

TERAYON COMMUNICATION SYSTEMS

Form 424B3

November 07, 2003

The information in this prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been filed with the Securities and Exchange Commission and has been declared effective. This prospectus supplement and the accompanying prospectus are not an offer to sell these securities and we are not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

**Filed Pursuant to Rule 424B3
Registration No. 333-109536**

Subject to completion, dated November 6, 2003

**Prospectus supplement
(To prospectus dated November 4, 2003)**

10,800,000 shares

Common stock

We intend to sell a number of shares that will result in gross proceeds of approximately \$75,000,000.

Our common stock trades on the Nasdaq National Market under the symbol TERN. The last reported sale price of our common stock on the Nasdaq National Market on November 5, 2003 was \$6.94 per share.

	Per Share	Total
Public offering price	\$	\$
Underwriting discounts and commissions	\$	\$
Proceeds, before expenses, to Terayon	\$	\$

We have granted the underwriters a 30-day option to purchase up to an additional 1,620,000 shares of our common stock to cover over-allotments, if any, at the public offering price per share, less the underwriting discounts and commissions.

Investing in our common stock involves risks. See Risk factors beginning on page S-7 of this prospectus supplement.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus supplement. Any representation to the contrary is a criminal offense.

JPMorgan

CIBC World Markets

Needham & Company, Inc.

Merriman Curhan Ford & Co.

November , 2003.

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About this prospectus supplement

This prospectus supplement and the accompanying prospectus are part of a registration statement that we filed with the SEC using a shelf registration process. Under the shelf registration process, we may offer from time to time debt securities, shares of preferred stock, shares of common stock and warrants up to an aggregate amount of \$125,000,000, of which this offering is a part. In the accompanying prospectus, we provide you with a general description of the securities we may offer from time to time under our shelf registration statement including the common stock that we are selling in this offering. Both this prospectus supplement and the accompanying prospectus include important information you should know before investing. This prospectus supplement also adds, updates and changes information contained in the accompanying prospectus. You should read both this prospectus supplement and the accompanying prospectus as well as additional information described under "Where You Can Find More Information" on page S-33 of this prospectus supplement before investing in our common stock.

You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with different information. We are not making an offer to sell these securities in any state where the offer is not permitted. You should not assume that the information contained in this prospectus supplement or the accompanying prospectus is accurate as of any date other than the dates on the front covers of those documents.

Unless the context otherwise requires, the terms "we," "our," "us," "the company" and "Terayon" refer to Terayon Communication Systems, Inc., a Delaware corporation.

To the extent any inconsistency or conflict exists between the information included in this prospectus supplement and the information included in the accompanying prospectus, the information included or incorporated by reference in this prospectus supplement updates and supersedes the information in the accompanying prospectus.

Forward-looking statements

The statements contained in this prospectus supplement that are not historical fact are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements, whether expressed or implied, are subject to risks and uncertainties which can cause actual results to differ materially from those currently anticipated, due to a number of factors, which include, but are not limited to:

- our ability to gain new business;
- our ability to develop and bring to market new, technologically advanced products and technology;
- the acceptance of our products and technology in the market;
- the impact of competition and technological changes on the development of our business and pricing of our products;
- the expansion of operations and capital expenditures by our customers;
- the deployment of our products in specific markets;
- our ability to lower and align our operating expenses with market conditions;
- our future capital needs and costs, if any, incurred with respect to acquisitions or restructuring activities;
- risks associated with the effects of general economic conditions and specifically in relation to the cable industry;
- industry trends and future growth of the markets for our products and technology; and
- loss associated with future and pending litigation matters, as they may arise.

Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. When used in this prospectus supplement, the words may, will, should, could, expect, plan, anticipate, believe, estimate, predict, continue, and similar expressions are generally intended to identify forward-looking statements.

Because the risks referred to above, as well as other risks, could cause actual results or outcomes to differ materially from those expressed in any forward-looking statements made by us or on our behalf, you should not place undue reliance on any forward-looking statements. New factors emerge from time to time, and it is not possible for us to predict which factors will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Further, any forward-looking statement speaks only as of the date on which it is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events unless, in the course of offering the securities under this prospectus supplement, we provide you with an additional prospectus supplement.

Prospectus supplement summary

The following information supplements, and should be read together with, the information contained or incorporated by reference in other parts of this prospectus supplement and in the accompanying prospectus. This summary highlights selected information contained elsewhere in this prospectus supplement and the accompanying prospectus to help you understand our business. Because the following is only a summary, it does not contain all of the information that may be important to you. You should carefully read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our common stock. You should pay special attention to the Risk Factors section beginning on page S-7 of this prospectus supplement to determine whether an investment in our common stock is appropriate for you.

Terayon Communication Systems, Inc.

We develop, market and sell Cable Modem Termination Systems, or CMTSs, customer premise equipment, or CPE, including cable modems, and digital video equipment. Our CMTS and CPE products enable cable operators to provision, deliver and manage cost-effective broadband Internet access and voice over Internet Protocol, or VoIP. Our digital video equipment allows cable and satellite operators to provide advanced digital video services to subscribers. We focus on the development and deployment of cable broadband access technologies that will improve cable operators' return on investment by leveraging their existing infrastructure to deliver broadband services to residential and commercial subscribers at lower expense and provide new services. We believe this strategy will provide the following benefits to cable operators: a competitive edge in winning new subscribers, a reduction in subscriber turnover, faster recovery of subscriber acquisition costs, increased revenues and reduced operational and capital expenditures. Our customers consist of some of the largest cable operators in North America, Europe and Asia, including: Adelphia Communications Corporation, Charter Communications, Comcast Corporation, Cox, Cross Beam Networks Corporation, a subsidiary of Sumitomo Corporation, i-CABLE Communications Limited, Rogers Communications Inc. and Time Warner.

For the three months ended September 30, 2003, our revenues increased 54% to \$37.6 million from \$24.5 million for the three months ended September 30, 2002, while our net loss for the third quarter of 2003 decreased to \$7.2 million, or \$0.10 per share, compared to a net loss of \$16.0 million, or \$0.22 per share, for the three months ended September 30, 2002. Over the last year, we completed the transition from selling proprietary-based products to selling standards-based products using the Data Over Cable System Interface Specification, or DOCSIS, 2.0 specification. Due primarily to the adoption of DOCSIS 2.0 and our current position as the only vendor of a CableLabs-qualified DOCSIS 2.0 CMTS, we now generate DOCSIS CMTS and cable modem sales to U.S. cable operators as well as to our legacy global customers.

Industry dynamics

We participate in the worldwide market for equipment sold primarily to cable and satellite operators. Our business is influenced by the following significant changes in our industry:

Increased broadband penetration.

As Internet usage by households continues to increase, more subscribers are electing to switch from dial up access services to high speed access services, particularly those offered by cable operators. The Dell Oro Group, an industry research firm, estimates the number of worldwide cable modem users in 2002 was approximately 21.6 million, up 51% from 14.3 million in 2001.

Dell Oro further projects that the number of cable modem users will continue to grow in 2003, reaching approximately 30 million worldwide, an increase of approximately 40% over 2002. According to Dell Oro, in North America, penetration of homes for high speed data was approximately 16% as of the end of 2002 and is projected to be greater than 20% by the end of 2003. By 2003, cable modem users are expected to represent 61% and 36% of all high speed data subscribers in North America and on a worldwide basis, respectively, based on data from Dell Oro.

Cable operators face increased competition from telecom operators for high speed data solutions.

As competition from telecom operators continues to increase, many cable operators are looking to their equipment vendors, such as us, to provide cost-effective solutions to enable the delivery of differentiated, robust service offerings to residential and commercial subscribers. As cable operators add new subscribers for these services, they must deploy CMTSs and CPEs, such as cable modems and embedded multimedia terminal adapters.

Cable operators face increased competition from satellite operators for video solutions.

Cable operators have responded to the increasing satellite operator digital video offerings by upgrading their networks to provide comparable digital quality video as well as two-way services such as video-on-demand, or VOD. In addition, both cable and satellite operators have recently begun providing high definition television, or HDTV, services to their subscribers. Cable operators have sought to compete with other cable and satellite operators by delivering a differentiated cost-effective bundled video, data and voice solution to their subscribers or by providing more value such as guaranteed downstream and upstream data rate speeds.

Increased demand for triple play broadband services.

Within the last few years, certain cable operators have begun to offer a triple play bundle of services that includes voice, video and data, over a single network, with the objective of capturing higher average revenues per subscriber. We believe cable operators are well positioned to deliver next-generation voice, video and data services because:

cable operators have invested significantly over the past few years to upgrade their cable plants to digital networks; these upgrades allow them to leverage their incumbent video and high speed data positions further;

many cable operators have well equipped networks to offer video and two way high speed data services to over 90% of their subscribers; and

cable operators existing Hybrid Fiber Co-axial, or HFC, infrastructure offers a robust network capable of delivering symmetrical high-bandwidth video, voice and data to the subscriber.

Improved financial prospects for many cable operators.

Beginning in 2001, the communications industry overall experienced a severe downturn, which resulted in a significant reduction in capital spending on communications equipment. Many cable operators were constrained by high debt loads and, in a few cases, filed for bankruptcy. In addition, consolidation in the cable industry, such as the merger of Comcast Corporation and AT&T Broadband, resulted in a temporary reduction in capital spending. We believe that the recent integration efforts in the industry, as well as the completion of certain financial

restructuring actions, will allow many cable operators to increase their investments in access equipment to provide advanced services to their subscribers in a cost-effective manner.

Terayon technology advantage

The delivery of broadband communication, which includes voice, video and data, requires expertise in radio frequency, or RF, motion picture experts group, or MPEG, processing and Internet Protocol, or IP. Our products leverage our expertise in these disciplines and our experience in designing, developing and manufacturing complex equipment, such as CMTSs and digital video head-end equipment.

We provide our customers with an end-to-end set of software and hardware products that allow them to deliver, provision and manage cost-effective, robust broadband offerings for subscribers. Currently, we are the only vendor to the cable industry with an end-to-end DOCSIS 2.0 cable data system qualified and certified by CableLabs. We believe our standards-based DOCSIS 2.0 cable data products enable cable operators to provision and deliver high-speed, symmetrical bandwidth to subscribers cost-effectively. Our cable data equipment is DOCSIS 2.0 qualified and backwards compatible with DOCSIS 1.0 and DOCSIS 1.1 CMTSs and cable modems. The DOCSIS 2.0 standard incorporates advanced physical layer technologies such as Synchronous Code Division Multiple Access, or S-CDMA.

With DOCSIS 2.0, we believe many cable operators can obtain compelling economic and performance advantages over existing CMTSs through higher data rate channel throughput, higher spectral efficiency and greater noise resiliency. DOCSIS 2.0 greatly increases the upstream throughput of cable networks, which enables cable operators to better handle the greater upstream traffic from subscribers to the Internet and to create new services for residential and business markets. These services include, but are not limited to, video conferencing, telephone service, guaranteed bandwidth and peer-to-peer computing.

In the digital video management system market, our expertise in MPEG processing technologies has helped secure a leadership position in statistical remultiplexing and providing the cable and satellite operators with bandwidth and bandwidth management capabilities for standard and high definition rate shaping, grooming and advertisement insertion. We believe we are well positioned to capitalize on the growing demand for cable and satellite operators to provide advanced video services to their subscribers, including bandwidth intensive applications such as HDTV and VOD.

Terayon products

We market and sell the following products:

DOCSIS 2.0 CMTS Products Our DOCSIS 2.0 BlueWave CMTS product line includes a scalable, carrier-class solution for cable operators with demanding broadband applications and a compact solution ideal for smaller or segmented cable networks. This product family is designed from the outset to support integrated voice, video and data broadband services. CMTSs are used by cable operators to provide broadband services to cable modems and other devices installed in their subscribers' homes or businesses.

Cable Modem Products Our TeraJet cable modems are certified to meet the DOCSIS 1.1 and 2.0 and Euro-DOCSIS 1.0 cable modem specifications. Our cable modems are being deployed by eight of the largest cable operators based in North America. We have shipped over 1 million DOCSIS 2.0 modems since their introduction in 2002, and according to Kinetic

Strategies, Inc., the growing acceptance of our DOCSIS 2.0 product line enabled us to capture the number-three position in cable modem shipments in North America for the quarter ended September 30, 2003.

Video Products Our CherryPicker DM 6400 digital video management system utilizes advanced statistical remultiplexing technology to give cable and satellite operators unprecedented flexibility in managing their digital video content. Cable operators use CherryPickers for a variety of digital video applications, including rate shaping for advanced digital stream processing, grooming customized channel line-ups, seamlessly inserting digital advertisements for local companies and HDTV.

Terayon's strategy

Our goal is to be the leading provider of intelligent access solutions that optimize the delivery of voice, video and data for broadband service providers, primarily cable operators, on a worldwide basis. To achieve this goal, we are pursuing the following strategies:

increase our CMTS market share by exploiting our DOCSIS 2.0 leadership;

capitalize on the increasing demand for advanced video services, including HDTV and VOD, by leveraging our leadership position in the market for digital video bandwidth management products;

use our expertise in DOCSIS, IP, MPEG and RF technologies to evolve our platform into an intelligent access solution capable of more effectively provisioning, delivering and managing triple play bundled services for cable operators;

selectively enhance our CPE product portfolio to increase the value add for cable operators to offer to their subscribers; and

improve margins through focused product cost-reduction efforts and operational streamlining activities across all product lines.

History

We were founded to provide broadband cable data equipment for cable operators based on our proprietary S-CDMA technology, which forms the basis of our current technology. By 2000, when our revenues reached \$340 million, we were primarily selling proprietary-based modems and CMTSs, and we engaged in an acquisition program to expand our product offerings beyond the cable industry equipment market. With the market downturn in 2000, we refocused our business by concentrating our resources on the cable industry and the DOCSIS 2.0 standard, transitioning from proprietary-based products to standards-based products, terminating acquired businesses and writing down the value of those assets to zero. Today we primarily sell standards-based products to cable operators.

We were incorporated in California in 1993 and reincorporated in Delaware in 1998. Our principal executive headquarters are located at 4988 Great America Parkway, Santa Clara, California 95054. Our telephone number is (408) 235-5500.

The offering

Shares of common stock offered by Terayon	10,800,000 shares
Shares of common stock to be outstanding after this offering	85,413,730 shares
Use of proceeds	We estimate that the net proceeds of this offering will be approximately \$70.5 million. We intend to use the net proceeds from this offering for general corporate purposes. See Use of Proceeds for more information regarding our intended use of the net proceeds from this offering.
Risk Factors	See Risk Factors beginning on page S-7 of this prospectus supplement for a description of risks that you should consider before making a decision to invest in our common stock.

Nasdaq National Market Symbol

TERN

The number of shares of our common stock that will be outstanding after this offering is based on 74,613,730 shares outstanding as of September 30, 2003. The number of shares of our common stock that will be outstanding after the offering excludes:

26,220,518 shares of our common stock reserved for issuance under our stock option plans, of which 17,634,021 shares were outstanding as of September 30, 2003;

1,797,790 shares of our common stock reserved for issuance under our employee stock purchase plan; and

425,593 shares of our common stock issuable pursuant to outstanding warrants.

Unless otherwise noted, all information in the prospectus supplement assumes that the underwriters will not exercise their over-allotment option.

Summary consolidated financial data

The following table presents our summary consolidated financial data as of and for the three years in the period ended December 31, 2002 and as of and for the nine months ended September 30, 2003 and 2002. The summary consolidated financial data for the nine months ended September 30, 2003 and 2002 is unaudited but does include, in our opinion, all adjustments (consisting only of normal recurring adjustments) that are necessary for a fair presentation of our financial position and results of operations for these periods. Operating results for the nine months ended September 30, 2003 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2003. You should read the summary consolidated financial data set forth below in conjunction with Management's discussion and analysis of financial condition and results of operations and with our consolidated financial statements and related notes for the years ended December 31, 2002, 2001 and 2000 incorporated by reference in this prospectus supplement and the accompanying prospectus.

(in thousands, except per share data)	Years ended December 31,			Nine months ended September 30,	
	2000	2001	2002	2002	2003
(unaudited)					
Consolidated statements of operations data:					
Revenues	\$ 339,549	\$ 279,481	\$ 129,403	\$ 104,100	\$ 90,495
Cost of goods sold	289,531	263,117	100,949	78,340	70,762
Gross profit	50,018	16,364	28,454	25,760	19,733
Total operating expenses	237,495	779,496	118,037	94,554	64,851
Loss from operations	(187,477)	(763,132)	(89,583)	(68,794)	(45,118)
Net loss	(180,767)	(563,846)	(44,213)	(23,747)	(44,338)
Basic and diluted net loss per share	\$ (2.95)	\$ (8.25)	\$ (0.61)	\$ (0.33)	\$ (0.60)
Shares used in computing basic and diluted net loss per share	61,349	68,331	72,803	72,828	73,994

	September 30, 2003	
	Actual	As Adjusted ¹
(unaudited)		
Consolidated balance sheet data:		
Cash, cash equivalents and short-term investments	\$ 149,392	\$ 219,909
Working capital	138,601	209,118
Total assets	217,459	287,976
Long-term liabilities	68,408	68,408
Stockholders' equity	95,663	166,180

(1) The information under "As Adjusted" reflects the receipt of the estimated net proceeds of approximately \$70,517,000 from the sale of 10,800,000 shares of common stock offered by us under this prospectus supplement based on an assumed offering price of \$6.94 per share (the last reported sale price of our common stock on the Nasdaq National Market on November 5, 2003), after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

Risk factors

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks actually occur, our business could be harmed. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Risks related to our business

We have a history of losses and may continue to incur losses in the future.

It is difficult to predict our future operating results. We began shipping products commercially in June 1997, and we have been shipping products in volume since the first quarter of 1998. As of September 30, 2003, we had an accumulated deficit of \$981.5 million. We believe that we will continue to experience challenges in selling our products at a profit and continue to operate with net losses for the foreseeable future. Moreover, we have had declining revenue since 2000. In the nine months ended September 30, 2003, our revenues decreased 13% from the same period in 2002. As a result of the operating deficiencies, we have had to use available cash and cash equivalents to supplement the operation of our business. Cash used in operating activities for the nine months ended September 30, 2003 was \$57.1 million as compared to \$56.5 million used in the same period in 2002. Additionally, we generally are unable to significantly reduce our short-term expenses in order to compensate for unexpected decreases in anticipated revenues or delays in generating anticipated revenues. For example, we have commitments with some of our suppliers to purchase their products. In the past, we have been unable to use all of the products that we purchased and as a result have taken vendor cancellation charges. We may have to take additional charges in the future if we are unable to use all of the products that we purchase from our suppliers. Further, we have been experiencing and will continue to experience declining average selling prices, or ASPs, of our products. We record an inventory charge to reduce our inventory to the lower of cost or market if average selling prices fall below the cost of these products. In addition, we have significant operating lease commitments for facilities and equipment that generally cannot be cancelled in the short-term without substantial penalties.

Our business may be adversely affected by delays in, or our failure to, commercialize new products, or reduce the cost of manufacturing our current products. Moreover, given the conditions in the broadband equipment market, the profit potential of our business remains unproven.

We may experience fluctuations in our operating results and face unpredictability in our future revenues.

Our quarterly revenues have fluctuated and are likely to continue to fluctuate significantly in the future due to a number of factors, many of which are outside our control. Factors that affect our revenues include, among others, the following:

variations in the timing of orders and shipments of our products;

variations in the size of the orders by our customers and pricing concessions on volume sales;

competitive market conditions;

unpredictable sales cycles;

new product introductions by competitors or by us;

delays in our introduction of new products;

delays in our introduction of added features to our products;

delays in reducing the cost of our products;

delays in the commercialization of products that are competitive in the marketplace;

delays in our receipt of and cancellation of orders forecasted by customers;

variations in capital spending budgets of cable operators and other broadband service providers;

international conflicts, including the continuing conflict in Iraq and acts of terrorism, and the impact of adverse economic, market and political conditions worldwide; and

ability of our products to be qualified or certified as meeting industry specifications.

A variety of factors affecting our gross margin include, among others, the following:

the sales mix of our products;

the volume of products manufactured;

the type of distribution channel through which we sell our products;

the ASPs of our products;

the costs of manufacturing our products; and

the effectiveness of our cost reduction measures.

We often recognize a substantial portion of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected sales levels and expenses are relatively fixed, particularly in the short-term. For example, a significant percentage of these operating expenses are fixed due to operating leases for our facilities and equipment. Also, we have commitments with some of our suppliers to purchase their products. As of September 30, 2003, \$53.0 million of purchase obligations were outstanding. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. In addition, because a significant portion of our business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results. Our expenses for any given quarter are typically based on expected sales and if sales are below expectations, our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall. Moreover, our research and development expenses fluctuate in response to new product development, changing industry requirements and customer demands.

Additionally, the unit ASPs of our products declined considerably in 2002, have continued to decline in 2003, and we anticipate that unit ASPs of our products may continue to decline in the future. This has caused and will continue to cause a decrease in our gross margins if we are unable to off-set the decline in ASPs with cost reduction measures. In addition, the gross margins we realize from the sale of our products are affected by the mix of product sales between higher margin, lower volume head-end equipment, such as CMTSs, and lower margin,

higher volume CPE, such as cable modems. In 2003, we expect that sales of our low-margin CPE will continue to make up a significant portion of our revenues.

We are dependent on a small number of customers and our business could be harmed by the loss of any of these customers or reductions in their purchasing volumes.

Our customers have undergone and continue to undergo significant consolidation in both North America and internationally, as a limited number of cable operators control an increasing number of systems. For example, the top ten cable operators in the United States own and operate systems that service approximately 82% of homes that receive cable services in the United States. As a result of the consolidation among cable operators, our revenue has been and will continue to be dependent on sales to the few leading cable operators worldwide. For example, three of our customers accounted for 10% or more of total revenues (29%, 13% and 13%) for the three months ended September 30, 2003. Two of our customers accounted for 10% or more of total revenues (25% and 14%) for the three months ended September 30, 2002. Three of our customers accounted for 10% or more of total revenues (20%, 17% and 12%) for the nine months ended September 30, 2003. One of our customers accounted for 10% or more of total revenues (32%) for the nine months ended September 30, 2002. We may not succeed in attracting new customers as many of our potential customers have pre-existing relationships with our current or potential competitors and the continued consolidation of the cable industry reduces the number of potential customers. To attract new customers, we may be faced with intense price competition, which may affect our gross margins. Our sales are made on a purchase order or system contract basis, and none of our customers has entered into a long-term agreement requiring it to purchase our products. Moreover, we do not typically require our customers to purchase a minimum quantity of our products, and our customers can generally cancel their orders on short notice without significant penalties. The loss of any of our customers can have a material adverse effect on our results of operations. Further, any reduction in orders from a given customer can likewise have a material adverse effect on our results of operations.

The sales cycle for certain of our products is lengthy, which makes forecasting of our customer orders and revenue difficult.

The sales cycle for certain of our products, such as our CMTS, is lengthy, often lasting nine months to more than a year. Our customers generally conduct significant technical evaluations, including customer trials, of our products as well as competing products prior to making a purchasing decision. In addition, purchasing decisions may also be delayed because of a customer's internal budget approval processes. Because of the lengthy sales cycle and the size of customer orders, if orders forecasted for a specific customer for a particular period do not occur in that period, our revenues and operating results for that particular quarter could suffer. Moreover, a portion of our expenses related to an anticipated order is fixed and difficult to reduce or change, which may further impact our revenues and operating results for a particular period.

There are many risks associated with our participation in industry standards.

In connection with the development of the DOCSIS 2.0 specification by Cable Television Laboratories, Inc., a cable industry consortium that establishes cable technology standards and administers compliance testing, or CableLabs, we entered into an agreement with CableLabs whereby we licensed to CableLabs on a royalty-free basis any of our intellectual property

rights, including rights to our proprietary S-CDMA technology, to the extent that such rights may be asserted against a party desiring to design, manufacture or sell DOCSIS based products, including DOCSIS 2.0 based products. This license agreement grants to CableLabs the right to sublicense our intellectual property, including our intellectual property rights in our S-CDMA patents, to manufacturers that compete with us in the marketplace for DOCSIS based products. As a result of this license to CableLabs, our competitors that produce DOCSIS-based products have access to our technology without having to pay us any royalties or other compensation for the use of our technology. As a result of our contribution of technology to the DOCSIS intellectual property pool, we may have foregone significant revenue from the potential licensing of our proprietary technology, and we may be unable to recoup the investment in the research and development efforts to develop the intellectual property contributed to the DOCSIS technology pool.

Additionally, the agreement that we signed with CableLabs to participate in the DOCSIS intellectual property pool may make it difficult for us to enforce our intellectual property rights against other companies. Certain cable equipment vendors manufacture and sell DOCSIS based and DOCSIS certified and qualified products without sublicensing from CableLabs the technology in the CableLabs intellectual property pool. Due to the interests of cable operators in having as many equipment vendors as possible, we may feel constrained by competitive pressures from pursuing the enforcement of our intellectual property rights against our competitors that have not entered into sublicenses with CableLabs. Moreover, if we seek to enforce our intellectual property rights against other equipment manufacturers that access technology from the CableLabs intellectual property pool, our license to the technology in the pool may be jeopardized. Certain contributors of technology to the CableLabs intellectual property pool are our competitors and may elect to revoke our license to their technology if we attempt to enforce our intellectual property rights against them.

We may have lost any competitive advantage that our proprietary S-CDMA technology may have provided us in the marketplace by licensing it to CableLabs, and we may face increased competition because our competitors have the ability to incorporate our technology into their products. We believe that this increased competition could come from existing competitors or from new competitors who enter the market and that such competition is likely to result in lower product ASPs, which could harm our revenues and gross margins. Additionally, because our competitors will be able to incorporate our technology into their products, our current customers may choose alternate suppliers or choose to purchase DOCSIS-compliant products from multiple suppliers. We may be unable to effectively compete with the other vendors if we cannot produce DOCSIS compliant cable products more quickly or at a lower cost than our competitors.

DOCSIS specifications have not yet been accepted in Europe and Asia, although an increasing number of Asian cable operators are requiring product to be DOCSIS qualified or certified. An alternate specification for cable products, called the Euro-DOCSIS specification, has been formalized by TComLabs, a cable technology consortium of European cable operators, and some European and Asian cable operators have embraced it. We intend to develop and sell products that comply with the Euro-DOCSIS specification, which may require the contribution of certain of our technologies, including our proprietary S-CDMA technology, to the Euro-DOCSIS specification. We may be unsuccessful in these efforts, and even if we are successful, we may face some of the same risks associated with our contribution of intellectual property to CableLabs DOCSIS intellectual property pool.

We need to certify and qualify our new and existing products to meet industry specifications in order to remain competitive.

Major cable operators worldwide have endorsed the DOCSIS, Euro-DOCSIS and PacketCable specifications and rarely purchase equipment that is not certified or qualified as compliant with these specifications. Cable operators have chosen to purchase only products meeting industry specifications because the specifications enable interoperability among products from multiple vendors, which leads to increased competition among equipment manufacturers and generally lowers product ASPs. Consequently, our future success depends on our ability to compete effectively in this marketplace by developing, marketing and selling products that are certified and qualified to industry standards in a timely fashion and in a cost-effective manner.

There is no guarantee that our products will be DOCSIS, EuroDOCSIS or PacketCable certified or qualified. If we are unable to certify or qualify our products as DOCSIS, EuroDOCSIS or PacketCable compliant in a timely manner, we may be unable to sell our products and may lose some or all of any advantage we might otherwise have had, and our future operating results may be adversely affected.

Although we sell certified and qualified products, there have been and may continue to be instances where our existing customers and potential new customers elect to purchase products from one or more of our competitors rather than from us. In response to this situation, we have reduced our prices and continue to experience customer demand to further reduce our prices in order to promote sales of our current products. This has had and may continue to have an adverse impact on our revenues, operating results and gross margin.

Developing products to meet these various industry specifications has several risks. The first is the cost and effort to engineer standards-based products and to then prepare them for compliance testing. Not only do we have to certify or qualify new products, but any of our currently certified or qualified products must be re-certified or re-qualified should they be changed in any way. Second, there is no guarantee that these products will be certified or qualified as meeting these specifications in a timely fashion, if ever. Because most cable operators purchase only those products that have been certified or qualified as meeting these specifications, it is highly unlikely that we will be able to sell our products until they achieve certification or qualification, which can be a lengthy process. As a result, we may incur significant research and development expenses to develop new products that may not receive certification or qualification and we cannot recoup the costs of these research and development expenses by marketing uncertified or unqualified products. Moreover, a consequence of cable operators only purchasing products certified or qualified as meeting industry specifications is the increased competition between equipment vendors, which has resulted in a steady and ongoing decline in equipment prices as vendors compete for cable operators' business. Third, there is no guarantee that we will be able to support all future cable industry specifications, which will likely have an adverse impact on our future revenues.

Average selling prices of broadband equipment continue to decline, which is decreasing our gross margins.

The broadband equipment market has been characterized by erosion of product ASPs. We expect this erosion to continue. The ASPs for our products are likely to continue to decline due to competitive pricing pressures, promotional programs and customers possessing strong negotiating positions and who require price reductions as a condition of purchase. In addition, we believe that the widespread adoption of industry specifications, such as the DOCSIS and

EuroDOCSIS specifications, is further eroding ASPs as cable modems and other similar CPE become commodity products. Decreasing ASPs could result in decreased revenues, even if the number of units sold increases. Decreasing ASPs may also require us to sell our products at much lower gross margin than in the past, and in fact, we may sell products at a loss. The primary reason that our gross profits have declined year-over-year is the decline in product ASPs. As a result, we may experience substantial period-to-period fluctuations in future revenue, gross margin and operating results due to ASP erosion. Therefore, we must continue to develop and introduce on a timely basis and a cost-effective manner new products or next-generation products with enhanced functionalities that can be sold at higher gross margins. Our failure to do this could cause our revenues and gross margin to decline further.

We must achieve cost reductions to attain profitability.

As product ASPs and revenue have declined in recent years, we have not sufficiently decreased our costs, including operating expenses and the costs associated with our products, to offset declining ASPs and revenue. This has resulted in increased losses and thus making it difficult for us to attain profitability. We have experienced a decrease in revenue, which was, in large part, due to declining product ASPs and a drop in the sale of CMTSs due to our transition from a proprietary platform to the DOCSIS standards platform. In order to achieve profitability, we must significantly increase our revenues, reduce the cost of our products and maintain or reduce our operating expenses.

We have made several attempts to lower our operating expenses. Although we have implemented expense reduction and restructuring plans in the past, including the latest restructuring in March 2003, that have focused on cost reductions and operating efficiencies, we have not been successful in lowering our operating expenses to keep pace with the decline in revenues. We cannot be certain that our future efforts to implement operating expense reduction will be successful. A large portion of our expenses, including rent and operating lease expenditures, are fixed and difficult to reduce or change. Accordingly, if our revenue does not meet our expectations, we may not be able to adjust our expenses quickly enough to compensate for the shortfall in revenue. In that event, our business, financial condition and results of operations could be materially and adversely affected.

As product ASPs rapidly decline, we need to reduce the cost of our products through design and engineering changes. We may not be successful in redesigning our products, and, even if we are successful, our efforts may be delayed or our redesigned products may contain significant errors and product defects. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce significantly the list price of our products or improve our gross margin. Reductions in our product costs will require us to use lower-priced components that are highly integrated in future products and may require us to enter into high volume or long-term purchase or manufacturing agreements. Volume purchase or manufacturing agreements may not be available on acceptable terms, if at all, and we could incur significant expenses without related revenues if we cannot use the products or services offered by such agreements. We have incurred significant cancellation charges related to volume purchase and manufacturing agreements in the past and may incur such charges in the future.

Broadband services delivered by cable operators have not achieved widespread market acceptance, and other competing service providers exist.

Our success will depend upon the widespread acceptance of broadband services delivered by cable operators. The markets for these services are growing but are not fully developed.

Additionally, these markets may not grow as cable operators have a limited amount of available bandwidth over which they can offer new services, such as high-speed Internet access, HDTV, VOD and telephony. Cable operators may elect not to provide any or all of these new services to their customers or may not aggressively market these services to their customers. If cable operators elect not to deploy such new services or if customers elect not to subscribe to such services, it may affect our ability to sell products to cable operators as their existing equipment may meet their current infrastructure demands. We depend on cable operators to provide new services and maintain their infrastructure in such a manner that allows us to continue to sell products to them.

Cable operators must also compete with other service providers in the delivery of services to their customers. Telecoms and satellite operators are aggressively competing with the cable industry to deliver broadband services via digital subscriber lines, or DSL, or satellite broadcast technologies. We cannot accurately predict the future growth rate or the ultimate size of the market for broadband services delivered via cable. The success of telecoms and satellite operators may slow or hamper the continued acceptance of cable operators in delivering broadband services, which in turn may impact demand for our products by cable operators.

We need to develop additional distribution channels to market and sell our products.

The vast majority of our sales are to large cable operators. However, we currently have limited access to smaller or geographically diverse cable operators. Although we intend to establish strategic relationships with leading distributors worldwide to access these customers, we may not succeed in establishing these relationships. Even if we do establish these relationships, the distributors may not succeed in marketing our products to their customers. Some of our competitors have already established long-standing relationships with these cable operators that may limit our and our distributors' abilities to sell our products to those customers. Even if we were to sell our products to those customers, it would likely not be based on long-term commitments, and those customers would be able to terminate their relationships with us at any time without significant penalties.

In addition, we anticipate that the North American cable modem market may at some point shift to a consumer purchase model. If this occurs, our success will depend on our ability to effectively sell our products in the consumer market. We may not have the capital required or the necessary personnel or expertise to develop these distribution channels. Also, some of our competitors, including Motorola and Thomson Consumer Electronics, have well-established retail distribution capabilities and existing brands with market acceptance that would provide them with a significant competitive advantage.

We depend on cable industry capital spending for a substantial portion of our revenue and any decrease or delay in capital spending by cable operators would negatively impact our resources, operating results and financial condition.

Historically, almost all of our sales had been derived from sales to cable operators, and we expect these sales to constitute a significant portion of net sales for the foreseeable future. Demand for our products will depend on the magnitude and timing of capital spending by

cable operators. These capital spending patterns are dependent on a variety of factors including:

- the availability of financing;
- annual budget cycles, as well as the typical reduction in upgrade projects during the winter months;
- the status of federal, local and foreign government regulation and deregulation of the telecommunications industry;
- overall demand for broadband services and the acceptance of new data, video and voice services;
- evolving industry specifications and network architectures;
- competitive pressures (including the availability of alternative data transmission and access technologies);
- discretionary consumer spending patterns; and
- general economic conditions.

In recent years, the cable industry has been characterized by consolidation. We cannot predict the effect, if any, that such consolidation will have on overall capital spending patterns by cable operators. The effect on our business of further industry consolidation also is uncertain.

The timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as fiber optic cable and the need for local zoning and licensing approvals. We believe that changes in our customers' deployment plans have, and may in the future delay, the receipt of new orders. Since the majority of our sales have been to relatively few customers, a delay in equipment deployment at any one customer has in the past and could have a material adverse effect on our sales in a particular quarter.

We may fail to accurately forecast customer demand for our products.

The nature of the cable industry makes it difficult for us to accurately forecast demand for our products. Our inability to forecast accurately the actual demand for our products may result in too much or too little supply of products or an over/under capacity of manufacturing or testing resources at any given point in time. The existence of any one or more of these situations could have a negative impact on our business, operating results or financial condition. We had purchase obligations of approximately \$53.0 million as of September 30, 2003, primarily to purchase materials and components used to manufacture our products. We must fulfill these obligations even if demand for our products is lower than we anticipate.

We may not be able to manage expenses and inventory risks associated with meeting the demand of our customers.

From time to time, we receive indications from our customers as to their future plans and requirements to ensure that we will be prepared to meet their demand for our products. If actual orders differ materially from these indications, our ability to manage inventory and expenses may be affected. In addition, if we fail to meet customers' supply expectations, we may lose business from such customers. If we enter into purchase commitments to acquire

materials, or expend resources to manufacture products and such products are not purchased by our customers, our business and operating results could suffer.

We may have financial exposure to litigation.

We and/or our directors and officers are defendants in a number of lawsuits, including securities litigation lawsuits. As a result, we may have financial exposure to litigation as a defendant and because we are obligated to indemnify our officers and directors for certain actions taken on our behalf.

In order to limit financial exposure arising from litigation and/or our obligation to indemnify our officers and directors, we have historically purchased directors and officers insurance, or D&O Insurance. However, the availability of D&O Insurance is becoming more difficult for companies to attain as a number of insurance underwriters no longer offer D&O Insurance and the remaining insurance underwriters offering D&O Insurance have significantly increased the premiums of such coverage. In recent years, we have experienced a significant increase in the cost of our D&O Insurance, and there can be no assurance that D&O Insurance will be available to us in the future or, if D&O Insurance is available, it may be prohibitively expensive. Additionally, some insurance underwriters who offered D&O Insurance in the past have been placed into liquidation or may be, at some future point, placed into liquidation. In October 2001, one of the insurance underwriters from which we purchased D&O Insurance, Reliance Insurance Co., or Reliance, was placed into liquidation by the state of Pennsylvania. Reliance was the underwriter for one excess layer of our D&O Insurance for the period covering the claims made against us and our officers in the pending securities litigation. Because Reliance is in liquidation, we will be responsible for the amount insured under the Reliance policy, which is approximately \$2.5 million.

We are dependent on key third-party suppliers and any failure by them to deliver components could limit our ability to satisfy customer demand.

We manufacture all of our products using components or subassemblies procured from third-party suppliers. Some of these components are available from a sole source and others are available from limited sources. A majority of our sales are from products containing one or more components that are available only from sole source suppliers. Additionally, some of our components are custom parts that are produced to our specifications, and it may be difficult to move the manufacturing of such components from one vendor to another vendor.

Any interruption in the operations of our vendors of sole source or custom product parts could adversely affect our ability to meet our scheduled product deliveries to customers. If we are unable to obtain a sufficient supply of components from our current sources, we could experience difficulties in obtaining alternative sources or in altering product designs to use alternative components. Resulting delays or reductions in product shipments could damage customer relationships and expose us to potential damages that may arise from our inability to supply our customers with products. Further, a significant increase in the price of one or more of these components could harm our gross margin or operating results. Additionally, we attempt to limit this risk by maintaining safety stocks of these components, subassemblies and modules. As a result of this investment in inventories, we have in the past and in the future may be subject to risk of excess and obsolete inventories, which could harm our business. In this regard, our gross margins and operating results could be adversely affected by excess and obsolete inventory.

We may be unable to migrate to new semiconductor process technologies successfully or on a timely basis.

Our future success will depend in part upon our ability to develop products that utilize new semiconductor process technologies. These technologies change rapidly and require us to spend significant amounts on research and development. We continuously evaluate the benefits of redesigning our integrated circuits using smaller geometry process technologies to improve performance and reduce costs. The transition of our products to integrated circuits with increasingly smaller geometries will be important to our competitive position. Other companies have experienced difficulty in migrating to new semiconductor processes and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. Moreover, we depend on our relationship with our third-party manufacturers to migrate to smaller geometry processes successfully.

Our ability to directly control product delivery schedules and product quality is dependent on third-party contract manufacturers.

Most of our products are assembled and tested by contract manufacturers using testing equipment that we provide. As a result of our dependence on these contract manufacturers for the assembly and testing of our products, we do not directly control product delivery schedules or product quality. Any product shortages or quality assurance problems could increase the costs of manufacturing, assembling or testing our products. In addition, as manufacturing volume increases, we will need to procure and assemble additional testing equipment and provide it to our contract manufacturers. The production and assembly of testing equipment typically requires significant lead times. We could experience significant delays in the shipment of our products if we are unable to provide this testing equipment to our contract manufacturers in a timely manner.

We are dependent upon international sales and there are many risks associated with international operations.

We expect sales to customers outside of the United States to continue to represent a significant percentage of our revenues for the foreseeable future. For the three months ended September 30, 2003 and September 30, 2002, approximately 56% and 51%, respectively, of our net revenues were from customers outside of the U.S. For the nine months ended September 30, 2003 and September 30, 2002, approximately 47% and 74%, respectively, of our net revenues were from customers outside of the U.S. International sales are subject to a number of risks, including the following:

changes in foreign government regulations and communications standards;

import and export license requirements, tariffs and taxes;

trade barriers;

difficulty in protecting intellectual property;

difficulty in collecting accounts receivable;

currency fluctuations;

the burden of complying with a wide variety of foreign laws, treaties and technical standards;

difficulty in staffing and managing foreign operations; and

political and economic instability.

If our customers are affected by currency devaluations or general economic downturns, such as the economic downturns affecting many Asian, European and Latin American economies, their ability to purchase our products could be reduced significantly. Payment cycles for international customers typically are longer than those for customers in North America.

While we generally invoice our foreign sales in U.S. dollars, we invoice the majority of our sales in Europe in Euros. Since we have also elected to take payment in Euros from our customers in Europe and may elect to take payment in other foreign currencies in the future, we are exposed to losses as the result of foreign currency fluctuations. Additionally, we have an Israel based operation whose expenses are denominated in Israeli NIS. We currently do not engage in foreign currency hedging transactions. We may in the future choose to limit our exposure by the purchase of forward foreign exchange contracts or through similar hedging strategies. No currency hedging strategy can fully protect against exchange-related losses. In addition, if the relative value of the U.S. dollar in comparison to the currency of our foreign customers should increase, the resulting effective price increase of our products to those foreign customers could result in decreased sales.

Furthermore, foreign countries may decide to prohibit, terminate or delay the construction of new cable infrastructures for a variety of reasons. These reasons include environmental issues, economic downturns and availability of favorable pricing for other communications services or the availability and cost of related equipment. Any such action by foreign countries would reduce the market for our products.

Our business may be affected by conditions in Israel.

We have significant operations in Israel. Our operations in Israel consist primarily of research and development, and to a lesser extent sales and manufacturing. Revenues generated by our business in Israel were \$0.6 million for the three months ending September 30, 2003 and September 30, 2002, respectively. Revenues generated by our business in Israel were \$1.4 million and \$0.9 million for the nine months ending September 30, 2003 and September 30, 2002, respectively. Our research and development operations may be significantly affected by conditions in Israel. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Hostilities within Israel have continued to escalate over the past year, which could disrupt some of our operations. We could be adversely affected by any major hostilities involving Israel. As a result of the hostilities and unrest presently occurring within Israel, the future of the peace efforts between Israel and its Arab neighbors is uncertain. A number of our employees based in Israel are currently obligated to perform annual military reserve duty and are subject to being called to active duty at any time under emergency circumstances. We cannot assess the full impact of these requirements and the hostilities on our workforce, business or operations if conditions should change, and we cannot predict the effect of any expansion or reduction of these obligations or the hostilities.

We may be unable to provide adequate customer support.

Our ability to achieve our planned sales growth and retain current and future customers will depend in part upon the quality of our customer support operations. Our customers generally

require significant support and training with respect to our products, particularly in the initial deployment and implementation stages. Spikes in demand of our support services may cause us to be unable to serve our customers. We may not have adequate personnel to provide the levels of support that our customers may require during initial product deployment or on an ongoing basis especially during peak periods. Our inability to provide sufficient support to our customers could delay or prevent the successful deployment of our products. In addition, our failure to provide adequate support could harm our reputation and relationships with our customers and could prevent us from selling product to existing customers or gaining new customers.

Our industry is highly competitive with many larger and more established competitors.

The market for our products is extremely competitive and is characterized by rapid technological change. Our direct competitors include Cisco Systems, ADC, Arris, BigBand Networks, Motorola, Thomson Consumer Electronics (which markets products under the brand name RCA), Scientific-Atlanta and Toshiba. Additionally, we face competition from early stage companies with access to significant financial backing that may improve existing technologies or develop new technologies. The principal competitive factors in our market include the following:

- product performance, features and reliability;
- price;
- size and stability of operations;
- breadth of product line;
- sales and distribution capabilities;
- technical support and service;
- relationships with providers of service providers; and
- compliance with industry standards.

Some of these factors are outside of our control. Conditions in the market could change rapidly and significantly as a result of technological advancements. The development and market acceptance of alternative technologies could decrease the demand for our products or render them obsolete. Our competitors may introduce products that are less costly, provide superior performance or achieve greater market acceptance than our products.

Many of our current and potential competitors have greater financial, technical, marketing, distribution, customer support and other resources, as well as better name recognition and access to customers than we do. The widespread adoption of DOCSIS and other industry specifications has and is likely to continue to cause increased price competition. We believe that the adoption of these specifications has resulted in and is likely to continue to result in lower ASPs for our products. Any increased price competition or reduction in sales of our products, particularly our higher margin head-end products, has resulted and will continue to result in decreased revenue and downward pressure on our gross margin. These competitive pressures have and are likely to continue to adversely impact our business.

We are dependent on key personnel.

Due to the specialized nature of our business, we are highly dependent on the continued service of, and on the ability to attract and retain, qualified engineering, sales, marketing and senior management personnel. The competition for some of these personnel is intense. The loss of any of these individuals may harm our business. In addition, if we are unable to hire qualified personnel as needed, we may be unable to adequately manage and grow our business.

Highly skilled employees with the education and training that we require, especially employees with significant experience and expertise in video, data networking and radio frequency design, are in high demand. We may be unable to continue to attract and retain qualified personnel necessary for the development of our business. We do not have key person insurance coverage for the loss of any of our employees. Any officer or employee can terminate his or her relationship with us at any time. Our employees are not bound by non-competition agreements with us.

Our business is subject to the risks of product returns, product liability and product defects.

Products like ours are very complex and can frequently contain undetected errors or failures, especially when first introduced or when new versions are released. Despite testing, errors may occur. The occurrence of errors could result in product returns and other losses to us and/or our customers. This occurrence could result in the loss of or delay in market acceptance of our products. We have limitation of liability provisions in our standard terms and conditions of sale. However, these terms and conditions may not be effective as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The sale and support of our products entails the risk of product liability claims. In addition, any failure by our products to properly perform could result in claims against us by our customers. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management's time and other resources.

We may be unable to adequately protect or enforce our intellectual property rights.

We rely on a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in our products. Even though we seek to establish and protect proprietary rights in our products, there are risks. We cannot be assured that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that su