APPLIED OPTOELECTRONICS, INC.
Form 10-Q
November 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2013

OR

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

For the transition period from __________ to __________

Commission File Number: 001-36083

Applied Optoelectronics, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**76-0533927**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

13115 Jess Pirtle Blvd.

Sugar Land, TX 77478

(Address of principal executive offices)

(281) 295-1800

(Registrant’s telephone number)

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 (“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 S No £

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

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

Large accelerated filer	£	Accelerated filer	£
Non-accelerated filer	x (Do not check if a smaller reporting company)	Smaller reporting company	£

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

As of November 7, 2013 there were 12,629,095 shares of the registrant’s Common Stock outstanding.

Applied Optoelectronics, Inc.

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Part I. Financial Information

Item 1. Condensed Consolidated Financial Statements

Applied Optoelectronics, Inc. and Subsidiaries

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share data)

	September 30, 2013	December 31, 2012
ASSETS		
Current Assets		
Cash and cash equivalents	$ 7,325	$ 10,723
Restricted cash	1,031	503
Accounts receivable - trade, net	17,043	13,525
Bank acceptance receivable	–	1,034
Inventories	16,421	12,493
Prepaid expenses and other current assets	3,765	968
Total current assets	45,585	39,246
Property, plant and equipment, net	27,125	24,838
Land use rights, net	957	674
Intangible assets, net	828	795
Other assets, net	1,439	195
TOTAL ASSETS	$ 75,934	$ 65,748
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Current portion of notes payable and long-term debt	$ 12,095	$ 13,900
Accounts payable	11,282	6,913
Bank acceptance payable	3,040	1,521
Accrued liabilities	3,557	3,243
Total current liabilities	29,974	25,577
Notes payable and long-term debt, less current portion	14,618	9,163
TOTAL LIABILITIES	44,592	34,740
Stockholders' equity (deficit):		
Redeemable Convertible Preferred Stock and Convertible Preferred Stock; 172,200 shares authorized; 5,547 shares issued and outstanding at December 31, 2012, no par value; 5,600 shares issued and outstanding at September 30, 2013, $0.001 par value	105,801	105,367
Common Stock; 300,000 shares authorized; 266 shares issued and outstanding at December 31, 2012, no par value; 290 shares issued and outstanding at September 30, 2013, $0.001 par value	1,222	1,074

Additional paid-in capital	4,801	4,468
Accumulated other comprehensive gain	2,320	2,016
Accumulated deficit	(82,802)	(81,917)
TOTAL STOCKHOLDERS' EQUITY	31,342	31,008
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	$ 75,934	$ 65,748

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

Applied Optoelectronics, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, in thousands, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Revenue, net	$20,766	$16,416	$54,680	$44,559
Cost of goods sold	14,445	11,743	38,327	31,074
Gross profit	6,321	4,673	16,353	13,485
Operating expenses				
Research and development	2,211	2,095	6,112	5,379
Sales and marketing	1,034	756	2,994	2,369
General and administrative	2,436	1,978	7,257	5,890
Total operating expenses	5,681	4,829	16,363	13,638
Income (loss) from operations	640	(156)	(10)	(153)
Other income (expense)				
Interest expense	(323)	(350)	(925)	(1,067)
Other income (expense), net	73	125	50	223
Total other expense	(250)	(225)	(875)	(844)
Income (loss) before income taxes	390	(381)	(885)	(997)
Income taxes	–	–	–	–
Net income (loss)	$390	$(381)	$(885)	$(997)
Net income (loss) per share				
Basic	$0.04	$(1.43)	$(3.24)	$(3.76)
Diluted	$0.04	$(1.43)	$(3.24)	$(3.76)
Weighted average shares used to compute net income (loss) per share				
Basic	8,995	266	273	265
Diluted	9,155	266	273	265
Pro forma net income (loss) per share				
Basic	$0.04		$(0.10)	
Diluted	$0.04		$(0.10)	
Pro forma weighted average shares used to compute net income (loss) per share				
Basic	9,034		9,004	
Diluted	9,194		9,004	

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

Applied Optoelectronics, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited, in thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Net income (loss)	$390	$(381)	$(885)	$(997)
Foreign currency translation adjustment, net of tax	66	(49)	304	(60)
Comprehensive income (loss)	$456	$(430)	$(581)	$(1,057)

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

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Applied Optoelectronics, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	Nine months ended September 30,	
	2013	2012
Operating activities:		
Net loss	$(885)	$(997)
Adjustments to reconcile net loss to net cash used in operating activities:		
Provision for obsolete inventory	550	556
Depreciation and amortization	2,436	2,213
Gain (loss) on disposal of assets	–	36
Stock-based compensation and warrant expense	375	51
Changes in operating assets and liabilities:		
Accounts receivable	(3,446)	438
Bank acceptance receivable	1,036	(174)
Inventory	(4,389)	(1,588)
Other current assets	(2,886)	(933)
Accounts payable	4,350	(687)
Accrued liabilities	405	278
Net cash used in operating activities	(2,454)	(807)
Investing activities:		
Purchase of property, plant and equipment	(4,697)	(2,711)
Proceeds from disposal of equipment	–	138
Deposits and deferred charges	(37)	(41)
Purchase of intangible assets	(83)	(159)
Net cash used in investing activities	(4,817)	(2,773)
Financing activities:		
Proceeds from issuance of notes payable and long-term debt	2,851	845
Principal payments of long-term debt and notes payable	(192)	(427)
Proceeds from line of credit borrowings	16,159	4,466
Repayments of line of credit borrowings	(15,406)	(2,106)
Proceeds from bank acceptance payable	4,746	8,412
Repayments of bank acceptance payable	(3,282)	(8,885)
Repayments of shareholder loans	–	(150)
(Increase) decrease in restricted cash	(511)	(193)
Exercise of stock options	87	6
Exercise of warrants	494	–
Deferred offering costs	(1,251)	–
Issuance of preferred stock, net	–	10,234
Net cash provided by financing activities	3,695	12,202
Effect of exchange rate changes on cash	178	(59)
Net increase (decrease) in cash	(3,398)	8,563

Cash and cash equivalents at beginning of year	10,723	1,768
Cash and cash equivalents at end of year	$7,325	$10,331
Supplemental disclosure of cash flow information:		
Cash paid for:		
Interest	959	1,122
Income taxes	2	–
Conversion of shareholders' loan to preferred stock	–	760

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

Applied Optoelectronics, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Description of Business

Business Overview

Applied Optoelectronics, Inc., or AOI, was originally incorporated in Texas in February of 1997 and then converted to a Delaware corporation in March of 2013. AOI together with its wholly-owned subsidiaries are collectively referred to as the Company. The Company is a leading, vertically integrated provider of fiber-optic networking products, primarily for three networking end-markets: cable television, fiber-to-the-home and internet data centers. The Company designs and manufactures a wide range of optical communications products at varying levels of integration, from components, subassemblies and modules to complete turn-key equipment.

The Company has manufacturing and research and development facilities in all three of its U.S., Taiwan and China locations. At its corporate headquarters and manufacturing facilities in Sugar Land, Texas, the Company primarily manufactures lasers and laser components and performs research and development activities for the laser component products. The Company operates a division in Taipei, Taiwan that primarily manufactures transceivers and performs research and development activities for the transceiver products. The Company operates in Ningbo, China through its wholly-owned subsidiary Prime World International Holdings, Ltd. (incorporated in the British Virgin Islands), the sole parent of Global Technology, Inc. (incorporated in the People's Republic of China). Through Global Technology, the Company primarily manufactures Cable TV Broadband ("CATV") systems and equipment and performs research and development activities for the CATV products.

Interim Financial Statements

The condensed consolidated financial statements of the Company, as of September 30, 2013 and December 31, 2012 and for the three and nine months ended September 30, 2013 and 2012, have been prepared in accordance with the instructions on Form 10-Q pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). In accordance with those rules and regulations, the Company has omitted certain information and notes normally provided in the Company's annual consolidated financial statements. In the opinion of management, the condensed consolidated financial statements contain all adjustments, except as otherwise noted, necessary for the fair presentation of the Company's financial position and results of operations for the periods presented. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by U.S. generally accepted accounting principles ("GAAP"). These condensed consolidated financial statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company’s Registration Statement on Form S-1 that was effective on September 25, 2013 as filed with the SEC (the “Registration Statement”). The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported. Actual results could differ from those estimates in the consolidated financial statements and accompanying notes. Significant estimates and assumptions that impact these financial statements and the accompanying notes relate to, among other things, allowance for doubtful accounts, valuation allowances for deferred tax assets, inventory reserve, stock-based compensation expense, estimated useful lives of property and equipment, and taxes.

Note 2. Significant Accounting Policies

There have been no changes in the Company’s significant accounting policies for the three months ended September 30, 2013, as compared to the significant accounting policies described in its Registration Statement.

Recent accounting pronouncements

There have been no recent accounting pronouncements for the three months ended September 30, 2013, as compared to the recent accounting pronouncements described in its Registration Statement.

Note 3. Fair Value of Financial Instruments

The following table presents a summary of the Company’s financial instruments measured at fair value on a recurring basis for the periods indicated (in thousands):

	As of September 30, 2013				**As of December 31, 2012**			
	(Level 1)	**(Level 2)**	**(Level 3)**	**Total**	**(Level 1)**	**(Level 2)**	**(Level 3)**	**Total**
Assets:								
Cash and cash equivalents	$7,325	$–	$ –	$7,325	$10,723	$–	$ –	$10,723
Restricted cash	1,031	–	–	1,031	503	–	–	503
Bank acceptance receivable	–	–	–	–	–	1,034	–	1,034
Total assets	$8,356	$–	$ –	$8,356	$11,226	$1,034	$ –	$12,260
Liabilities:								
Interest rate swap	$–	$–	$ –	$–	$–	$11	$ –	$11
Bank acceptance payable		3,040		3,040		1,521		1,521
Total liabilities	$–	$3,040	$ –	$3,040	$–	$1,532	$ –	$1,532

The carrying value amounts of accounts receivable, prepaid expenses and other current assets, borrowings from our credit facility, accounts payable, accrued expenses and other current liabilities approximate fair value because of the short-term maturity of these instruments.

Note 4. Earnings Per Share

Basic net income (loss) per share has been computed using the weighted-average number of shares of common stock outstanding during the period. The Company’s preferred shares that were outstanding prior to the completion of the Company’s initial public offering had the right to participate in the Company’s earnings and dividends; however, since there is not a contractual obligation for the preferred shareholders to share in losses, the preferred shares should not be included in loss periods, as their effect is anti-dilutive. Therefore, for those periods presented below that ended with a net loss, the Company has presented both basic and diluted loss per share excluding those preferred shares. For periods with net income, shares used in computing basic and diluted earnings per share include common shares assuming conversion of the preferred stock.

Diluted net income (loss) per share has been computed using the weighted-average number of shares of common stock and dilutive potential common shares from options and warrants outstanding during the period. In periods with net losses, normally dilutive shares become anti-dilutive, and therefore for those periods basic and dilutive earnings per share are the same.

The following table sets forth the computation of the basic and diluted net loss per share for the periods indicated (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Numerator:				
Net income (loss)	$390	$(381)	$(885)	$(997)
Denominator:				
Weighted average shares used to compute net income (loss) per share				
Basic	8,995	266	273	265
Effective of dilutive options and warrants	160	–	–	–
Diluted	9,155	266	273	265
Net income (loss) per share				
Basic	$0.04	$(1.43)	$(3.24)	$(3.76)
Diluted	$0.04	$(1.43)	$(3.24)	$(3.76)

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Pro Forma earnings per share (unaudited)

The Company's registration statement on Form S-1 was declared effective on September 25, 2013 by the SEC and the Company's common stock began trading on the NASDAQ Global Market ("NASDAQ"), on September 26, 2013. On October 1, 2013, the Company completed and closed its initial public offering (the "Offering"), selling 3,600,000 shares of common stock, at a price of $10.00 per share, providing $33.5 million in net proceeds after underwriting discounts and commissions. Accordingly, events that were to be triggered on completion of an Offering did not occur until October 1st, post-period. Because the Offering priced within the third quarter but closed post-period, the Company has presented Pro Forma share and earnings per share information, for comparative purposes only. This pro forma presentation presumes that there was a qualified Offering that was completed on the first day of trading on September 26, 2013. The following unaudited calculation of the numerator and denominator of basic and diluted earnings per share, or EPS gives effect to the automatic conversion of all outstanding shares of the Company's convertible preferred stock (using the as if-converted method) into common stock as though the conversion had occurred as of the beginning of the period or the original date of issuance, if later, together with the IPO shares that would have been issued using the weighted average shares outstanding (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Numerator:				
Net income (loss)	$390	$(381)	$(885)	$(997)
Denominator:				
Number of shares used to compute net income (loss) per share				
Basic	8,995		8,965	
Effective of dilutive options and warrants	160		–	
Diluted	9,155		8,965	
Assumed issuance of shares in IPO to new investors	39		39	
Number of shares used to compute pro forma net income (loss) per share				
Basic	9,034		9,004	
Effective of dilutive options and warrants	160		–	
Diluted	9,194		9,004	
Pro forma net income (loss) per share				
Basic	$0.04		$(0.10)	
Diluted	$0.04		$(0.10)	

The following potentially dilutive securities were excluded from the computation of diluted net income (loss) per share as their effect would have been anti-dilutive (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Employee stock options	1,347	412	1,484	412
Preferred stock warrants	10	89	33	89
	1,357	501	1,517	501

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Note 5. Inventory

Inventories consist of the following for the periods indicated (in thousands):

	September 30, 2013	December 31, 2012
Raw materials	$ 6,710	$ 4,755
Work in process	6,539	4,434
Finished goods	3,172	3,304
	$ 16,421	$ 12,493

The lower of cost or market adjustment expensed for inventory for the three and nine months ended September 30, 2013 was $0.1 million and $0.5 million, respectively. For the three and nine months ended September 30, 2012, the lower of cost or market adjustment expensed for inventory was $0.1 million and $0.3 million, respectively.

Note 6. Property, Plant & Equipment

Property, plant and equipment consisted of the following for the periods indicated (in thousands):

	September 30, 2013	December 31, 2012
Land improvements	$ 96	$ 93
Building and improvements	15,560	15,239
Machinery and equipment	33,690	29,977
Furniture and fixtures	853	739
Computer equipment and software	3,183	2,851
Transportation equipment	188	173
	53,570	49,072
Less accumulated depreciation and amortization	(27,178)	(24,967)
	26,392	24,105
Land	733	733
Property, plant and equipment, net	$ 27,125	$ 24,838

For the three and nine months ended September 30, 2013, depreciation expense of property, plant and equipment was $0.9 million and $2.4 million, respectively.

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Note 7. Notes Payable and Long-Term Debt

Notes payable and long-term debt consisted of the following for the periods indicated (in thousands):

	September 30, 2013	December 31, 2012
Long-Term and Short-Term Debt		
Term loan with a U.S. bank with monthly payments of principal and interest at prime plus 1.125% (floor rate: 4.375%), maturing May 3, 2014	$ 67	$ 141
Term loan with a U.S. bank with monthly payments of principal and interest at prime plus 0.75% (floor rate: 4%) or swap contract (fixed 5%), maturing November 15, 2014	3,103	3,181
Revolving line of credit with a U.S. bank up to $10,500 with interest at prime plus 1.0% (floor rate: 4.25%), maturing November 15, 2014	9,360	8,637
Term loan with a U.S. bank with monthly payments of principal and interest at prime plus 1.25% (floor rate: 4.50%), maturing September 10, 2017	1,850	–
Revolving line of credit with a China bank up to $12,074 with interest at 110% of China Prime rate which ranged from 4.10% to 6.60% in 2013 with various maturity dates from October 2013 to August 2014	11,089	10,668
Revolving line of credit with a China bank up to $1,627 with 6.16% interest and various maturity dates from January 2014 to February 2014	266	–
Note payable to a finance company due in monthly installments with 9% interest, maturing October 31, 2013	–	38
Note payable to a finance company due in monthly installments with 4.95% interest, maturing July 30, 2015	978	398
Total	26,713	23,063
Less current portion	12,095	13,900
Long term portion	$ 14,618	$ 9,163
Bank Acceptance Payable		
Bank acceptance notes issued to vendors with a zero percent interest rate, a 30% guarantee deposit of $997, and maturity dates ranging from October 2013 to January 2014	$ 3,040	$ 1,521

The U.S. bank loans and line of credit agreement require the Company to meet certain financial covenants including a minimum current ratio, minimum quarterly debt service coverage requirements, a minimum unrestricted cash balance as well as maximum debt to tangible net worth ratio and reporting requirements. Collateral for the U.S. bank loans and line of credit includes substantially all of the assets of the Company. As of September 30, 2013, the Company was in compliance with all of its financial and operational covenants associated with these loans. As of September 30, 2013, the Company had $1.1 million of unused borrowing capacity.

On September 10, 2013, the Company's outstanding loan agreement with East West Bank was amended to add $5.0 million of borrowing capability to the existing credit line, for the purpose of financing equipment. The additional equipment term loan allows the Company to draw up to the lesser of (i) $5.0 million, or (ii) 90% of the costs of equipment purchased between March 31, 2013 and March 10, 2014. Through March 10, 2014, the Company is required to pay interest only on the then-outstanding balance, and then pay equal principal payments plus accrued interest monthly for the following 42 months. The interest rate for such equipment term loan is the bank's prime lending rate plus 1.25%, or as of September 30, 2013, a total of 4.5%. As of September 30, 2013, the Company drew $1.85 million on this equipment line in reimbursement for capital equipment expenditures.

As of September 30, 2013, the Company's China subsidiary had a line of credit facility with China banks totaling $13.7 million. As of September 30, 2013, a total of $11.4 million was outstanding under various notes, each with its own maturity date and each renewing annually from December 2013 to August 2014. The notes that begin to mature in December 2013 are expected to be renewed on the same terms and with new one year terms. These loans have renewed each year for the past three years. While there can be no assurance of renewal as each loan matures, these loans are expected to renew this year as they have over the past periods. As of September 30, 2013, the Company had $2.3 million of unused borrowing capacity.

In July 2013, the Company entered into a 24-month equipment financing agreement of $1.0 million in Taiwan with a financing company. The financing agreement requires equipment collateral and is payable in monthly installment payments over 24 months, maturing in July 2015.

A customary business practice in China is to pay accounts payable with bank acceptance notes issued by a bank (so-called Bank Acceptances). From time to time the Company issues Bank Acceptances to its suppliers in China. These Bank Acceptances are non-interest bearing and are generally due within six months, and such Bank Acceptances may be redeemed with the issuing bank prior to maturity at a discount. As a condition of the Bank Acceptances lending arrangements, the Company is required to keep a compensating balance at the issuing bank that is a percentage of the total bank acceptances balance until the Bank Acceptances are paid by our China subsidiary. These balances are classified as restricted cash on our consolidated balance sheets. As of September 30, 2013, our restricted cash and Bank Acceptance payable totaled $1.0 million and $3.0 million respectively

Note 8. Accrued Liabilities

Accrued liabilities consisted of the following for the periods indicated (in thousands):

	September 30, 2013	December 31, 2012
Accrued payroll	$ 2,003	$ 1,631
Accrued employee benefits	447	429
Accrued property taxes	125	167
Accrued interest	70	74
Accrued payments	153	189
Accrued commission	100	69
Accrued professional fees	71	22
Accrued other	588	662
	$ 3,557	$ 3,243

Note 9. Other Income and Expense

Other income and expense consisted of the following for the periods indicated (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Interest income	$15	$5	$49	$12
Unrealized foreign exchange gain (loss)	(65)	119	(256)	150

Realized foreign exchange gain (loss)	57	–	(8)	(1)
Government subsidy income	75	20	269	86
Other non-operating gain (loss)	(9)	(18)	(13)	14
Gain (loss) on disposal of assets	–	(1)	9	(38)
	$73	$125	$50	$223

Note 10. Stock-Based Compensation

The Company's board of directors and stockholders previously approved, the 1998 Share Incentive Plan, the 2000 Share Incentive Plan, the 2004 Share Incentive Plan and the 2006 Share Incentive Plan, (collectively the "Prior Plans"). As of September 30, 2013, the Company had options outstanding to purchase 725,277 shares of common stock under its Prior Plans with a weighted average exercise price of $6.66. Following the Offering, no further awards will be granted under the Prior Plans. However, all outstanding awards under the Prior Plans will continue to exist and will continue to be governed by their existing terms.

On April 12, 2013, our board of directors adopted and approved the Company's 2013 Equity Incentive Plan, (the "2013 Plan"), and it was subsequently approved by the Company's stockholders on May 21, 2013. As of September 30, 2013, the Company had options outstanding to purchase 759,163 shares of common stock under the 2013 Plan with a weighted average exercise price of $9.96.

The Company issues stock options to employees, consultants and non-employee directors. Stock option awards for the Prior Plans and the 2013 Plan generally vest over a four year period and have a maximum term of ten years. Stock options under these plans have been granted at the fair market value on the date of the grant. Nonqualified and Incentive Stock Options and restrictive stock units may be granted from these plans. The fair market value of the Company's stock has been historically determined by the board of directors and from time to time with the assistance of third party valuation specialists.

In 2010, 2011 and 2012, the Company had estimated the fair value of employee stock options at the date of the grant using the Black-Scholes option-pricing model with the following assumptions: expected volatility of 70%, risk free interest rate of 1.01%, 2.32% and 1.72%, respectively, expected term of 6.25 years, no expected dividend yield, and estimated forfeitures of 10%. For grants issued after September 25, 2013, the same factors were used except that the expected volatility of 52% was used. Prior to the Offering, there had been no public market for the Company's common stock. Therefore the expected volatility for options granted was derived from an analysis of reported data for a peer group of companies that issued options with similar terms. The expected volatility has been determined using an average of the expected volatility reported by this peer group of companies. The Company uses a risk free interest rate based on the 10-year Treasury as reported during the period. The expected term of options has been determined utilizing the simplified method which calculates a simple average based on vesting period and option life. The Company does not anticipate paying dividends in the near future. Estimated forfeitures were based on historical experience and future work force projections.

Employee stock-based compensation expenses recognized for three and nine months ended September 30, were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Cost of sales	$14	$ 2	$40	$ 6
Research and development	12	2	37	6
Sales and marketing	11	1	31	6
General and administrative	98	10	267	33
	$135	$ 15	$375	$ 51

Options have been granted to the Company's employees under the Prior Plans and the 2013 Plan and generally become exercisable as to 25% of the shares on the first anniversary date following the vesting commencement date, generally the date of grant, and semi-annually thereafter. All options expire ten years after the date of grant. As of September 30, 2013, the Company had outstanding options to purchase 3,862 shares under the 1998 plan; 20,840 shares under the 2000 plan; 25,075 shares under the 2004 plan; 675,500 shares under the 2006 plan; and 759,163 shares under the 2013 plan.

The following is a summary of option activity during the nine month period ending September 30, 2013 (in thousands, except price data):

	Number of shares	Exercise price	Weighted average exercise price
Outstanding, December 31, 2012	419	3.00 - 9.00	5.935
Granted	1,097	7.50 - 9.96	9.207
Exercised	(14)	6.00	6.000

Forfeited	(13)	6.00 - 7.50	6.629
Expired	(5)	6.00 - 7.50	5.985
Outstanding, September 30, 2013	1,484	3.00 - 9.00	8.347
Exercisable, September 30, 2013	277	3.00 - 7.50	5.901
Vested and expected to vest	1,244	3.00 - 9.00	8.180

As of September 30, 2013, total compensation cost related to unvested stock options not yet recognized was $5.5 million, which is expected to be expensed over a weighted-average period of 3.74 years. The aggregate intrinsic value of options outstanding and options exercisable as of September 30, 2013 was $1.1 million.