer did not have a significant effect on our unaudited condensed consolidated financial statements.

Fluctuations in foreign currency exchange rates and changes in governmental policies regarding foreign currencies could increase our operating costs, which would adversely affect our operating results.

Volatility in the functional and non-functional currencies of our entities and the U.S. dollar could seriously harm our business, financial condition, and operating results. The primary impact of currency exchange fluctuations is on our cash, receivables, and payables of our operating entities. We may experience significant unexpected expenses from fluctuations in exchange rates.

Our customer contracts generally require that our customers pay us in U.S. dollars. However, the majority of our payroll and other operating expenses are paid in Thai baht. As a result of these arrangements, we have significant exposure to changes in the exchange rate between the Thai baht and the U.S. dollar, and our operating results are adversely impacted when the U.S. dollar depreciates relative to the Thai baht and other currencies. We have experienced such depreciation in the U.S. dollar as compared with the Thai baht, and our results have been adversely impacted by this fluctuation in exchange rates. As of September 30, 2016, the U.S. dollar had appreciated approximately 7.3% against the Thai baht since September 26, 2014. Further, while we attempt to hedge against certain exchange rate risks, we typically enter into hedging contracts with maturities of up to 12 months, leaving us exposed to longer term changes in exchange rates.

Also, we have significant exposure to changes in the exchange rate between the RMB and GBP and the U.S. dollar. The expenses of our PRC and the United Kingdom (UK) subsidiary are denominated in RMB and GBP, respectively. Currently, RMB are convertible in connection with trade- and service-related foreign exchange transactions, foreign debt service, and payment of dividends. The PRC government may at its discretion restrict access in the future to foreign currencies for current account transactions. If this occurs, our PRC subsidiary may not be able to pay us dividends in U.S. dollars without prior approval from the PRC State Administration of Foreign Exchange. In addition, conversion of RMB for most capital account items, including direct investments, is still subject to government approval in the PRC. This restriction may limit our ability to invest the earnings of our PRC subsidiary. As of September 30, 2016, the U.S. dollar had appreciated approximately 8.9% against the RMB since September 26, 2014. There remains significant international pressure on the PRC government to adopt a substantially more liberalized

currency policy. GBP are convertible in connection with trade- and service-related foreign exchange transaction and foreign debt service. As of September 30, 2016, the U.S. dollar had appreciated approximately 26.0% against the GBP since September 26, 2014. Any appreciation in the value of the RMB and GBP against the U.S. dollar could negatively impact our operating results.

We purchase some of the critical materials used in certain of our products from a single source or a limited number of suppliers. Supply shortages have in the past, and could in the future, impair the quality, reduce the availability or increase the cost of materials, which could harm our revenues, profitability and customer relations.

We rely on a single source or a limited number of suppliers for critical materials used in a significant number of the products we manufacture. We generally purchase these single or limited source materials through standard purchase orders and do not maintain long-term supply agreements with our suppliers. We generally use a rolling 12 month forecast based on anticipated product orders, customer forecasts, product order history, backlog, and warranty and service demand to determine our materials requirements. Lead times for the parts and components that we order vary significantly and depend on factors such as manufacturing cycle times, manufacturing yields, and the availability of raw materials used to produce the parts or components. Historically, we have experienced supply shortages resulting from

various causes, including reduced yields by our suppliers, which prevented us from manufacturing products for our customers in a timely manner. Our revenues, profitability and customer relations could be harmed by a stoppage or delay of supply, a substitution of more expensive or less reliable parts, the receipt of defective parts or contaminated materials, an increase in the price of supplies, or an inability to obtain reductions in price from our suppliers in response to competitive pressures.

We continue to undertake programs to strengthen our supply chain. Nevertheless, we are experiencing, and expect for the foreseeable future to continue to experience, strain on our supply chain, and periodic supplier problems. We have incurred, and expect to continue to incur for the foreseeable future, costs to address these problems.

Managing our inventory is complex and may require write-downs due to excess or obsolete inventory, which could cause our operating results to decrease significantly in a given fiscal period.

Managing our inventory is complex. We are generally required to procure material based upon the anticipated demand of our customers. The inaccuracy of these forecasts or estimates could result in excess supply or shortages of certain materials. Inventory that is not used or expected to be used as and when planned may become excess or obsolete. Generally, we are unable to use most of the materials purchased for one of our customers to manufacture products for any of our other customers. Additionally, we could experience reduced or delayed product shipments or incur additional inventory write-downs and cancellation charges or penalties, which would increase costs and could harm our business, financial condition and operating results. While our agreements with customers are structured to mitigate our risks related to excess or obsolete inventory, enforcement of these provisions may result in material expense, and delay in payment for inventory. If any of our significant customers becomes unable or unwilling to purchase inventory or does not agree to such contractual provisions in the future, our business, financial condition and operating results may be harmed.

We conduct operations in a number of countries, which creates logistical and communications challenges for us and exposes us to other risks that could harm our business, financial condition and operating results.

The vast majority of our operations, including manufacturing and customer support, are located primarily in the Asia-Pacific region. The distances between Thailand, the PRC and our customers and suppliers globally, create a number of logistical and communications challenges for us, including managing operations across multiple time zones, directing the manufacture and delivery of products across significant distances, coordinating the procurement of raw materials and their delivery to multiple locations and coordinating the activities and decisions of our management team, the members of which are based in different countries.

Our customers are located throughout the world. Total revenues from the bill-to-location of customers outside of North America accounted for 50.0% and 50.8% of our total revenues for the three months ended September 30, 2016 and September 25, 2015, respectively. We expect that total revenues from the bill-to-location of customers outside of North America will continue to account for a significant portion of our total revenues. Our customers also depend on international sales, which further exposes us to the risks associated with international operations. In addition, our international operations and sales subject us to a variety of domestic and foreign trade regulatory requirements.

Political unrest and demonstrations, as well as changes in the political, social, business or economic conditions in Thailand, could harm our business, financial condition and operating results.

The majority of our assets and manufacturing operations are located in Thailand. Therefore, political, social, business and economic conditions in Thailand have a significant effect on our business. In March 2016, Thailand was assessed as a medium-high political risk by AON Political Risk, a risk management, insurance and consulting firm. Any

changes to tax regimes, laws, exchange controls or political action in Thailand may harm our business, financial condition and operating results.

Thailand has a history of political unrest that includes the involvement of the military as an active participant in the ruling government. In recent years, political unrest in the country has sparked political demonstrations and, in some instances, violence. In May 2014, the Thai military took over the government in a coup, and it continues to rule the country today. It is unknown how long it may take for the current political situation to be resolved and for democracy to be restored, or what effects the current political situation may have on Thailand and the surrounding region. Most recently, in October 2016, Thailand s King Bhumibol Adulyadej died at the age of 88. Aside from the mourning among Thai people across Thailand, the condition in the country is still calm and peaceful, and we do not see any negative impact to our business in Thailand. Any succession crisis in the Kingdom of Thailand could cause new or increased political instability, which could prevent shipments from entering or leaving the country and disrupt our ability to manufacture products in Thailand, and we could be forced to transfer our manufacturing activities to more stable, and potentially more costly, regions.

Further, the Thai government may raise the minimum wage standards for labor and could repeal certain promotional certificates that we have received or tax holidays for certain export and value added taxes that we enjoy, either preventing us from engaging in our current or anticipated activities or subjecting us to higher tax rates. A new regime could nationalize our business or otherwise seize our assets and any other future political instability could harm our business, financial condition and operating results.

We expect to continue to invest in our manufacturing operations in the PRC, which will continue to expose us to risks inherent in doing business in the PRC, any of which risks could harm our business, financial condition and operating results.

We anticipate that we will continue to invest in our customized optics manufacturing facilities located in Fuzhou, China. Because these operations are located in the PRC, they are subject to greater political, legal and economic risks than the geographies in which the facilities of many of our competitors and customers are located. In particular, the political and economic climate in the PRC (both at national and regional levels) is fluid and unpredictable. In March 2016, AON Political Risk assessed the PRC as a medium political risk. A large part of the PRC s economy is still being operated under varying degrees of control by the PRC government. By imposing industrial policies and other economic measures, such as control of foreign exchange, taxation, import and export tariffs, environmental regulations, land use rights, intellectual property and restrictions on foreign participation in the domestic market of various industries, the PRC government exerts considerable direct and indirect influence on the development of the PRC economy. Many of the economic reforms carried out by the PRC government are unprecedented or experimental and are expected to change further. Any changes to the political, legal or economic climate in the PRC could harm our business, financial condition and operating results.

Our PRC subsidiary is a wholly foreign-owned enterprise and is therefore subject to laws and regulations applicable to foreign investment in the PRC, in general, and laws and regulations applicable to wholly foreign-owned enterprises, in particular. The PRC has made significant progress in the promulgation of laws and regulations pertaining to economic matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. However, the promulgation of new laws, changes in existing laws and abrogation of local regulations by national laws may have a negative impact on our business and prospects. In addition, these laws and regulations are relatively new, and published cases are limited in volume and non-binding. Therefore, the interpretation and enforcement of these laws and regulations involve significant uncertainties. Laws may be changed with little or no prior notice, for political or other reasons. These uncertainties could limit the legal protections available to foreign investors. Furthermore, any litigation in the PRC may be protracted and result in substantial costs and diversion of resources and management s attention.

Our business and operations would be adversely impacted in the event of a failure of our information technology infrastructure and/or cyber security attacks.

We rely upon the capacity, availability and security of our information technology hardware and software infrastructure. For instance, we use a combination of standard and customized software platforms to manage, record, and report all aspects of our operations and, in many instances, enable our customers to remotely access certain areas of our databases to monitor yields, inventory positions, work-in-progress status and vendor quality data. We are constantly expanding and updating our information technology infrastructure in response to our changing needs. Any failure to manage, expand and update our information technology infrastructure or any failure in the operation of this infrastructure could harm our business.

Despite our implementation of security measures, our systems are vulnerable to damages from computer viruses, natural disasters, unauthorized access and other similar disruptions. Any system failure, accident or security breach

could result in disruptions to our operations. To the extent that any disruptions, cyber-attack or other security breach results in a loss or damage to our data, or inappropriate disclosure of confidential information, it could harm our business. In addition, we may be required to incur significant costs to protect against damage caused by these disruptions or security breaches in the future.

Consolidation in the markets we serve could harm our business, financial condition and operating results.

Consolidation in the markets we serve has resulted in a reduction in the number of potential customers for our services. In some cases, consolidation among our customers has led to a reduction in demand for our services as customers acquired the capacity to manufacture products in-house.

Consolidation among our customers and their customers may continue and may adversely affect our business, financial condition and operating results in several ways. Consolidation among our customers and their customers may result in a smaller number of large customers whose size and purchasing power give them increased leverage that may result in, among other things, decreases in our average selling prices. In addition to pricing pressures, this consolidation may also reduce overall demand for our manufacturing services if customers obtain new capacity to manufacture products in-house or discontinue duplicate or competing product lines in order to streamline operations. If demand for our manufacturing services decreases, our business, financial condition and operating results could be harmed.

Unfavorable worldwide economic conditions may negatively affect our business, operating results and financial condition.

Volatility and disruption in the capital and credit markets, depressed consumer confidence, and negative global economic conditions have affected levels of business and consumer spending. Concerns about the potential default of various national bonds and debt backed by individual countries as well as the politics impacting these, could negatively impact the U.S. and global economies and adversely affect our financial results. In particular, Brexit and recent economic uncertainty in Europe has led to reduced demand in some of our customers optical communications product portfolios. Brexit could also lead to economic and legal uncertainty, including significant volatility in global stock markets and currency exchange rates, and increasingly divergent laws and regulations as the United Kingdom determines which European Union laws to replace or replicate. Any of these effects of Brexit, among others, could adversely affect our financial results. If economic conditions in Europe do not recover or if they continue to deteriorate, our operating results could be harmed.

Uncertainty about worldwide economic conditions poses a risk as businesses may further reduce or postpone spending in response to reduced budgets, tight credit, negative financial news and declines in income or asset values, which could adversely affect our business, financial condition and results of operations and increase the volatility of our share price. In addition, our ability to access capital markets may be restricted, which could have an impact on our ability to react to changing economic and business conditions and could also adversely affect our results of operations and financial condition.

If we fail to adequately expand our manufacturing capacity, we will not be able to grow our business, which would harm our business, financial condition and operating results. Conversely, if we expand too much or too rapidly, we may experience excess capacity, which would harm our business, financial condition and operating results.

We may not be able to pursue many large customer orders or sustain our historical growth rates if we do not have sufficient manufacturing capacity to enable us to commit to provide customers with specified quantities of products. If our customers do not believe that we have sufficient manufacturing capacity, they may: (1) outsource all of their production to another source that they believe can fulfill all of their production requirements; (2) look to a second source for the manufacture of additional quantities of the products that we currently manufacture for them; (3) manufacture the products themselves; or (4) otherwise decide against using our services for their new products.

In February 2015, we expanded our manufacturing capacity with the purchase of land and a building in Santa Clara, California. In December 2015, we completed the purchase of land in Chonburi, Thailand and began construction of a new manufacturing facility on such land, which we substantially completed in October 2016. We may continue to devote significant resources to the expansion of our manufacturing capacity, and any such expansion will be expensive, will require management s time and may disrupt our operations. In the event we are unsuccessful in our attempts to expand our manufacturing capacity, our business, financial condition and operating results could be harmed.

However, if we expand our manufacturing capacity and are unable to promptly utilize the additional space due to reduced demand for our services, an inability to win new projects, new customers or penetrate new markets, or if the optics industry does not grow as we expect, we may experience periods of excess capacity, which could harm our business, financial condition and operating results.

We may experience manufacturing yields that are lower than expected, potentially resulting in increased costs, which could harm our business, operating results and customer relations.

Manufacturing yields depend on a number of factors, including the following:

- the quality of input, materials and equipment;
- the quality and feasibility of our customer s design;
- the repeatability and complexity of the manufacturing process;
- the experience and quality of training of our manufacturing and engineering teams; and
- the monitoring of the manufacturing environment.

Lower volume production due to continually changing designs generally results in lower yields. Manufacturing yields and margins can also be lower if we receive or inadvertently use defective or contaminated materials from our suppliers. In addition, our customer contracts typically provide that we will supply products at a fixed price each quarter, which assumes specific production yields and quality metrics. If we do not meet the yield assumptions and quality metrics used in calculating the price of a product, we may not be able to recover the costs associated with our failure to do so. Consequently, our operating results and profitability may be harmed.

If the products that we manufacture contain defects, we could incur significant correction costs, demand for our services may decline and we may be exposed to product liability and product warranty claims, which could harm our business, financial condition, operating results and customer relations.

We manufacture products to our customers specifications, and our manufacturing processes and facilities must comply with applicable statutory and regulatory requirements. In addition, our customers products and the manufacturing processes that we use to produce them are often complex. As a result, products that we manufacture may at times contain manufacturing or design defects, and our manufacturing processes may be subject to errors or fail to be in compliance with applicable statutory or regulatory requirements. Additionally, not all defects are immediately detectible. The testing procedures of our customers are generally limited to the evaluation of the products that we manufacture under likely and foreseeable failure scenarios. For various reasons (including, among others, the occurrence of performance problems that are unforeseeable at the time of testing or that are detected only when products are fully deployed and operated under peak stress conditions), these products may fail to perform as expected after their initial acceptance by a customer.

We generally provide a warranty of between one to two years on the products that we manufacture for our customers. This warranty typically guarantees that products will conform to our customers specifications and be free from defects in workmanship. Defects in the products we manufacture, whether caused by a design, engineering, manufacturing or component failure or by deficiencies in our manufacturing processes and whether during or after the warranty period, could result in product or component failures, which may damage our business reputation, whether or not we are indemnified for such failures. We could also incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. In some instances, we may also be required to incur costs to repair or replace defective products outside of the warranty period in the event that a recurring defect is discovered in a certain percentage of a customer s products delivered over an agreed upon period of time. We have experienced product or component failures in the past and remain exposed to such failures, as the products that we manufacture are widely deployed throughout the world in multiple environments and applications. Further, due to the difficulty in determining whether a given defect resulted from our customer s design of the product or our manufacturing process, we may be exposed to product liability or product warranty claims arising from defects that are not our fault. In addition, if the number or type of defects exceeds certain percentage limitations contained in our contractual arrangements, we may be required to conduct extensive failure analysis, re-qualify for production or cease production of the specified products.

Product liability claims may include liability for personal injury or property damage. Product warranty claims may include liability to pay for a recall, repair or replacement of a product or component. Although liability for these claims is generally assigned to our customers in our contracts, even where they have assumed liability, our customers may not, or may not have the resources to, satisfy claims for costs or liabilities arising from a defective product. Additionally, under one of our contracts, in the event the products we manufacture do not meet the end-customer s testing requirements or otherwise fail, we may be required to pay penalties to our customer, including a fee during the time period that the customer or end-customer s production line is not operational as a result of the failure of the products that we manufacture, all of which could harm our business, operating results and customer relations. If we engineer or manufacture a product that is found to cause any personal injury or property damage or is otherwise found

to be defective, we could incur significant costs to resolve the claim. While we maintain insurance for certain product liability claims, we do not maintain insurance for any recalls and, therefore, would be required to pay any associated costs that are determined to be our responsibility. A successful product liability or product warranty claim in excess of our insurance coverage or any material claim for which insurance coverage is denied, limited, is not available or has not been obtained could harm our business, financial condition and operating results.

If we are unable to meet regulatory quality standards applicable to our manufacturing and quality processes for the products we manufacture, our business, financial condition or operating results could be harmed.

As a manufacturer of products for the optics industry, we are required to meet certain certification standards, including the following: ISO9001 for Manufacturing Quality Management Systems; ISO14001 for Environmental Management Systems; TL9000 for Telecommunications Industry Quality Certification; ISO/TS16949 for Automotive Industry Quality Certification; ISO13485 for Medical Devices Industry Quality Certification; AS9100 for Aerospace Industry Quality Certification; and OHSAS18001 for Occupational Health and Safety Management Systems. We also maintain compliance with various additional standards imposed by the U.S. Food and Drug Administration, or FDA, with respect to the manufacture of medical devices.

Additionally, we are required to register with the FDA and other regulatory bodies and are subject to continual review and periodic inspection for compliance with various regulations, including testing, quality control and documentation procedures. We hold the following additional certifications: ANSI ESD S20.20 for facilities and manufacturing process control, in compliance with ESD standard; Transported Asset Protection Association, or TAPA, for Logistic Security Management System; and CSR-DIW for Corporate Social Responsibility in Thailand. In the European Union, we are required to maintain certain ISO certifications in order to sell our precision optical, electro-mechanical and electronic manufacturing services and we must undergo periodic inspections by regulatory bodies to obtain and maintain these certifications. If any regulatory inspection reveals that we are not in compliance with applicable standards, regulators may take action against us, including issuing a warning letter, imposing fines on us, requiring a recall of the products we manufactured for our customers, or closing our manufacturing facilities. If any of these actions were to occur, it could harm our reputation as well as our business, financial condition and operating results.

If we fail to attract additional skilled employees or retain key personnel, our business, financial condition and operating results could suffer.

Our future success depends, in part, upon our ability to attract additional skilled employees and retain our current key personnel. We have identified several areas where we intend to expand our hiring, including business development, finance, human resources, operations and supply chain management. We may not be able to hire and retain such personnel at compensation levels consistent with our existing compensation and salary structure. Our future also depends on the continued contributions of our executive management team, including Mr. Mitchell, and other key management and technical personnel, each of whom would be difficult to replace. We do not have key person life insurance or long-term employment contracts with any of our key personnel. The loss of any of our executive officers or key personnel or the inability to continue to attract qualified personnel could harm our business, financial condition and operating results.

Failure to comply with applicable environmental laws and regulations could have a material adverse effect on our business, results of operations and financial condition.

The sale and manufacturing of products in certain states and countries may subject us to environmental laws and regulations. In addition, rules adopted by the U.S. Securities and Exchange Commission (SEC) implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 impose diligence and disclosure requirements regarding the use of conflict minerals mined from the Democratic Republic of Congo and adjoining countries in the products we manufacture for our customers. Compliance with these rules has resulted in additional cost and expense, including for due diligence to determine and verify the sources of any conflict minerals used in the products we manufacture, and may result in additional costs of remediation and other changes to processes or sources of supply as a consequence of such verification activities. These rules may also affect the sourcing and availability of minerals used in the products we manufacture, as there may be only a limited number of suppliers offering conflict free metals that can be used in the products we manufacture for our customers.

Although we do not anticipate any material adverse effects based on the nature of our operations and these laws and regulations, we will need to ensure that we and, in some cases, our suppliers comply with applicable laws and regulations. If we fail to timely comply with such laws and regulations, our customers may cease doing business with us, which would have a material adverse effect on our business, results of operations and financial condition. In addition, if we were found to be in violation of these laws, we could be subject to governmental fines, liability to our customers and damage to our reputation, which would also have a material adverse effect on our business, results of operations and financial condition.

We have incurred and will continue to incur significant increased costs as a result of operating as a public company, and our management will be required to continue to devote substantial time to various compliance initiatives.

The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as well as other rules implemented by the SEC and the New York Stock Exchange (NYSE), impose various requirements on public companies, including requiring changes in corporate governance practices. These and proposed corporate governance laws and regulations under consideration may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management s attention from other business concerns, it could have a material adverse effect on our business, financial condition and results of operations. The Sarbanes-Oxley Act requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually and disclosure controls and procedures quarterly. While we were able to assert in our Annual Report on Form 10-K that our internal control over financial reporting was effective as of June 24, 2016, we cannot predict the outcome of our testing in future periods. If we are unable to assert in any future reporting periods that our internal control over financial reporting is effective (or if our independent registered public accounting firm is unable to express an opinion on the effectiveness of our internal controls), we could lose investor confidence in the accuracy and completeness of our financial reports, which would have an adverse effect on our share price.

Given the nature and complexity of our business and the fact that some members of our management team are located in Thailand while others are located in the United States, control deficiencies may periodically occur. For example, following an internal investigation by the Audit Committee of our Board of Directors in September 2014 concerning various accounting cut-off issues, we identified certain significant deficiencies in our internal control over financial reporting, which have been remediated. While we have ongoing measures and procedures to prevent and remedy control deficiencies, if they occur there can be no assurance that we will be successful or that we will be able to prevent material weaknesses or significant deficiencies in our internal control over financial reporting in the future. Moreover, if we identify deficiencies in our internal control over financial reporting that are deemed to be material weaknesses in future periods, the market price of our ordinary shares could decline and we could be subject to potential delisting by the NYSE and review by the NYSE, the SEC, or other regulatory authorities, which would require the expenditure by us of additional financial and management resources. As a result, our shareholders could lose confidence in our financial reporting, which would harm our business and the market price of our ordinary shares.

We are subject to the risk of increased income taxes, which could harm our business, financial condition and operating results.

We base our tax position upon the anticipated nature and conduct of our business and upon our understanding of the tax laws of the various countries in which we have assets or conduct activities. However, our tax position is subject to review and possible challenge by tax authorities and to possible changes in law, which may have retroactive effect. Fabrinet (the Cayman Islands Parent) is an exempted company incorporated in the Cayman Islands. We maintain manufacturing operations in Thailand, the PRC and the United States, any of which jurisdictions could assert tax claims against us. We cannot determine in advance the extent to which some jurisdictions may require us to pay taxes or make payments in lieu of taxes. Preferential tax treatment from the Thai government in the form of a corporate tax exemption is currently available to us through June 2020 on income generated from the manufacture of products at Pinehurst Building 6. Such preferential tax treatment is contingent on various factors, including the export of our customers products out of Thailand and our agreement not to move our manufacturing facilities out of our current province in Thailand for at least 15 years from the date on which preferential tax treatment was granted. We will lose this favorable tax treatment in Thailand unless we comply with these restrictions, and as a result we may delay or forego certain strategic business decisions due to these tax considerations. In addition, we benefit from permanent reductions in corporate tax rates in Thailand for fiscal years 2017 onward.

There is also a risk that Thailand or another jurisdiction in which we operate may treat the Cayman Islands Parent as having a permanent establishment in such jurisdiction and subject its income to tax. If we become subject to additional taxes in any jurisdiction or if any jurisdiction begins to treat the Cayman Islands Parent as having a permanent establishment, such tax treatment could materially and adversely affect our business, financial condition and operating results.

Certain of our subsidiaries provide products and services to, and may from time to time undertake certain significant transactions with, us and our other subsidiaries in different jurisdictions. For instance, we have intercompany agreements in place that provide for our California and Singapore subsidiaries to provide administrative services for the Cayman Islands Parent, and the Cayman Islands Parent has entered into manufacturing agreements with our Thai subsidiary. In general, related party transactions and, in particular, related party financing transactions, are subject to close review by tax authorities. Moreover, several jurisdictions in which we operate have tax laws with detailed transfer pricing rules that require all transactions with non-resident related parties to be priced using arm s length pricing principles and require the existence of contemporaneous documentation to support such pricing. Tax authorities in various jurisdictions could challenge the validity of our related party transfer pricing policies. Such a challenge generally involves a complex area of taxation and a significant degree of judgment by management. If any taxation authorities are successful in challenging our financing or transfer pricing policies, our income tax expense

may be adversely affected and we could become subject to interest and penalty charges, which may harm our business, financial condition and operating results.

We may encounter difficulties completing or integrating acquisitions, asset purchases and other types of transactions that we may pursue in the future, which could disrupt our business, cause dilution to our shareholders and harm our business, financial condition and operating results.

We have grown and may continue to grow our business through acquisitions, asset purchases and other types of transactions, including the transfer of products from our customers and their suppliers. Most recently, we acquired Exception EMS in September 2016. Acquisitions and other strategic transactions typically involve many risks, including the following:

the integration of the acquired assets and facilities into our business may be difficult, time-consuming and costly, and may adversely impact our profitability;

- we may lose key employees of the acquired companies or divisions;
- we may issue additional ordinary shares, which would dilute our current shareholders percentage ownership in us;
- we may incur indebtedness to pay for the transactions;
- we may assume liabilities, some of which may be unknown at the time of the transactions;
- we may record goodwill and non-amortizable intangible assets that will be subject to impairment testing and potential periodic impairment charges;
- we may incur amortization expenses related to certain intangible assets;
- we may devote significant resources to transactions that may not ultimately yield anticipated benefits;
- we may incur greater than expected expenses or lower than expected revenues;
- we may assume obligations with respect to regulatory requirements, including environmental regulations, which may prove more burdensome than expected; or
- we may become subject to litigation.

Acquisitions are inherently risky, and we can provide no assurance that the acquisition of Exception EMS or any future acquisitions will be successful or will not harm our business, financial condition and operating results.

We may not be able to obtain capital when desired on favorable terms, if at all, or without dilution to our shareholders.

We anticipate that our current cash and cash equivalents, together with cash provided by operating activities and funds available through our working capital and credit facilities, will be sufficient to meet our current and anticipated needs for general corporate purposes for at least the next 12 months. We operate in a market, however, that makes our prospects difficult to evaluate. It is possible that we may not generate sufficient cash flow from operations or otherwise have the capital resources to meet our future capital needs. If this occurs, we may need additional financing to execute on our current or future business strategies.

Furthermore, if we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our shareholders could be significantly diluted, and these newly-issued securities may have rights, preferences or privileges senior to those of existing shareholders. If adequate additional funds are not available or are not available on acceptable terms, if and when needed, our ability to fund our operations, take advantage of

unanticipated opportunities, develop or enhance our manufacturing services, hire additional technical and other personnel, or otherwise respond to competitive pressures could be significantly limited.

Intellectual property infringement claims against our customers or us could harm our business, financial condition and operating results.

Our services involve the creation and use of intellectual property rights, which subject us to the risk of intellectual property infringement claims from third parties and claims arising from the allocation of intellectual property rights among us and our customers.

Our customers may require that we indemnify them against the risk of intellectual property infringement arising out of our manufacturing processes. If any claims are brought against us or our customers for such infringement, whether or not these claims have merit, we could be required to expend significant resources in defense of such claims. In the event of an infringement claim, we may be required to spend a significant amount of money to develop non-infringing alternatives or obtain licenses. We may not be successful in developing such alternatives or obtaining such licenses on reasonable terms or at all, which could harm our business, financial condition and operating results.

Any failure to protect our customers intellectual property that we use in the products we manufacture for them could harm our customer relationships and subject us to liability.

We focus on manufacturing complex optical products for our customers. These products often contain our customers intellectual property, including trade secrets and know-how. Our success depends, in part, on our ability to protect our customers intellectual property. We may maintain separate and secure areas for customer proprietary manufacturing processes and materials and dedicate floor space, equipment, engineers and supply chain management to protect our customers proprietary drawings, materials and products. The steps we take to protect our customers intellectual property may not adequately prevent its disclosure or misappropriation. If we fail to protect our customers intellectual property, our customer relationships could be harmed and we may experience difficulty in establishing new customer relationships. In addition, our customers might pursue legal claims against us for any failure to protect their intellectual property, possibly resulting in harm to our reputation and our business, financial condition and operating results.

There are inherent uncertainties involved in estimates, judgments and assumptions used in the preparation of financial statements in accordance with U.S. GAAP. Any changes in estimates, judgments and assumptions could have a material adverse effect on our business, financial condition and operating results.

The preparation of financial statements in accordance with U.S. GAAP involves making estimates, judgments and assumptions that affect reported amounts of assets (including intangible assets), liabilities and related reserves, revenues, expenses and income. Estimates, judgments and assumptions are inherently subject to change in the future, and any such changes could result in corresponding changes to the amounts of assets, liabilities, revenues, expenses and income. Any such changes could have a material adverse effect on our business, financial condition and operating results.

We are subject to governmental export and import controls in several jurisdictions that could subject us to liability or impair our ability to compete in international markets.

We are subject to governmental export and import controls in Thailand, the PRC, the United Kingdom and the United States that may limit our business opportunities. Various countries regulate the import of certain technologies and have enacted laws that could limit our ability to export or sell the products we manufacture. The export of certain technologies from the United States, the United Kingdom and other nations to the PRC is barred by applicable export controls, and similar prohibitions could be extended to Thailand, thereby limiting our ability to manufacture certain products. Any change in export or import regulations or related legislation, shift in approach to the enforcement of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could limit our ability to offer our manufacturing services to existing or potential customers, which could harm our business, financial condition and operating results.

The loan agreements for our long-term debt obligations and other credit facilities contain financial ratio covenants that may impair our ability to conduct our business.

The loan agreements for our long-term and short-term debt obligations contain financial ratio covenants that may limit management s discretion with respect to certain business matters. These covenants require us to maintain a specified debt-to-equity ratio, debt service coverage ratio (earnings before interest and depreciation and amortization plus cash on hand minus short-term debt), a minimum tangible net worth and a minimum quick ratio, which may restrict our ability to incur additional indebtedness and limit our ability to use our cash. In the event of our default on these loans or a breach of a covenant, the lenders may immediately cancel the loan agreement, deem the full amount of the outstanding indebtedness immediately due and payable, charge us interest on a monthly basis on the full amount of the

outstanding indebtedness and, if we cannot repay all of our outstanding obligations, sell the assets pledged as collateral for the loan in order to fulfill our obligation. We may also be held responsible for any damages and related expenses incurred by the lender as a result of any default. Any failure by us or our subsidiaries to comply with these agreements could harm our business, financial condition and operating results.

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

We use professional investment management firms to manage our excess cash and cash equivalents. Our marketable securities as of September 30, 2016 are primarily investments in a fixed income portfolio, including corporate bonds and commercial paper, U.S. agency and U.S. Treasury securities, and sovereign and municipal securities. Our investment portfolio may become impaired by deterioration of the capital markets. We follow an established investment policy and set of guidelines to monitor and help mitigate our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes. The policy also provides that we may not invest in marketable securities with a maturity in excess of three years.

We regularly review our investment portfolio to determine if any security is other-than-temporarily impaired, which would require us to record an impairment charge in the period any such determination is made. In making this judgment, we evaluate, among other things, the duration and extent to which the fair value of a security is less than its cost; the financial condition of the issuer and any changes thereto; and our intent to sell, or whether we will more likely than not be required to sell, the security before recovery of its amortized cost basis. Our assessment on whether a security is other-than-temporarily impaired could change in the future due to new developments or changes in assumptions related to any particular security.

Should financial market conditions worsen, investments in some financial instruments may pose risks arising from market liquidity and credit concerns. In addition, any deterioration of the capital markets could cause our other income and expense to vary from expectations. As of September 30, 2016, we did not record any impairment charges associated with our investment portfolio of marketable securities, and although we believe our current investment portfolio has little risk of material impairment, we cannot predict future market conditions or market liquidity, or credit availability, and can provide no assurance that our investment portfolio will remain materially unimpaired.

Energy price volatility may negatively impact our results of operations.

We, along with our suppliers and customers, rely on various energy sources in our manufacturing and transportation activities. Energy prices have been subject to increases and volatility caused by market fluctuations, supply and demand, currency fluctuation, production and transportation disruption, world events and government regulations. While we are currently experiencing lower energy prices, a significant increase is possible, which could increase our raw material and transportation costs. In addition, increased transportation costs of our suppliers and customers could be passed along to us. We may not be able to increase our prices enough to offset these increased costs, and any increase in our prices may reduce our future customer orders, which could harm our business, financial condition and operating results.

Risks Related to Ownership of Our Ordinary Shares

Our share price may be volatile due to fluctuations in our operating results and other factors, including the activities and operating results of our customers or competitors, any of which could cause our share price to decline.

Our revenues, expenses and results of operations have fluctuated in the past and are likely to do so in the future from quarter to quarter and year to year due to the risk factors described in this section and elsewhere in this Quarterly Report on Form 10-Q. In addition to market and industry factors, the price and trading volume of our ordinary shares may fluctuate in response to a number of events and factors relating to us, our competitors, our customers and the markets we serve, many of which are beyond our control. Factors such as variations in our total revenues, earnings and cash flow, announcements of new investments or acquisitions, changes in our pricing practices or those of our competitors, commencement or outcome of litigation, sales of ordinary shares by us or our principal shareholders, fluctuations in market prices for our services and general market conditions could cause the market price of our ordinary shares to change substantially. Any of these factors may result in large and sudden changes in the volume and price at which our ordinary shares trade. Among other things, volatility and weakness in our share price could mean that investors may not be able to sell their shares at or above the prices they paid. Volatility and weakness could also impair our ability in the future to offer our ordinary shares or convertible securities as a source of additional capital and/or as consideration in the acquisition of other businesses.

Furthermore, the stock markets have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been

unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political and market conditions such as recessions, interest rate changes or international currency fluctuations, may cause the market price of our ordinary shares to decline. In the past, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management s attention from other business concerns, which could seriously harm our business.

If securities or industry analysts do not publish research or if they publish misleading or unfavorable research about our business, the market price and trading volume of our ordinary shares could decline.

The trading market for our ordinary shares depends in part on the research and reports that securities or industry analysts publish about us or our business. If securities or industry analysts stop covering us, or if too few analysts cover us, the market price of our ordinary shares would be adversely impacted. If one or more of the analysts who covers us downgrades our ordinary shares or publishes misleading or unfavorable research about our business, our market price would likely decline. If one or more of these analysts ceases coverage of us or fails to publish reports on us regularly, demand for our ordinary shares could decrease, which could cause the market price or trading volume of our ordinary shares to decline.

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We may become a passive foreign investment company, which could result in adverse U.S. tax consequences to U.S. investors.

Based upon estimates of the value of our assets, which are based in part on the trading price of our ordinary shares, we do not expect to be a passive foreign investment company, or PFIC, for U.S. federal income tax purposes for the taxable year 2015 or for the foreseeable future. However, despite our expectations, we cannot assure you that we will not be a PFIC for the taxable year 2015 or any future year because our PFIC status is determined at the end of each year and depends on the composition of our income and assets during such year. If we are a PFIC, our U.S. investors will be subject to increased tax liabilities under U.S. tax laws and regulations and to burdensome reporting requirements.

Certain provisions in our constitutional documents may discourage our acquisition by a third party, which could limit your opportunity to sell shares at a premium.

Our constitutional documents include provisions that could limit the ability of others to acquire control of us, modify our structure or cause us to engage in change-of-control transactions, including, among other things, provisions that:

- establish a classified board of directors;
- prohibit our shareholders from calling meetings or acting by written consent in lieu of a meeting;

2,213

2,052

Stock-based compensation

3,432

2,810

Loss on sale of market-based business unit

-

324

Gain on sale of other assets

(337)

(279)

Net change in receivables, inventory and prepayments

(11,110)

(7,417)

Net change in payables, accrued interest, accrued taxes and other accrued liabilities

(6,165)

(10,969)

Pension and other postretirement benefits contributions

(8,692)

(15,421)

Other

4,658

2,262

Net cash flows from operating activities

169,685

157,261

Cash flows from investing activities:

Property, plant and equipment additions, including the debt component of allowance for funds used during construction of $1,613 and $1,543

(216,614)

(208,472)

Acquisitions of utility systems and other, net

(190)

(5,765)

Net proceeds from the sale of market-based business unit and other assets

398

1,102

Other

(152)

(144)

Net cash flows used in investing activities

(216,558)

(213,279)

Cash flows from financing activities:

Customers' advances and contributions in aid of construction

4,068

3,629

Repayments of customers' advances

(1,818)

(1,774)

Net (repayments) proceeds of short-term debt

(3,650)

60,921

Proceeds from long-term debt

218,037

222,780

Repayments of long-term debt

(41,001)

(145,499)

Change in cash overdraft position

(6,062)

(12,616)

Proceeds from issuing common stock

720

715

Proceeds from exercised stock options

1,019

2,327

Repurchase of common stock

(2,491)

(2,093)

Dividends paid on common stock

(72,802)

(67,920)

Other

(403)

(404)

Net cash flows from financing activities

95,617

60,066

Net change in cash and cash equivalents

48,744

4,048

Cash and cash equivalents at beginning of period

4,204

3,763

Cash and cash equivalents at end of period

$

52,948

$

7,811

Non-cash investing activities:

Property, plant and equipment additions purchased at the period end, but not yet paid for

$

26,010

$

32,770

Non-cash customer advances and contributions in aid of construction

10,468

11,488

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 1 – Basis of Presentation

The accompanying consolidated balance sheets and statements of capitalization of Aqua America, Inc. and subsidiaries (the "Company") at June 30, 2018, the consolidated statements of net income and comprehensive income for the three and six months ended June 30, 2018 and 2017 the consolidated statements of cash flow for the six months ended June 30, 2018 and 2017, and the consolidated statement of equity for the six months ended June 30, 2018 are unaudited, but reflect all adjustments, consisting of only normal recurring accruals, which are, in the opinion of management, necessary to present a fair statement of its consolidated financial position, consolidated changes in equity, consolidated results of operations, and consolidated cash flow for the periods presented. Because they cover interim periods, the statements and related notes to the financial statements do not include all disclosures and notes normally provided in annual financial statements and, therefore, should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017. The results of operations for interim periods may not be indicative of the results that may be expected for the entire year. The December 31, 2017 consolidated balance sheet data presented herein was derived from the Company's December 31, 2017 audited consolidated financial statements, but does not include all disclosures and notes normally provided in annual financial statements. Certain prior period amounts have been reclassified to conform to the current period presentation in the consolidated statements of net income as a result of the adoption, in the first quarter of 2018, of the Financial Accounting Standards Board's ("FASB") accounting guidance on the presentation of net periodic pension and postretirement benefit cost (refer to Note 16 – Recent Accounting Pronouncements).

The preparation of financial statements often requires the selection of specific accounting methods and policies. Further, significant estimates and judgments may be required in selecting and applying those methods and policies in the recognition of the assets and liabilities in its consolidated balance sheets, the revenues and expenses in its consolidated statements of net income, and the information that is contained in its summary of significant accounting policies and notes to consolidated financial statements. Making these estimates and judgments requires the analysis of information concerning events that may not yet be complete and of facts and circumstances that may change over time. Accordingly, actual amounts or future results can differ materially from those estimates that the Company includes currently in its consolidated financial statements, summary of significant accounting policies, and notes.

There have been no changes to the summary of significant accounting policies, other than as described in Note 2 – Revenue Recognition as a result of the adoption of a new accounting pronouncement adopted on January 1, 2018, previously identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 2 – Revenue Recognition

The Company recognizes revenue as water and wastewater services are provided to our customers, which happens over time as the service is delivered and the performance obligation is satisfied. The Company's utility revenues recognized in an accounting period include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the last billing to the end of the accounting period. Unbilled amounts are calculated by deriving estimates based on average usage of the prior month. The Company's actual results could differ from these estimates, which would result in operating revenues being adjusted in the period that the revision to our estimates is determined. Unbilled amounts are included in accounts receivable and unbilled revenues, net on the consolidated balance sheet.

Generally, payment is due within 30 days once a bill is issued to a customer. Sales tax and other taxes we collect on behalf of government authorities, concurrent with our revenue-producing activities, are primarily excluded from revenue. The Company has determined that its revenue recognition is not materially different under the FASB's new accounting standard for revenue from contracts with customer, and has not made any changes to our accounting policy. The Company's revenues are being reported identical in the consolidated statements of net income to how they were reported under the FASB's former accounting standard for revenue recognition. The following table presents our revenues disaggregated by major source and customer class:

	Three Months Ended June 30,2018			Six Months Ended June 30,2018		
	Water Revenues	Wastewater Revenues	Other Revenues	Water Revenues	Wastewater Revenues	Other Revenues
Regulated:						
Residential	$ 122,530	$ 17,583	$ -	$ 236,367	$ 35,115	$ -
Commercial	33,456	2,975	-	63,798	5,863	-
Fire protection	7,970	-	-	15,908	-	-
Industrial	7,309	498	-	13,669	961	-
Other water	14,220	-	-	25,241	-	-
Other wastewater	-	1,920	-	-	2,711	-

Alternative revenue program	(120)	164	-	(120)	164	-
Other utility	-	-	2,319	-	-	4,654
Regulated segment total	185,365	23,140	2,319	354,863	44,814	4,654
Other and eliminations	-	-	1,036	-	-	1,876
Consolidated	$ 185,365	$ 23,140	$ 3,355	$ 354,863	$ 44,814	$ 6,530

Regulated Segment Revenues – These revenues are composed of three main categories: water, wastewater, and other. Water revenues represent revenues earned for supplying customers with water service. Wastewater revenues represent revenues earned for treating wastewater and releasing it into the water supply. Other revenues are associated fees that relate to the regulated business but are not water and wastewater revenues. See description below for a discussion on the performance obligation for each of these revenue streams.

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Tariff Revenues – These revenues are categorized by customer class: residential, commercial, fire protection, industrial, and other water and other wastewater. The rates that generate these revenues are approved by the respective state utility commission, and revenues are billed cyclically and accrued for when unbilled. Other water and other wastewater revenues consist primarily of fines, penalties, surcharges, and availability lot fees. Our performance obligation for tariff revenues is to provide potable water or wastewater treatment service to customers. This performance obligation is satisfied over time as the services are rendered.

Alternative Revenue Program – These revenues represent the difference between the actual billed utility water and wastewater revenues for Aqua Illinois and the revenues set in the last Aqua Illinois rate case. We recognize revenues based on the target amount established in the last rate case, and then record either a regulatory asset or liability based on the cumulative difference between the target and actual, which results in either a refund due to customers or a payment from customers. This revenue program represents a contract between the utility and its regulators, not customers, and therefore is not within the scope of the FASB's accounting guidance for recognizing revenue from contracts with customers.

Other Utility Revenues – Other utility revenues represent revenues earned primarily from: antenna revenues, which represent fees received from telecommunication operators that have put cellular antennas on our water towers, operation and maintenance and billing contracts, which represent fees earned from municipalities for our operation of their water or wastewater treatment services or performing billing services, and fees earned from developers for accessing our water mains. The performance obligations vary for these revenues, but all are primarily recognized over time as the service is delivered.

Other and Eliminations – Other and eliminations consist of our market-based revenues, which comprises: Aqua Infrastructure and Aqua Resources (described below), and intercompany eliminations for revenue billed between our subsidiaries.

Aqua Infrastructure is the holding company for our 49% investment in a joint venture that operates a private pipeline system to supply raw water to natural gas well drilling operations in the Marcellus Shale of north central Pennsylvania. The joint venture earns revenues through providing non-utility raw water supply services to natural gas drilling companies which enter into water supply contracts. The performance obligation is to deliver non-potable water to the joint venture's customers. Aqua Infrastructure's share of the revenues recognized by the joint venture is

reflected, net, in equity earnings in joint venture on our consolidated statements of net income.

Aqua Resources earns revenues by providing non-regulated water and wastewater services through operating and maintenance contracts, and third-party water and sewer service line repair. The performance obligations are performing agreed upon services in the contract, most commonly operation of third-party water or wastewater treatment services, or billing services, or allowing the use of our logo to a third-party water and sewer service line repair. Revenues are primarily recognized over time as service is delivered.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 3 – Goodwill

The following table summarizes the changes in the Company's goodwill, by business segment:

	Regulated Segment	Other	Consolidated
Balance at December 31, 2017	$ 37,389	$ 4,841	$ 42,230
Goodwill acquired	25	-	25
Reclassification to utility plant acquisition adjustment	(25)	-	(25)
Other	(180)	-	(180)
Balance at June 30, 2018	$ 37,209	$ 4,841	$ 42,050

The reclassification of goodwill to utility plant acquisition adjustment results from a mechanism approved by the applicable utility commission. The mechanism provides for the transfer over time, and the recovery through customer rates, of goodwill associated with some acquisitions upon achieving specific objectives.

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 4 – Acquisitions

During the first six months of 2018, the Company completed three acquisitions of water and wastewater utility systems in various states adding 448 customers. The total purchase price of these utility systems consisted of $190 in cash. The purchase price allocation for these acquisitions consisted primarily of acquired property, plant and equipment. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

In July 2018, the Company entered into a purchase agreement to acquire the wastewater utility system assets of Cheltenham Township, Pennsylvania, which serves approximately 10,500 customers for $50,250. The purchase price for this pending acquisition is subject to certain adjustments at closing, and is subject to regulatory approval, including the final determination of the fair value of the rate base acquired.

In addition to the Company's pending acquisition in Cheltenham Township, Pennsylvania, as part of the Company's growth-through-acquisition strategy, the Company entered into purchase agreements to acquire the water or wastewater utility system assets of seven municipalities for a total combined purchase price in cash of $152,800, which we plan to finance by the issuance of debt. The purchase price for these acquisitions is subject to certain adjustments at closing, and the acquisitions are subject to regulatory approvals, including the final determination of the fair value of the rate base acquired. In July 2018, we closed on the following acquisitions:

· Manteno, Illinois for $25,000 in cash, which serves approximately 3,800 wastewater customers, and
· Limerick, Pennsylvania for $75,100 in cash, which serves approximately 5,400 wastewater customers.

Closings for our remaining acquisitions are expected to occur by the end of 2019, subject to the timing of the regulatory approval process. In total, these acquisitions will add approximately 16,750 customers in two of the states in which the Company operates in.

During 2017, the Company completed four acquisitions of water and wastewater utility systems in various states adding 1,003 customers. The total purchase price of these utility systems consisted of $5,860 in cash, which resulted in $72 of goodwill being recorded. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

Note 5 – Assets Held for Sale

In the first quarter of 2017, the Company decided to market for sale a water system that serves approximately 265 customers. This water system is reported as assets held for sale in the Company's consolidated balance sheet. The Company has been in discussions with a potential buyer for the water system and is currently negotiating the terms of a sale, which will require regulatory approval.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 6 – Capitalization

In June 2018, the Company amended its unsecured revolving credit facility, to extend the expiration from February 2021 to June 2023, and to increase the facility from $250,000 to $500,000. Funds borrowed under this facility are classified as long-term debt and are used to provide working capital as well as support for letters of credit for insurance policies and other financing arrangements. Interest under this facility is based at the Company's option, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. A facility fee is charged on the total commitment amount of the agreement.

In June 2018, Aqua Pennsylvania issued $100,000 of first mortgage bonds, of which $25,000 is due in 2042, $10,000 is due in 2045, and $65,000 is due in 2048 with interest rates of 3.99%, 4.04%, and 4.09%, respectively. The proceeds from these bonds were used to repay existing indebtedness and for general corporate purposes.

In July 2018, Aqua Pennsylvania redeemed $49,660 of tax-exempt bonds at 5.25% that were originally maturing in 2042 and 2043, respectively.

Note 7 –Financial Instruments

The Company follows the FASB's accounting guidance for fair value measurements and disclosures, which defines fair value and establishes a framework for using fair value to measure assets and liabilities. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1: unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access;
- Level 2: inputs other than Level 1 that are observable, either directly or indirectly, such as quoted market prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in non-active markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; or
- Level 3: inputs that are unobservable and significant to the fair value measurement.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs. There have been no changes in the valuation techniques used to measure fair value, or asset or liability transfers between the levels of the fair value hierarchy for the quarter ended June 30, 2018.

Financial instruments are recorded at carrying value in the financial statements and approximate fair value as of the dates presented. The fair value of these instruments is disclosed below in accordance with current accounting guidance related to financial instruments.

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

The fair value of loans payable is determined based on its carrying amount and utilizing Level 1 methods and assumptions. As of December 31, 2017, the carrying amount of the Company's loans payable was $3,650, which equates to their estimated fair value. The fair value of cash and cash equivalents, which is comprised of uninvested cash, is determined based on the net asset value per unit utilizing Level 1 methods and assumptions. As of June 30, 2018 and December 31, 2017, the carrying amounts of the Company's cash and cash equivalents was $52,948 and $4,204, respectively, which equates to their fair value. The Company's assets underlying the deferred compensation and non-qualified pension plans are determined by the fair value of mutual funds, which are based on quoted market prices from active markets utilizing Level 1 methods and assumptions. As of June 30, 2018 and December 31, 2017, the carrying amount of these securities was $21,759 and $21,776, which equates to their fair value, and is reported in the consolidated balance sheet in deferred charges and other assets.

Unrealized gain and losses on equity securities held in conjunction with our non-qualified pension plan is as follows:

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Net gain (loss) recognized during the period on equity securities	$ 19	$ (2)
Less: net gain / loss recognized during the period on equity securities sold during the period	-	-
Unrealized gain (loss) recognized during the reporting period on equity securities still held at the reporting date	$ 19	$ (2)

The net gain (loss) recognized on equity securities is presented on the consolidated statements of net income on the line item "Other." Additionally, the unrealized gain (loss) recognized during the three and six months ended June 30, 2017, was reported on the consolidated statements of comprehensive income.

The carrying amounts and estimated fair values of the Company’s long-term debt is as follows:

	June 30, 2018	December 31, 2017
Carrying amount	$ 2,320,903	$ 2,143,127
Estimated fair value	2,322,759	2,262,785

The fair value of long-term debt has been determined by discounting the future cash flows using current market interest rates for similar financial instruments of the same duration utilizing Level 2 methods and assumptions.

The Company’s customers’ advances for construction have a carrying value of $93,342 as of June 30, 2018, and $93,186 as of December 31, 2017. Their relative fair values cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels, and future rates. Portions of these non-interest bearing instruments are payable annually through 2028 and amounts not paid by the respective contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 8 – Net Income per Common Share

Basic net income per common share is based on the weighted average number of common shares outstanding. Diluted net income per common share is based on the weighted average number of common shares outstanding and potentially dilutive shares. The dilutive effect of employee stock-based compensation is included in the computation of diluted net income per common share. The dilutive effect of stock-based compensation is calculated using the treasury stock method and expected proceeds upon exercise or issuance of the stock-based compensation. The treasury stock method assumes that the proceeds from stock-based compensation are used to purchase the Company's common stock at the average market price during the period. The following table summarizes the shares, in thousands, used in computing basic and diluted net income per common share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Average common shares outstanding during the period for basic computation	177,901	177,609	177,852	177,545
Dilutive effect of employee stock-based compensation	372	436	447	497
Average common shares outstanding during the period for diluted computation	178,273	178,045	178,299	178,042

For the three months ended June 30, 2017 and the six months ended June 30, 2018 and 2017, all of the Company's employee stock options were included in the calculations of diluted net income per share as the calculated cost to exercise the stock options was less than the average market price of the Company's common stock during these periods. For the three months ended June 30, 2018, employee stock options to purchase 159,244 shares of common stock were excluded from the calculation of diluted net income per share as the calculated cost to exercise the stock options was greater than the average market price of the Company's common stock during this period.

Note 9 – Stock-based Compensation

Under the Company's 2009 Omnibus Equity Compensation Plan, as amended as of February 27, 2014 (the "2009 Plan"), as approved by the Company's shareholders to replace the 2004 Equity Compensation Plan (the "2004 Plan"), stock options, stock units, stock awards, stock appreciation rights, dividend equivalents, and other stock-based awards may be granted to employees, non-employee directors, and consultants and advisors. No further grants may be made under the 2004 Plan. The 2009 Plan authorizes 6,250,000 shares for issuance under the plan. A maximum of 3,125,000 shares under the 2009 Plan may be issued pursuant to stock awards, stock units and other stock-based awards, subject to adjustment as provided in the 2009 Plan. During any calendar year, no individual may be granted (i) stock options and stock appreciation rights under the 2009 Plan for more than 500,000 shares of Company stock in the aggregate or (ii) stock awards, stock units or other stock-based awards under the 2009 Plan for more than 500,000 shares of Company stock in the aggregate, subject to adjustment as provided in the 2009 Plan. Awards to employees and consultants under the 2009 Plan are made by a committee of the Board of Directors of the Company, except that with respect to awards to the Chief Executive Officer, the

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

committee recommends those awards for approval by the non-employee directors of the Board of Directors. In the case of awards to non-employee directors, the Board of Directors makes such awards. At June 30, 2018, 3,413,103 shares were still available for issuance under the 2009 Plan.

Performance Share Units – A performance share unit ("PSU") represents the right to receive a share of the Company's common stock if specified performance goals are met over the three-year performance period specified in the grant, subject to exceptions through the respective vesting period, generally three years. Each grantee is granted a target award of PSUs, and may earn between 0% and 200% of the target amount depending on the Company's performance against the performance goals. The following table provides compensation costs for stock-based compensation related to PSUs:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Stock-based compensation within operations and maintenance expenses	$ 1,339	$ 971	$ 2,198	$ 1,841
Income tax benefit	373	394	614	747

The following table summarizes the PSU transactions for the six months ended June 30, 2018:

	Number of Share Units	Weighted Average Fair Value
Nonvested share units at beginning of period	452,333	$ 26.16
Granted	87,593	37.65
Performance criteria adjustment	9,505	31.89
Forfeited	(7,780)	30.61
Share units vested in prior period and issued in current period	9,400	26.54

Share units issued	(136,081)	31.70
Nonvested share units at end of period	414,970	26.83

A portion of the fair value of PSUs was estimated at the grant date based on the probability of satisfying the market-based conditions using the Monte Carlo valuation method, which assesses probabilities of various outcomes of market conditions. The other portion of the fair value of the PSUs is based on the fair market value of the Company's stock at the grant date, regardless of whether the market-based condition is satisfied. The per unit weighted-average fair value at the date of grant for PSUs granted during the six months ended June 30, 2018 and 2017 was $37.65 and $30.79, respectively. The fair value of each PSU grant is amortized monthly into compensation expense on a straight-line basis over their respective vesting periods, generally 36 months. The accrual of compensation costs is based on the Company's estimate of the final expected value of the award, and is adjusted as required for the portion based on the performance-based condition. The Company assumes that forfeitures will be minimal, and recognizes forfeitures as they occur, which results in a reduction in compensation expense. As the payout of the PSUs includes dividend equivalents, no separate dividend yield assumption is required in

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AQUA AMERICA, INC. AND SUBSIDIARIES

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calculating the fair value of the PSUs. The recording of compensation expense for PSUs has no impact on net cash flows.

Restricted Stock Units – A restricted stock unit ("RSU") represents the right to receive a share of the Company's common stock. RSUs are eligible to be earned at the end of a specified restricted period, generally three years, beginning on the date of grant. The Company assumes that forfeitures will be minimal, and recognizes forfeitures as they occur, which results in a reduction in compensation expense. As the payout of the RSUs includes dividend equivalents, no separate dividend yield assumption is required in calculating the fair value of the RSUs. The following table provides the compensation cost and income tax benefit for stock-based compensation related to RSUs:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Stock-based compensation within operations and maintenance expenses	$ 355	$ 322	$ 706	$ 603
Income tax benefit	100	133	201	249

The following table summarizes the RSU transactions for the six months ended June 30, 2018:

	Number of Stock Units	Weighted Average Fair Value
Nonvested stock units at beginning of period	116,787	$ 29.46
Granted	54,073	34.91
Stock units vested in prior period and issued in current period	1,467	31.47
Stock units vested and issued	(42,836)	26.39
Forfeited	(322)	34.91
Nonvested stock units at end of period	129,169	32.77

The per unit weighted-average fair value at the date of grant for RSUs granted during the six months ended June 30, 2018 and 2017 was $34.91 and $30.37, respectively.

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Stock Options – A stock option represents the option to purchase a number of shares of common stock of the Company as specified in the stock option grant agreement at the exercise price per share as determined by the closing market price of our common stock on the grant date. Stock options are exercisable in installments of 33% annually, starting one year from the grant date and expire 10 years from the grant date. The fair value of each stock option is amortized into compensation expense using the graded-vesting method, which results in the recognition of compensation costs over the requisite service period for each separately vesting tranche of the stock options as though the stock options were, in substance, multiple stock option grants. The following table provides the compensation cost and income tax benefit for stock-based compensation related to stock options:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Stock-based compensation within operations and maintenance expenses	$ 154	$ 74	$ 248	$ 104
Income tax benefit	42	33	101	125

The fair value of options was estimated at the grant date using the Black-Scholes option-pricing model. The following assumptions were used in the application of this valuation model:

	2018	2017
Expected term (years)	5.46	5.45
Risk-free interest rate	2.72%	2.01%
Expected volatility	17.2%	17.7%
Dividend yield	2.37%	2.51%
Grant date fair value per option	$ 5.10	$ 4.07

Historical information was the principal basis for the selection of the expected term and dividend yield. The expected volatility is based on a weighted-average combination of historical and implied volatilities over a time period that approximates the expected term of the option. The risk-free interest rate was selected based upon the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.

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The following table summarizes stock option transactions for the six months ended June 30, 2018:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Aggregate Intrinsic Value
Outstanding at beginning of period	364,932	$ 19.83		
Granted	160,859	34.51		
Forfeited	(4,489)	31.92		
Expired / Cancelled	(107)	30.47		
Exercised	(63,099)	16.14		
Outstanding at end of period	458,096	$ 25.37	5.9	$ 4,494
Exercisable at end of period	225,117	$ 17.23	2.4	$ 4,040

Stock Awards – Stock awards represent the issuance of the Company's common stock, without restriction. The issuance of stock awards results in compensation expense which is equal to the fair market value of the stock on the grant date, and is expensed immediately upon grant. The following table provides the compensation cost and income tax benefit for stock-based compensation related to stock awards:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Stock-based compensation within operations and maintenance expenses	$ 140	$ 131	$ 280	$ 262
Income tax benefit	41	54	81	109

The following table summarizes stock award transactions for the six months ended June 30, 2018:

	Number of Stock Awards	Weighted Average Fair Value
Nonvested stock awards at beginning of period	-	$ -
Granted	8,099	34.58
Vested	(8,099)	34.58
Nonvested stock awards at end of period	-	-

The per unit weighted-average fair value at the date of grant for stock awards granted during the six months ended June 30, 2018 and 2017 was $34.58 and $32.79, respectively.

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Note 10 – Pension Plans and Other Postretirement Benefits

The Company maintains a qualified defined benefit pension plan (the "Pension Plan"), a nonqualified pension plan, and other postretirement benefit plans for certain of its employees. The net periodic benefit cost is based on estimated values and an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by the Company's employees, mortality, turnover, and medical costs. The following tables provide the components of net periodic benefit cost:

	Pension Benefits			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Service cost	$ 812	$ 794	$ 1,625	$ 1,587
Interest cost	2,874	3,108	5,748	6,217
Expected return on plan assets	(4,553)	(4,270)	(9,106)	(8,539)
Amortization of prior service cost	132	145	264	290
Amortization of actuarial loss	1,823	2,001	3,646	4,002
Net periodic benefit cost	$ 1,088	$ 1,778	$ 2,177	$ 3,557

	Other Postretirement Benefits			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Service cost	$ 262	$ 255	$ 525	$ 510
Interest cost	708	737	1,416	1,473
Expected return on plan assets	(677)	(647)	(1,353)	(1,294)
Amortization of prior service cost	(127)	(127)	(255)	(254)
Amortization of actuarial loss	296	291	591	583
Net periodic benefit cost	$ 462	$ 509	$ 924	$ 1,018

The components of net periodic benefit cost other than service cost are presented on the consolidated statements of net income on the line item "Other."

The Company made cash contributions of $8,627 to its Pension Plan during the first six months of 2018, and intends to make additional cash contributions of $3,857 to the Pension Plan during the remainder of 2018.

Note 11 – Water and Wastewater Rates

During the first six months of 2018, the Company's operating divisions in Illinois and Ohio were granted base rate increases designed to increase total operating revenues on an annual basis by $8,640. On April 6, 2018, the base rate case in Illinois was petitioned for a rehearing; however, this petition was denied on April 19, 2018. No appeals were filed and the approved rates are considered final. Further, during the

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first six months of 2018, the Company's operating divisions in Pennsylvania, North Carolina, and New Jersey received approval to bill infrastructure rehabilitation surcharges designed to increase total operating revenues on an annual basis by $19,343. Additionally, commencing in the second quarter of 2018, due to the decrease in our federal income tax rate from 35% to 21% from the Tax Cuts and Jobs Act, the Company's operating divisions in Texas, New Jersey, Ohio, and Indiana implemented base rate reductions or added credits to customer bills that are estimated to reduce total operating revenues by $7,959 on an annualized basis.

As of February 10, 2018, the Company had been billing interim rates in Virginia, which had a base rate case filing in progress. Because of the Tax Cuts and Jobs Act, which reduced our federal income tax rate from 35% to 21%, our Virginia subsidiary reduced its water rate increase request and eliminated its wastewater rate increase request. In May 2018, the rates charged to our Virginia customers reverted to the previous rates, pursuant to a submitted stipulation, which is currently pending approval by the Virginia State Corporation Commission. As of June 30, 2018, $183 of billings already collected has been refunded to our Virginia customers.

Note 12 – Taxes Other than Income Taxes

The following table provides the components of taxes other than income taxes:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Property	$ 6,775	$ 6,867	$ 13,524	$ 13,652
Gross receipts, excise and franchise	3,789	3,363	7,053	6,538
Payroll	2,180	2,132	5,455	5,256
Regulatory assessments	627	630	1,254	1,259
Pumping fees	1,424	1,350	2,415	2,294
Other	34	77	95	157
Total taxes other than income	$ 14,829	$ 14,419	$ 29,796	$ 29,156

Note 13 – Segment Information

The Company has ten operating segments and one reportable segment. The Regulated segment, the Company's single reportable segment, is comprised of eight operating segments representing its water and wastewater regulated utility companies which are organized by the states where the Company provides water and wastewater services. These operating segments are aggregated into one reportable segment because each of these operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution or wastewater collection methods, and the nature of the regulatory environment.

Two operating segments are included within the Other category below. These segments are not quantitatively significant and are comprised of Aqua Infrastructure and Aqua Resources. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry. Aqua Resources provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to its utility companies' service territories; and offers,

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through a third-party, water and sewer service line protection solutions and repair services to households. In addition to these segments, Other is comprised of other business activities not included in the reportable segment, including corporate costs that have not been allocated to the Regulated segment and intersegment eliminations. Corporate costs include general and administrative expenses, and interest expense.

The following table presents information about the Company's reportable segment:

	Three Months Ended June 30, 2018			Three Months Ended June 30, 2017		
	Regulated	Other	Consolidated	Regulated	Other	Consolidated
Operating revenues	$ 210,824	$ 1,036	$ 211,860	$ 201,960	$ 1,458	$ 203,418
Operations and maintenance expense	73,047	468	73,515	71,322	(1,707)	69,615
Depreciation	36,603	10	36,613	34,141	(734)	33,407
Amortization	103	46	149	145	(18)	127
Operating income	86,672	82	86,754	82,390	3,460	85,850
Interest expense, net	21,756	1,967	23,723	19,747	1,640	21,387
Allowance for funds used during construction	2,577	-	2,577	3,463	-	3,463
Income tax expense (benefit)	(147)	(220)	(367)	5,249	320	5,569
Net income (loss)	67,877	(1,287)	66,590	59,629	1,339	60,968

	Six Months Ended June 30, 2018			Six Months Ended June 30, 2017		
	Regulated	Other	Consolidated	Regulated	Other	Consolidated
Operating revenues	$ 404,331	$ 1,876	$ 406,207	$ 388,309	$ 2,896	$ 391,205
Operations and maintenance expense	144,350	3,111	147,461	137,592	(87)	137,505
Depreciation	72,561	19	72,580	67,807	(563)	67,244
Amortization	191	88	279	354	(38)	316
Operating income (loss)	158,730	(2,639)	156,091	154,697	2,287	156,984
Interest expense, net	43,464	3,730	47,194	39,524	3,189	42,713
Allowance for funds used during construction	5,444	-	5,444	6,656	-	6,656
Income tax expense (benefit)	(790)	(1,708)	(2,498)	9,105	(606)	8,499
Net income (loss)	121,904	(4,475)	117,429	110,525	(485)	110,040
Capital expenditures	216,614	-	216,614	208,174	298	208,472

	June 30, 2018	December 31, 2017
Total assets:		
Regulated	$ 6,484,778	$ 6,236,109
Other	85,567	96,354
Consolidated	$ 6,570,345	$ 6,332,463

Note 14 – Commitments and Contingencies

The Company is routinely involved in various disputes, claims, lawsuits and other regulatory and legal matters, including both asserted and unasserted legal claims, in the ordinary course of business. The status of each such matter, referred to herein as a loss contingency, is reviewed and assessed in accordance with applicable accounting rules regarding the nature of the matter, the likelihood that a loss will be incurred, and the amounts involved. As of June 30, 2018, the aggregate amount of $18,602 is

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accrued for loss contingencies and is reported in the Company's consolidated balance sheet as other accrued liabilities and other liabilities. These accruals represent management's best estimate of probable loss (as defined in the accounting guidance) for loss contingencies or the low end of a range of losses if no single probable loss can be estimated. For some loss contingencies, the Company is unable to estimate the amount of the probable loss or range of probable losses. While the final outcome of these loss contingencies cannot be predicted with certainty, and unfavorable outcomes could negatively impact the Company, at this time in the opinion of management, the final resolution of these matters are not expected to have a material adverse effect on the Company's financial position, results of operations or cash flows. Further, the Company has insurance coverage for certain of these loss contingencies, and as of June 30, 2018, estimates that approximately $6,541 of the amount accrued for these matters are probable of recovery through insurance, which amount is also reported in the Company's consolidated balance sheet as deferred charges and other assets, net.

Although the results of legal proceedings cannot be predicted with certainty, there are no pending legal proceedings to which the Company or any of its subsidiaries is a party or to which any of its properties is the subject that are material or are expected to have a material effect on the Company's financial position, results of operations, or cash flows.

In addition to the aforementioned loss contingencies, the Company self-insures its employee medical benefit program, and maintains stop-loss coverage to limit the exposure arising from these claims. The Company's reserve for these claims totaled $1,451 at June 30, 2018 and represents a reserve for unpaid claim costs, including an estimate for the cost of incurred but not reported claims.

Note 15 – Income Taxes

During the six months ended June 30, 2018, the Company's Federal net operating loss ("NOL") carryforward decreased by $26,393. In addition, during the six months ended June 30, 2018, the Company's state NOL carryforward increased by $15,835. As of June 30, 2018, the balance of the Company's Federal NOL was $36,909. The Company believes its Federal NOL carryforward is more likely than not to be recovered and requires no valuation allowance. As of June 30, 2018, the balance of the Company's gross state NOL was $642,923, a portion of which is offset by a valuation allowance because the Company does not believe the state NOLs are more likely than not to be realized. The Company's Federal and state NOL carryforwards begin to expire in 2032 and 2023, respectively. The Company's Federal and state NOL carryforwards are reduced by an unrecognized tax position, on a gross basis, of $64,914 and

$85,550, respectively. The amounts of the Company's Federal and state NOL carryforwards prior to being reduced by the unrecognized tax positions were $101,823 and $728,473 respectively. The Company records its unrecognized tax benefit as a reduction to its deferred income tax liability.

In accordance with a 2012 settlement agreement with the Pennsylvania Public Utility Commission, Aqua Pennsylvania expenses, for tax purposes, qualifying utility asset improvement costs, which results in a substantial reduction in income tax expense and greater net income and cash flows. The Company's effective income tax rate for the second quarter of 2018 and 2017 was -0.6% and 8.4%, respectively, and for the first six months of 2018 and 2017 was -2.2% and 7.2%, respectively.

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As of June 30, 2018, the total gross unrecognized tax benefit was $18,986. As a result of the regulatory treatment afforded for qualifying infrastructure improvements in Pennsylvania, $25,569, if recognized, would affect the Company's effective tax rate. At December 31, 2017, the Company had unrecognized tax benefits of $17,583.

Accounting rules for uncertain tax positions specify that tax positions for which the timing of resolution is uncertain should be classified as long-term liabilities. Judgment is required in evaluating the Company's uncertain tax positions and determining the provision for income taxes. Management believes that an adequate provision has been made for any adjustments that may result from tax examinations. Although the timing of income tax audit resolutions and negotiations with taxing authorities is highly uncertain, the Company does not anticipate a significant change to the total amount of unrecognized income tax benefits within the next 12 months.

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "TCJA") into law. Substantially all of the provisions of the TCJA are effective for taxable years beginning after December 31, 2017. The TCJA includes significant changes to the Internal Revenue Code and the taxation of business entities, and includes specific provisions related to regulated public utilities. Significant changes that impact the Company included in the TCJA are a reduction in the corporate federal income tax rate from 35% to 21%, effective January 1, 2018, and a limitation of the utilization of NOLs arising after December 31, 2017 to 80% of taxable income with an indefinite carryforward. The specific TCJA provisions related to our regulated entities generally allow for the continued deductibility of interest expense, the elimination of full expensing for tax purposes of certain property acquired after September 27, 2017 and the continuation of certain rate normalization requirements for accelerated depreciation benefits. Our market-based companies still qualify for 100% deductibility of qualifying property acquired after September 27, 2017.

In accordance with the FASB's accounting guidance for income taxes, the tax effects of changes in tax laws must be recognized in the period in which the law is enacted, or December 22, 2017 for the TCJA. Additionally, deferred tax assets and liabilities are required to be measured at the enacted tax rate expected to apply when temporary differences are to be realized or settled. Thus, at the date of enactment, the Company's deferred taxes were re-measured based upon the new tax rate. For our regulated entities, the change in deferred taxes is recorded as either an offset to a regulatory asset or liability and may be subject to refund to customers. In instances where the deferred tax balances are not in ratemaking, such as the Company's market-based operations, the change in deferred taxes is recorded as an adjustment to our deferred tax provision.

The staff of the SEC has recognized the complexity of reflecting the impacts of the TCJA, and on December 22, 2017 issued guidance, which clarifies accounting for income taxes if information is not yet available or complete and provides for up to a one year period in which to complete the required analyses and accounting (the measurement period). The guidance describes three scenarios (or "buckets") associated with a company's status of accounting for income tax reform: (1) a company is complete with its accounting for certain effects of tax reform, (2) a company is able to determine a reasonable estimate for certain effects of tax reform and records that estimate as a provisional amount, or (3) a company is not able to determine a reasonable estimate and therefore continues to apply the FASB's accounting guidance, based on the provisions of the tax laws that were in effect immediately prior to the TCJA being enacted.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

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The Company has completed or has made a reasonable estimate for the measurement and accounting of the effect of the TCJA which were reflected in the December 31, 2017 financial statements, which resulted in a decrease to the accumulated deferred income tax liability of $303,320. Additionally, due to the reduction in the Company's corporate income tax rate, in the first quarter of 2018, the Company reserved $2,532 for amounts expected to be refundable to utility customers. During the first quarter of 2018, in Illinois and Virginia, the Company's base rates have been adjusted to reflect the lower corporate income tax rate, and Texas and New Jersey implemented adjusted tariff rates in the second quarter of 2018. In the second quarter of 2018, the Company reserved $1,251 for amounts expected to be refundable to utility customers.

As of December 31, 2017, the Company had provisionally estimated that $175,108 of deferred income tax liabilities for our Pennsylvania subsidiary will be a regulatory liability as a result of the accounting effect of the TCJA. In May 2018, the Pennsylvania Public Utility Commission ("PA PUC") issued an order that set forth the requirements for utilities to either immediately initiate the refund or otherwise address the impacts of the TCJA in the utilities' next rate case. Aqua Pennsylvania was included in the rate filing group of utilities as the Company plans to file a base rate case in August 2018, during which the PA PUC is expected to address the effects of the TCJA within the base rate case filing. Additionally, the PA PUC has ordered that all rates charged by utilities, including those billed by Aqua Pennsylvania since January 1, 2018, are temporary and subject to refund pending the outcome of its review of the effects of the TCJA within the next base rate case. Based on the Company's review of the present circumstances, no reserve is considered necessary for the revenue recognized to date in 2018.

Additionally, two operating divisions in Ohio operate under locally-negotiated contractual rates with their respective counties, and it is expected that negotiations will result in a contract that will return to customers the effects of the reduction in the corporate net income tax rate under the TCJA; however, these negotiations have not yet started. As of December 31, 2017, the Company had provisionally estimated that $9,419 of deferred income tax liabilities for these two divisions will be a regulatory liability. Overall, the Company has applied a reasonable interpretation of the impact of the TCJA and a reasonable estimate of the regulatory resolution. Further clarification of the TCJA and regulatory resolution may change the amounts estimated for the deferred income tax provision and the accumulated deferred income tax liability.

The Company's regulated operations accounting for income taxes are impacted by the FASB's accounting guidance for regulated operations. Reductions in accumulated deferred income tax balances due to the reduction in the Federal corporate income tax rates to 21% under the provisions of the TCJA will result in amounts previously collected from utility customers for these deferred taxes to be refundable to such customers, generally through reductions in future

rates. The TCJA includes provisions that stipulate how these excess deferred taxes related to certain accelerated tax depreciation deduction benefits are to be passed back to customers. Potential refunds of other deferred taxes will be determined by our state regulators. Our state regulatory commissions have or are in the process of issuing procedural orders directing how the tax law changes are to be reflected in our utility customer rates.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

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Note 16 – Recent Accounting Pronouncements

In March 2017, the FASB issued updated accounting guidance on the presentation of net periodic pension and postretirement benefit cost (net benefit cost). Historically, net benefit cost is reported as an employee cost within operating income, net of amounts capitalized. The guidance requires the bifurcation of net benefit cost. The service cost component will be presented with other employee compensation costs in operating income and the other components of net benefit cost will be reported separately outside of operating income, and will not be eligible for capitalization. The guidance is effective for annual reporting periods beginning after December 15, 2017, and interim periods within that reporting period, and is to be applied retrospectively for the presentation of the service cost component and the other components of net benefit cost, and on a prospective basis for the capitalization of only the service cost component of net benefit cost. On January 1, 2018, the Company adopted the updated guidance, which did not have a material impact on its results of operations or financial position, and resulted in the reclassification, for the three and six months ended June 30, 2017, of $1,238 and $2,478, respectively, for the other components of net benefit cost from operations and maintenance expense to other in the consolidated statements of net income.

In June 2016, the FASB issued updated accounting guidance on accounting for impairments of financial instruments, including trade receivables, which requires companies to estimate expected credit losses on trade receivables over their contractual life. Historically, companies reserve for expected credit losses by applying historical loss percentages to respective aging categories. Under the updated accounting guidance, companies will use a forward-looking methodology that incorporates lifetime expected credit losses, which will result in an allowance for expected credit losses for receivables that are either current or not yet due, which historically have not been reserved for. The updated accounting guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with early adoption available. The Company is evaluating the requirements of the updated guidance to determine the impact of adoption.

In February 2016, the FASB issued updated accounting guidance on accounting for leases, which requires lessees to establish a right-of-use asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. For income statement purposes, leases will be classified as either operating or finance. Operating leases will result in straight-line expense while finance leases will result in a front-loaded expense pattern. The updated accounting guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption available. The Company is in the process of evaluating the requirements of the updated guidance to determine the impact adoption will have on its consolidated financial statements; however, the Company expects that the adoption of the updated accounting guidance on accounting for leases should not have a

material impact on the Company’s consolidated balance sheet due to the recognition of right-of-use assets and lease liabilities.

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In January 2016, the FASB issued updated accounting guidance on the recognition and measurement of financial assets and financial liabilities, which amends certain aspects of recognition, measurement, presentation, and disclosure of financial instruments, including the requirement to measure certain equity investments at fair value with changes in fair value recognized in net income. The updated guidance is effective for interim and annual periods beginning after December 31, 2017. On January 1, 2018, the Company adopted the updated guidance, which did not have a material impact on its results of operations or financial position, and resulted in the recognition of $860 of previous unrealized gains, which was recorded as an adjustment to beginning retained earnings (refer to the presentation of “cumulative effect of change in accounting principle – financial instruments” on the Company’s consolidated statement of equity).

In May 2014, the FASB issued updated accounting guidance on recognizing revenue from contracts with customers, which outlines a single comprehensive model that an entity will apply to determine the measurement of revenue and timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. In 2017, the American Institute of Certified Public Accountants (“AICPA”) power and utility entities revenue recognition task force determined that contributions in aid of construction are not in the scope of the new standard, which was approved by the AICPA’s revenue recognition working group. The Company implemented the updated guidance using the modified retrospective approach on January 1, 2018, which did not result in a change in the Company’s measurement of revenue, and reached the following conclusions:

- The Company’s tariff sale contracts, including those with lower credit quality customers, are generally deemed to be probable of collection, and thus the timing of revenue recognition will continue to be concurrent with the delivery of water and wastewater services, consistent with our current practice.
- Contributions in aid of construction are outside of the scope of the standard, and will continue to be accounted for as a noncurrent liability.

AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(In thousands of dollars, except per share amounts)

Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Quarterly Report contain, in addition to historical information, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements address, among other things: the projected impact of various legal proceedings; the projected effects of recent accounting pronouncements; prospects, plans, objectives, expectations and beliefs of management, as well as information contained in this report where statements are preceded by, followed by or include the words "believes," "expects," "estimates," "anticipates," "plans," "future," "potential," "probably," "predictions," "intends," "will," "continue," "in the event" or the negative of such terms or si expressions. Forward-looking statements are based on a number of assumptions concerning future events, and are subject to a number of risks, uncertainties and other factors, many of which are outside our control, which could cause actual results to differ materially from those expressed or implied by such statements. These risks and uncertainties include, among others: the effects of regulation, abnormal weather, changes in capital requirements and funding, acquisitions, changes to the capital markets, and our ability to assimilate acquired operations, as well as those risks, uncertainties and other factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 under the captions "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in such report. As a result, readers are cautioned not to place undue reliance on any forward-looking statements. We undertake no obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.

General Information

Aqua America, Inc. ("we", "us", "our" or the "Company"), a Pennsylvania corporation, is the holding company for regulated utilities providing water or wastewater services to what we estimate to be almost three million people in Pennsylvania, Ohio, Texas, Illinois, North Carolina, New Jersey, Indiana, and Virginia. Our largest operating subsidiary, Aqua Pennsylvania, provides water or wastewater services to approximately one-half of the total number of people we serve, who are located in the suburban areas in counties north and west of the City of Philadelphia and in 27 other

counties in Pennsylvania. Our other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company's market-based activities are conducted through Aqua Infrastructure, LLC and Aqua Resources, Inc. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry. Aqua Resources provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our utility companies' service territories; and offers, through a third-party, water and sewer service line protection solutions and repair services to households.

AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

Aqua America, Inc., which prior to its name change in 2004 was known as Philadelphia Suburban Corporation, was formed in 1968 as a holding company for its primary subsidiary, Aqua Pennsylvania, formerly known as Philadelphia Suburban Water Company. In the early 1990s, we embarked on a growth-through-acquisition strategy focused on water and wastewater operations. Our most significant transactions to date have been the merger with Consumers Water Company in 1999, the acquisition of the regulated water and wastewater operations of AquaSource, Inc. in 2003, the acquisition of Heater Utilities, Inc. in 2004, and the acquisition of American Water Works Company, Inc.'s regulated operations in Ohio in 2012. Since the early 1990s, our business strategy has been primarily directed toward the regulated water and wastewater utility industry, where we have more than quadrupled the number of regulated customers we serve, and has extended our regulated operations from southeastern Pennsylvania to include operations in seven other states. Currently, the Company seeks to acquire businesses in the U.S. regulated sector, which includes water and wastewater utilities and other regulated utilities, and to opportunistically pursue growth ventures in select market-based activities, such as infrastructure opportunities that are supplementary and complementary to our regulated businesses.

The following discussion and analysis of our financial condition and results of operations should be read together with our consolidated financial statements and related notes.

Financial Condition

During the first six months of 2018, we incurred $216,614 of capital expenditures, expended $190 for the acquisition of water and wastewater utility systems, issued $218,037 of long-term debt, and repaid debt and made sinking fund contributions and other loan repayments of $41,001. The capital expenditures were related to new and replacement water mains, improvements to treatment plants, tanks, hydrants, and service lines, well and booster improvements, and other enhancements and improvements. The issuance of long-term debt was comprised principally of the funds borrowed under our revolving credit facility, and $100,000 of first mortgage bonds issued by Aqua Pennsylvania in June 2018. The proceeds from the first mortgage bonds were used to repay existing indebtedness and for general corporate purposes.

In July 2018, we completed the acquisition of Manteno, Illinois for $25,000 in cash, which serves approximately 3,800 wastewater customers, and Limerick, Pennsylvania for $75,100 in cash, which serves approximately 5,400 wastewater customers. These acquisitions were funded through the issuance of debt.

At June 30, 2018, we had $52,948 of cash and cash equivalents compared to $4,204 at December 31, 2017. During the first six months of 2018, we used the proceeds from the issuance of long-term debt and internally generated funds to fund the cash requirements discussed above and to pay dividends.

At June 30, 2018, our $500,000 unsecured revolving credit facility, which was amended and now expires in June 2023, had $323,157 available for borrowing. At June 30, 2018, we had short-term lines of credit of $135,500, of which $135,500 was available for borrowing. One of our short-term lines of credit is an Aqua Pennsylvania $100,000 364-day unsecured revolving credit facility with four banks, which is used to provide working capital, and as of June 30, 2018, $100,000 was available for borrowing.

AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

Our short-term lines of credit of $135,500 are subject to renewal on an annual basis. Although we believe we will be able to renew these facilities, there is no assurance that they will be renewed, or what the terms of any such renewal will be.

The Company's consolidated balance sheet historically has had a negative working capital position whereby routinely our current liabilities exceed our current assets. Management believes that internally generated funds along with existing credit facilities and the proceeds from the issuance of long-term debt will be adequate to provide sufficient working capital to maintain normal operations and to meet our financing requirements for at least the next twelve months.

Results of Operations

Analysis of Second Quarter of 2018 Compared to Second Quarter of 2017

Revenues increased by $8,442 or 4.2%, primarily due to:

- an increase in water and wastewater rates and infrastructure rehabilitation surcharges of $7,426;
- an increase in wastewater revenues of $1,639 primarily due to an increase in the volume of treated wastewater flows from the City of Ft. Wayne, Indiana at our Indiana wastewater treatment plant; and
- additional water and wastewater revenues of $1,262 associated with a larger customer base due to organic growth and utility acquisitions;
- offset by a reserve of $1,251 for amounts expected to be refundable to utility customers associated with the decrease in the corporate income tax rate from 35% to 21% due to the TCJA.

Operations and maintenance expenses increased by $3,900 or 5.6%, primarily due to:

- an increase in labor and benefits expenses of $1,551 primarily due to wage increases;
- the prior year effect of a favorable settlement for a disputed contract of $1,062; and
- an increase in insurance expense of $441;
- offset by a reduction in operating expenses for our market-based activities of $690 primarily associated with the completion of the disposition of business units within Aqua Resources, which was finalized in June 2017.

Depreciation expense increased by $3,206 or 9.6%, primarily due to the utility plant placed in service since June 30, 2017.

Interest expense increased by $2,336 or 10.9%, primarily due to an increase in average borrowings, offset by a decrease in our effective interest rate.

AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

Allowance for funds used during construction ("AFUDC") decreased by $886, due to a decrease in the average balance of utility plant construction work in progress, to which AFUDC is applied.

Equity earnings in joint venture increased by $1,072 due to an increase in the sale of raw water to firms in the natural gas drilling industry.

Other decreased by $801 primarily due to a decrease in the non-service cost components of our net benefit cost for pension and postretirement benefits.

Our effective income tax rate was -0.6% in the second quarter of 2018 and 8.4% in the second quarter of 2017. The effective income tax rate decreased due to the reduction in the corporate income tax rate from 35% to 21%, and the effect of additional tax deductions recognized in the second quarter of 2018 for certain qualifying infrastructure improvements for Aqua Pennsylvania.

Net income increased by $5,622 or 9.2%, primarily as a result of the factors described above.

Analysis of First Six Months of 2018 Compared to First Six Months of 2017

Revenues increased by $15,002 or 3.8%, primarily due to:

· an increase in water and wastewater rates and infrastructure rehabilitation surcharges of $12,523;

- additional water and wastewater revenues of $2,896 associated with a larger customer base due to organic growth and utility acquisitions;
- an increase in customer water consumption; and
- an increase in wastewater revenues of $2,003 primarily due to an increase in the volume of treated wastewater flows from the City of Ft. Wayne, Indiana at our Indiana wastewater treatment plant;
- offset by a reserve of $3,783 for amounts expected to be refundable to utility customers associated with the decrease in the corporate income tax rate from 35% to 21% due to the TCJA.

Operations and maintenance expenses increased by $9,956 or 7.2%, primarily due to:

- an increase in labor and benefits expenses of $6,095, primarily due to additional overtime expenses for increased maintenance activities in the first quarter and wage increases;
- the prior year effect of a favorable settlement for a disputed contract of $1,062;
- an increase in maintenance expenses of $1,057, mainly resulting from expenses incurred due to more severe winter weather conditions; and
- the prior year effect of the favorable treatment of a regulatory asset of $1,000 due to a rate proceeding that occurred in 2017;

AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

- offset by a reduction in operating expenses for our market-based activities of $2,436 primarily associated with the completion of the disposition of business units within Aqua Resources, which was finalized in June 2017.

Depreciation expense increased by $5,336 or 7.9%, primarily due to the utility plant placed in service since June 30, 2017.

Interest expense increased by $4,481 or 10.5%, primarily due to an increase in average borrowings, offset by a decrease in our effective interest rate.

AFUDC decreased by $1,212, due to a decrease in the average balance of utility plant construction work in progress, to which AFUDC is applied.

Equity earnings in joint venture increased by $1,484 due to an increase in the sale of raw water to firms in the natural gas drilling industry.

Other decreased by $1,436 primarily due to a decrease in the non-service cost components of our net benefit cost for pension and postretirement benefits.

Our effective income tax rate was -2.2% during the first six months of 2018 and 7.2% during the first six months of 2017. The effective income tax rate decreased due to the reduction in the corporate income tax rate from 35% to 21%, and the effect of additional tax deductions recognized during the first six months of 2018 for certain qualifying infrastructure improvements for Aqua Pennsylvania.

Net income increased by $7,389 or 6.7%, primarily as a result of the factors described above.

Impact of Recent Accounting Pronouncements

We describe the impact of recent accounting pronouncements in Note 16, Recent Accounting Pronouncements, to the consolidated financial statements in this report.

Item 3 – Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. There have been no significant changes in our exposure to market risks since December 31, 2017. Refer to Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, filed February 28, 2018, for additional information.

Item 4 – Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this report are effective such that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

(b) Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1 – Legal Proceedings

We are party to various legal proceedings. Although the results of legal proceedings cannot be predicted with certainty, there are no pending legal proceedings to which we or any of our subsidiaries is a party or to which any of

our properties is the subject that we believe are material or are expected to have a material adverse effect on our financial position, results of operations or cash flows.

Item 1A – Risk Factors

There have been no material changes to the risks disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017, filed February 28, 2018, under “Part 1, Item 1A – Risk Factors.”

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Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

The following table summarizes the Company's purchases of its common stock for the quarter ended June 30, 2018:

	Issuer Purchases of Equity Securities			
Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs
April 1-30, 2018	-	$ -	-	-
May 1-31, 2018	-	$ -	-	-
June 1-30, 2018	-	$ -	-	-
Total	-	$ -	-	-

Item 6 – Exhibits

Exhibit No.	Description
4.1	Bond Purchase Agreement, dated June 29, 2018, by and among Aqua Pennsylvania, Inc., CMFG Life Insurance Company, Manufactures Life Reinsurance Limited, The Lincoln National Life Insurance Company, New York Life Insurance Company, The State Life Insurance Company, and Phoenix Life Insurance Company
10.1	Revolving Credit Agreement, dated as of June 7, 2018, between Aqua America, Inc. and PNC Bank, National Association, CoBank, ACB, The Huntington National Bank, Bank of America, N.A, and Royal Bank of Canada
10.2	Employment Agreement dated July 1, 2018 between Aqua America, Inc. and Christopher Franklin (Incorporated by reference to Exhibit 10.1 of Form 8-K filed on July 6, 2018)*
31.1	Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934.
31.2	Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934.
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRES	XBRL Taxonomy Extension Presentation Linkbase Document

*Indicates management contract or compensatory plan or arrangement

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SIGNATURES

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

August 3, 2018

Aqua America, Inc.
Registrant

/s/ Christopher H. Franklin
Christopher H. Franklin
Chairman, President and
Chief Executive Officer

/s/ David P. Smeltzer
David P. Smeltzer
Executive Vice President and
Chief Financial Officer

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