

Fabrinet
Form 10-Q
November 05, 2013
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

þ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 27, 2013

OR

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

FABRINET

(Exact name of registrant as specified in its charter)

Edgar Filing: Fabrinet - Form 10-Q

Cayman Islands
(State or other jurisdiction of
incorporation or organization)

Not Applicable
(I.R.S. Employer
Identification No.)

c/o Intertrust Corporate Services (Cayman) Limited

190 Elgin Avenue

George Town

Grand Cayman

Cayman Islands
(Address of principal executive offices)

KY1-9005
(Zip Code)

+66 2-524-9600

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer

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

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

As of October 25, 2013, the registrant had 34,734,574 ordinary shares, \$0.01 par value, outstanding.

Table of Contents

FABRINET

FORM 10-Q

QUARTER ENDED SEPTEMBER 27, 2013

Table of Contents

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	3
<u>Item 1. Financial Statements</u>	3
<u>Unaudited Condensed Consolidated Balance Sheets as of September 27, 2013 and June 28, 2013</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the three months ended September 27, 2013 and September 28, 2012</u>	4
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the three months ended September 27, 2013 and September 28, 2012</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	30
<u>Item 4. Controls and Procedures</u>	31
<u>PART II. OTHER INFORMATION</u>	31
<u>Item 1. Legal Proceedings</u>	31
<u>Item 1A. Risk Factors</u>	32
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	47
<u>Item 6. Exhibits</u>	47
<u>Signature</u>	48
<u>Exhibit Index</u>	49

Table of Contents**PART I: FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****FABRINET****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands of U.S. dollars, except share data)

	September 27, 2013	June 28, 2013
Assets		
Current assets		
Cash and cash equivalents	\$ 163,860	\$ 149,716
Trade accounts receivable, net	125,876	118,475
Inventory, net	94,528	88,962
Deferred tax assets	1,618	1,937
Prepaid expenses	1,398	1,931
Other current assets	2,105	3,505
Total current assets	389,385	364,526
Non-current assets		
Property, plant and equipment, net	97,133	97,206
Intangibles, net	136	164
Deferred tax assets	2,912	2,905
Deposits and other non-current assets	102	107
Total non-current assets	100,283	100,382
Total assets	\$ 489,668	\$ 464,908
Liabilities and Shareholders Equity		
Current liabilities		
Long-term loans from bank, current portion	\$ 9,668	\$ 9,668
Trade accounts payable	90,328	77,139
Income tax payable	1,985	1,825
Deferred tax liability	2,607	2,481
Accrued payroll, bonus and related expenses	6,954	6,220
Accrued expenses	4,174	3,121
Other payables	4,437	5,163
Liabilities to third parties due to flood losses	1,558	9,812
Total current liabilities	121,711	115,429
Non-current liabilities		
Long-term loans from bank, non-current portion	16,826	19,243
Severance liabilities	4,564	4,382
Other non-current liabilities	536	536
Total non-current liabilities	21,926	24,161

Edgar Filing: Fabrinet - Form 10-Q

Total liabilities	143,637	139,590
Commitments and contingencies (Note 12)		
Shareholders' equity		
Preferred shares (5,000,000 shares authorized, \$0.01 par value; no shares issued and outstanding as of September 27, 2013 and June 28, 2013)		
Ordinary shares (500,000,000 shares authorized, \$0.01 par value; 34,733,691 shares and 34,634,967 issued and outstanding as of September 27, 2013 and June 28, 2013, respectively)	347	346
Additional paid-in capital	72,616	71,101
Retained earnings	273,068	253,871
Total shareholders' equity	346,031	325,318
Total Liabilities and Shareholders' Equity	\$ 489,668	\$ 464,908

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

Table of Contents**FABRINET****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands of U.S. dollars, except share data)

	Three Months Ended	
	September 27, 2013	September 28, 2012
Revenues	\$ 171,551	\$ 158,625
Cost of revenues	(152,906)	(140,903)
Gross profit	18,645	17,722
Selling, general and administrative expenses	(6,694)	(5,859)
Income related to flooding	6,597	4,820
Operating income	18,548	16,683
Interest income	364	188
Interest expense	(206)	(286)
Foreign exchange gain, net	1,088	277
Other income	184	190
Income before income taxes	19,978	17,052
Income tax expense	(781)	(1,033)
Net income	\$ 19,197	\$ 16,019
Earnings per share		
Basic	\$ 0.55	\$ 0.46
Diluted	\$ 0.55	\$ 0.46
Weighted average number of ordinary shares outstanding (thousands of shares)		
Basic	34,674	34,485
Diluted	35,138	34,670

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

Table of Contents**FABRINET****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands of U.S. dollars)

	Three Months Ended	
	September 27, 2013	September 28, 2012
Cash flows from operating activities		
Net income for the period	\$ 19,197	\$ 16,019
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	2,509	2,522
Amortization of intangibles	28	75
Loss on disposal of property, plant and equipment		1
Income related to flooding	(6,597)	(4,820)
Proceeds from insurers for business interruption losses related to flooding		4,741
Proceeds from insurers for inventory losses related to flooding	6,597	
Reversal of allowance for doubtful accounts	(53)	(49)
Unrealized gain on exchange rate and fair value of derivative	(808)	(714)
Share-based compensation	1,563	1,254
Deferred income tax	438	256
Other non-cash expenses	218	588
Reversal of inventory obsolescence		(166)
Changes in operating assets and liabilities		
Trade accounts receivable	(7,348)	(9,556)
Inventory	(5,566)	(7,302)
Other current assets and non-current assets	60	1,299
Trade accounts payable	13,189	5,919
Income tax payable	124	231
Other current liabilities and non-current liabilities	550	(349)
Liabilities to third parties due to flood losses	(5,964)	(4,000)
Net cash provided by operating activities	18,137	5,949
Cash flows from investing activities		
Purchase of property, plant and equipment	(1,253)	(4,126)
Proceeds from insurers in settlement of claims related to flood damage		79
Net cash used in investing activities	(1,253)	(4,047)
Cash flows from financing activities		
Repayment of long-term loans from bank	(2,417)	(2,417)
Proceeds from issuance of ordinary shares under employee share option plans	43	124
Withholding tax related to net share settlement of restricted share units	(90)	
Net cash used in financing activities	(2,464)	(2,293)
Net increase (decrease) in cash and cash equivalents	14,420	(391)
Movement in cash and cash equivalents		
Cash and cash equivalents at beginning of period	149,716	115,507
Increase (decrease) in cash and cash equivalents	14,420	(391)
Effect of exchange rate on cash and cash equivalents	(276)	278

Edgar Filing: Fabrinet - Form 10-Q

Cash and cash equivalents at end of period	\$ 163,860	\$ 115,394
---	------------	------------

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

Table of Contents

FABRINET

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

1. Business and organization

General

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

The Company provides advanced optical packaging and precision optical, electro-mechanical and electronic manufacturing services to original equipment manufacturers (OEMs) of complex products, such as optical communication components, modules and sub-systems, industrial lasers and sensors. The Company offers a broad range of advanced optical and electro-mechanical capabilities across the entire manufacturing process, including process design and engineering, supply chain management, manufacturing, advanced packaging, integration, final assembly and test. The Company focuses primarily on the production of low-volume, high-mix products.

Fabrinet has the following subsidiaries:

Fabrinet Co., Ltd. (Fabrinet Thailand), incorporated in Thailand on September 27, 1999;

Fabrinet USA, Inc., incorporated in the U.S. in the State of California on October 12, 1999;

FBN New Jersey Manufacturing, Inc., incorporated in the U.S. in the State of Delaware on May 11, 2005;

Fabrinet China Holdings, incorporated in Mauritius, and CASIX, Inc., incorporated in the People's Republic of China, which were both acquired on May 29, 2005;

Fabrinet Pte. Ltd., incorporated in Singapore on November 14, 2007; and

Fabrinet AB, incorporated in Sweden on September 29, 2010.

Asia Pacific Growth Fund III, L.P. and its affiliates held 17.7% and 17.8% of the Company's share capital (fully diluted) as of September 27, 2013 and June 28, 2013, respectively. The Company has no commercial transactions with Asia Pacific Growth Fund III, L.P. and its affiliates.

2. Accounting policies

Basis of presentation

The condensed consolidated financial statements of Fabrinet included herein have been prepared on a basis consistent with the June 28, 2013 audited consolidated financial statements and include all material adjustments, consisting of normal recurring adjustments, necessary to fairly present the information set forth therein. These condensed consolidated financial statements should be read in conjunction with the June 28,

Edgar Filing: Fabrinet - Form 10-Q

2013 audited consolidated financial statements and notes thereto. The year-end condensed balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America (U.S. GAAP). Fabrinet s results of operations for the three months ended September 27, 2013 and September 28, 2012 are not necessarily indicative of future operating results.

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

Table of Contents

Fiscal years

The Company utilizes a 52-53 week fiscal year ending on the Friday in June closest to June 30. The three months ended September 27, 2013 and September 28, 2012 each consisted of 13 weeks. Fiscal year 2014 will be comprised of 52 weeks and will end on June 27, 2014.

Concentration of credit risk

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

As of September 27, 2013, the Company's cash and cash equivalents were held in deposits and highly liquid investment products with maturities of three months or less with banks and other financial institutions having credit ratings of A minus or above. The Company had two customers that each contributed to 10% or more of its total accounts receivable as of September 27, 2013 and June 28, 2013, respectively.

Accounts receivable include amounts due from customers that are monitored by the Company for credit worthiness. Management has implemented a program to closely monitor near term cash collection and credit exposures and believes no material loss will be incurred.

Recent accounting pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11 Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The guidance suggested that an unrecognized tax benefit or a portion of an unrecognized of tax benefit, should be presented in the financial statements as a reduction to a deferred tax assets for a net operating loss carryforward, a similar tax loss, or a tax loss creditforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax loss creditforward is not available at the reporting date under tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax loss of the applicable jurisdiction does not required the entity to use, and the entity does not intended to use, the deferred tax assets for such purpose, the unrecognized tax benefit should be presented in the financial statement as a liabilities and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company does not expect that the adoption of this guidance will have an effect on its consolidated financial statements.

In April 2013, the FASB issued ASU No. 2013-07 Presentation of Financial Statements (Topic 205) Liquidation Basis of Accounting. The amendments require an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either (a) a plan for liquidation is approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties, or (b) a plan for liquidation is being imposed by other forces (for example, involuntary bankruptcy). If a plan for liquidation was specified in the entity's governing documents from the entity's inception (for example, limited-life entities), the entity should apply the liquidation basis of accounting only if the approved plan for liquidation differs from the plan for liquidation that was specified at the entity's inception. The amendments require financial statements prepared using the liquidation basis of accounting to present relevant information about an entity's expected resources in liquidation by measuring and presenting assets at the amount of the expected cash proceeds from liquidation. The entity should include in its presentation of assets any items it had not previously recognized under U.S. GAAP but that it expects to either sell in liquidation or use in settling liabilities (for example, trademarks). An entity should recognize and measure its liabilities in accordance with U.S. GAAP that otherwise applies to those liabilities. The entity should not anticipate that it will be legally released from being the primary obligor under those liabilities, either judicially or by creditors. The entity also is required to accrue and separately present the costs that it expects to incur and the income that it expects to earn during the expected duration of the liquidation, including any costs associated with sale or settlement of those assets and liabilities. Additionally, the amendments require disclosures about an entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of the liquidation process. This guidance is effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013 and interim reporting periods therein. The Company does not expect that the adoption of this guidance will have an effect on its consolidated financial statements.

Table of Contents

In March 2013, the FASB issued ASU No. 2013-05 Foreign Currency Matters (Topic 830) Parents Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity. When a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity, the parent is required to apply the guidance in Subtopic 830-30 to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. For an equity method investment that is a foreign entity, the partial sale guidance in Section 830-30-40 still applies. As such, a pro rata portion of the cumulative translation adjustment should be released into net income upon a partial sale of such an equity method investment. However, this treatment does not apply to an equity method investment that is not a foreign entity. In those instances, the cumulative translation adjustment is released into net income only if the partial sale represents a complete or substantially complete liquidation of the foreign entity that contains the equity method investment. Additionally, the amendments in this Update clarify that the sale of an investment in a foreign entity includes both (1) events that result in the loss of a controlling financial interest in a foreign entity (that is, irrespective of any retained investment) and (2) events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (sometimes also referred to as a step acquisition). Accordingly, the cumulative translation adjustment should be released into net income upon the occurrence of those events. This guidance is effective prospectively for fiscal years and interim reporting periods within those years beginning after December 15, 2013. The Company does not expect that the adoption of this guidance will have an effect on its consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-04 Liabilities (Topic 405) Obligations Resulting from Joint and Several Liability Arrangements for which the Total Amount of the Obligation is Fixed at the Reporting Date. The guidance in this update requires an entity to measure obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date, as the sum of the following: (a) the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors, and (b) any additional amount the reporting entity expects to pay on behalf of its co-obligors. The guidance also requires an entity to disclose the nature and amount of the obligation as well as other information about those obligations. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company does not expect that the adoption of this guidance will have an effect on its consolidated financial statements.

In January 2013, the FASB issued ASU No. 2013-01 Balance Sheet (Topic 210) Clarifying the Scope of Disclosure about Offsetting Assets and Liabilities. The amendments clarify that the scope of Update 2011-11 applies to derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. This guidance is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The Company adopted this guidance in the first quarter of fiscal year 2014. This guidance did not impact the Company's presentation, financial position, or results of operations.

In July 2012, the FASB issued ASU No. 2012-02 Intangibles Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment. Under the amendments in ASU No. 2012-02, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount in accordance with Subtopic 350-30. This guidance is effective for fiscal years beginning after September 15, 2012. The Company adopted this guidance in the first quarter of fiscal year 2014. This guidance did not impact the Company's presentation, financial position, or results of operations.

In December 2011, the FASB issued ASU No. 2011-11 Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. The amendments in ASU No. 2011-11 will enhance disclosures required by U.S. GAAP by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with Section 210-20-45 or Section 815-

Table of Contents

10-45. Information about offsetting and related arrangements will enable users of an entity's financial statements to understand the effect of those arrangements on an entity's financial position, including the effect or potential effect of rights of setoff associated with certain financial instruments and derivative instruments in the scope of ASU No. 2011-11. This guidance is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company adopted this guidance in the first quarter of fiscal year 2014. This guidance did not impact the Company's presentation, financial position, or results of operations.

3. Earnings per ordinary share

Basic earnings per ordinary share is computed by dividing reported net income by the weighted average number of ordinary shares outstanding during each period.

	Three Months Ended	
	September 27, 2013	September 28, 2012
Net income attributable to shareholders	\$ 19,197	\$ 16,019
Weighted average number of ordinary shares outstanding (thousands of shares)	34,674	34,485
Basic earnings per ordinary share	\$ 0.55	\$ 0.46

Diluted earnings per ordinary share is computed by dividing reported net income by the weighted average number of ordinary shares and dilutive ordinary equivalent shares outstanding during each period. Dilutive ordinary equivalent shares consist of share options and restricted shares. Diluted earnings per ordinary share is calculated as follows:

	Three Months Ended	
	September 27, 2013	September 28, 2012
Net income used to determine diluted earnings per ordinary share	\$ 19,197	\$ 16,019
Weighted average number of ordinary shares outstanding (thousands of shares)	34,674	34,485
Adjustment for incremental shares arising from the assumed exercise of share options and vesting of restricted share units (thousands of shares)	464	185
Weighted average number of ordinary shares for diluted earnings per ordinary share (thousands of shares)	35,138	34,670
Diluted earnings per ordinary share	\$ 0.55	\$ 0.46
Outstanding share options excluded in the computation of diluted earnings per ordinary shares*	655,931	1,237,877

* These share options were not included in the computation of diluted earnings per ordinary share for the three months ended September 27, 2013 and September 28, 2012, respectively, because the exercise price of the options was greater than the average market price of the underlying shares.

4. Fair value

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

Edgar Filing: Fabrinet - Form 10-Q

measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Table of Contents

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

The following table sets forth the Company's applicable assets measured at fair value on a recurring basis as of September 27, 2013:

	Fair Value Measurements at Reporting Date Using			Total Balance
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets				
Derivative assets		372		372
Total assets measured at fair value	\$	\$ 372	\$	\$ 372

The above derivative assets are classified in other current assets on the condensed consolidated balance sheet.

The following table sets forth the Company's applicable liabilities measured at fair value on a recurring basis as of June 28, 2013:

	Fair Value Measurements at Reporting Date Using			Total Balance
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Liabilities				
Derivative liabilities		766		766
Total liabilities measured at fair value	\$	\$ 766	\$	\$ 766

The above derivative liabilities are classified in accrued expenses on the consolidated balance sheet.

5. Allowance for doubtful accounts

The activities and balances for allowance for doubtful accounts for the three months ended September 27, 2013 and September 28, 2012 were as follows:

Balance at Beginning of Period	(Credited to Income)	Balance at End of Period
--------------------------------------	-------------------------	-----------------------------

Edgar Filing: Fabrinet - Form 10-Q

Three months ended September 27, 2013	\$ 109	\$ (53)	\$ 56
Three months ended September 28, 2012	\$ 203	\$ (49)	\$ 154

Table of Contents**6. Inventory**

	September 27, 2013	June 28, 2013
Raw materials	\$ 26,199	\$ 34,572
Work in progress	53,511	43,806
Finished goods	9,561	7,342
Goods in transit	7,374	5,359
	96,645	91,079
<u>Less</u> Inventory obsolescence	(2,117)	(2,117)
Inventory, net	\$ 94,528	\$ 88,962

7. Intangibles

The following tables present details of the Company's intangibles:

	September 27, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net
Software	\$ 3,458	\$ (3,322)	\$ 136
Total intangibles	\$ 3,458	\$ (3,322)	\$ 136

	June 28, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net
Software	\$ 3,458	\$ (3,294)	\$ 164
Total intangibles	\$ 3,458	\$ (3,294)	\$ 164

The Company recorded amortization expense relating to intangibles of \$28 and \$75 for the three months ended September 27, 2013 and September 28, 2012, respectively.

Based on the carrying amount of intangibles as of September 27, 2013, and assuming no future impairment of the underlying assets, the estimated future amortization at the end of each fiscal year below is as follows:

2014	\$ 65
2015	64
2016	5
2017	2
Total amortization	\$ 136

8. Borrowings

Bank borrowings and long-term debt was comprised of the following:

	September 27, 2013	June 28, 2013
Long-term loans from bank	\$ 26,494	\$ 28,911
Total borrowings	\$ 26,494	\$ 28,911
<i>Long-term loans from bank consisted of:</i>		
Current portion	\$ 9,668	\$ 9,668
Non-current portion	16,826	19,243

Table of Contents

As of September 27, 2013 and June 28, 2013, the Company had outstanding borrowings under long-term loan agreements with banks totaling \$26,494 and \$28,911, respectively, which consisted of:

Contract No.	Amount		Interest Rate Per Annum (%)	Conditions	Repayment Term
	September 27, 2013	June 28, 2013			
1	\$ 21,000	\$ 22,500	LIBOR + 2.8% per annum	Repayable in quarterly installments within 6 years	June 2012 to March 2017
2	5,494	6,411	SIBOR + 1.5% per annum	Repayable in quarterly installments within 8 years	May 2009 to February 2015
Total	\$ 26,494	\$ 28,911			

Certain of the long-term loans are secured by certain property, plant and equipment. The carrying amount of assets secured and pledged as collateral was \$21,577 and \$21,815 as of September 27, 2013 and June 28, 2013, respectively. The carrying amounts of borrowings approximate their fair value.

The long-term loans prescribe maximum ratios of debt to equity and minimum levels of debt service coverage ratios. As of September 27, 2013 and June 28, 2013, the Company was in compliance with its long-term loan agreements. In addition to financial ratios, certain of the Company's packing credits and long-term loans include customary events of default.

The movements of long-term loans were as follows for the three months ended September 27, 2013 and September 28, 2012:

	Three Months Ended	
	September 27, 2013	September 28, 2012
Opening net book amount	\$ 28,911	\$ 38,579
Repayment during the period	(2,417)	(2,417)
Closing net book amount	\$ 26,494	\$ 36,162

As of September 27, 2013, future maturities of long-term debt were as follows at the end of each fiscal year below:

2014	\$ 7,251
2015	8,743
2016	6,000
2017	4,500
Total	\$ 26,494

Credit facilities:

Undrawn available credit facilities as of September 27, 2013 and June 28, 2013 totaled:

Edgar Filing: Fabrinet - Form 10-Q

	September 27, 2013	June 28, 2013
Bank borrowings:		
Short-term loans	\$ 5,443	\$ 5,461

9. Income taxes

As of September 27, 2013, the liability for uncertain tax positions including accrued interest and penalties increased to \$1,871 (June 28, 2013: \$1,835). The Company expects the estimated amount of liability associated with its uncertain tax positions to decrease within the next 12 months due to the lapse of the applicable statute of limitations in foreign tax jurisdictions.

The Company files income tax returns in the U.S. and foreign tax jurisdictions. The tax years from 2009 to 2013 remain open to examination by U.S. federal and state tax authorities, and foreign tax authorities. The Company's income tax is recognized based on the best estimate of the expected annual effective tax rate for the full financial year of each entity in the Company, adjusted for discrete items arising in that quarter. If the Company's estimated annual effective tax rate changes, the Company makes a cumulative adjustment in that quarter.

Table of Contents

The effective tax rate for the Company for the three months ended September 27, 2013 and September 28, 2012 was 3.9% and 6.1% of net income, respectively. The decrease in effective tax rate for the three months ended September 27, 2013 was primarily due to the absence of additional reserves for uncertain tax positions for the three months ended September 27, 2013 as compared to \$183 of additional reserves for uncertain tax positions for the three months ended September 28, 2012.

10. Share-based compensation***Share-based compensation***

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

The effect of recording share-based compensation expense for the three months ended September 27, 2013 and September 28, 2012 was as follows:

	Three Months Ended	
	September 27, 2013	September 28, 2012
Share-based compensation expense by type of award:		
Share options	\$ 298	\$ 643
Restricted share units	1,265	611
 Total share-based compensation expense	 1,563	 1,254
Tax effect on share-based compensation expense		
 Net effect on share-based compensation expense	 \$ 1,563	 \$ 1,254

Share-based compensation expense was recorded in the condensed consolidated statements of operations as follows: cost of revenues of \$307 and \$345 for the three months ended September 27, 2013 and September 28, 2012, respectively; and SG&A expenses of \$1,256 and \$909 for the three months ended September 27, 2013 and September 28, 2012, respectively. The Company did not capitalize any share-based compensation expense as part of any asset costs during the three months ended September 27, 2013 and September 28, 2012.

Share-based award activity

Share options have been granted to directors and employees. As of September 27, 2013, there were 93,807 share options outstanding under the Amended and Restated 1999 Share Option Plan (the "1999 Plan"). Additional option grants may not be made under the 1999 Plan.

On March 12, 2010, Fabrinet's shareholders adopted the 2010 Performance Incentive Plan (the "2010 Plan"). On December 20, 2010 and December 20, 2012, Fabrinet's shareholders adopted amendments to the 2010 Plan to increase the number of ordinary shares authorized for issuance under the 2010 Plan by 500,000 and 3,700,000 shares, respectively. A total of 5,700,000 ordinary shares are authorized for issuance under the 2010 Plan, plus any shares subject to share options under the 1999 Plan outstanding as of June 24, 2010, that expire, are canceled or terminate after such date. As of September 27, 2013, there were an aggregate of 1,149,286 share options outstanding, 853,784 restricted share units outstanding, and 3,478,859 ordinary shares available for future grant under the 2010 Plan.

Share options

Fabrinet's board of directors has the authority to determine the type of option and the number of shares subject to an option. Options generally vest and become exercisable over four years and expire, if not exercised, within 7 years of the grant date. In the case of a grantee's first grant, 25 percent of the underlying shares subject to an option vest 12 months after the vesting commencement date and 1/48 of the underlying shares vest

Edgar Filing: Fabrinet - Form 10-Q

monthly over each of the subsequent 36 months. In the case of any additional grants to a grantee, 1/48 of the underlying shares subject to an option vest monthly over four years, commencing one month after the vesting commencement date.

Table of Contents

The following summarizes share option activity under the 1999 Plan:

	Number of Shares Underlying Options		Weighted-Average Exercise Price Per Share	
	Three Months Ended September 27, 2013	Three Months Ended September 28, 2012	Three Months Ended September 27, 2013	Three Months Ended September 28, 2012
Shares underlying options outstanding at beginning of the period	104,078	189,540	\$ 5.38	\$ 5.18
Granted				
Exercised	(8,871)*	(25,408)	5.02	4.90
Forfeited				
Expired	(1,400)		5.50	
Shares underlying options outstanding at end of the period	93,807	164,132	\$ 5.41	\$ 5.23
Shares underlying options exercisable at end of the period	87,087	120,270	\$ 5.38	\$ 5.03

* Included in the exercised number are 308 shares options exercised on September 26, 2013, but not settled as of September 27, 2013. The following summarizes information for share options outstanding as of September 27, 2013 under the 1999 Plan:

	Number of Shares Underlying Options	Exercise Price Per Share	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
	10,120	\$ 3.50	0.26	
	1,125	4.25	0.92	
	1,101	4.75	1.17	
	6,624	5.00	1.38	
	2,280	5.25	1.61	
	2,050	5.50	1.92	
	69,907	5.75	3.12	
	600	6.25	3.61	
Options outstanding	93,807		2.58	\$ 999
Options exercisable	87,087		2.53	\$ 930

As of September 27, 2013, \$1 of estimated share-based compensation expense related to share options under the 1999 Plan remains to be recorded. That cost is expected to be recorded over an estimated amortization period of 0.27 years.

The following summarizes share option activity under the 2010 Plan:

	Number of Shares Underlying Options	Weighted-Average Exercise Price Per Share
--	-------------------------------------	---

Edgar Filing: Fabrinet - Form 10-Q

	Three Months Ended		Three Months Ended	
	September 27, 2013	September 28, 2012	September 27, 2013	September 28, 2012
Shares underlying options outstanding at beginning of the period	1,173,233	1,280,750	\$ 16.25	\$ 16.32
Granted				
Exercised				
Forfeited	(1,902)	(5,983)	16.16	16.39
Expired	(22,045)	(36,890)	17.44	16.63
Shares underlying options outstanding at end of the period	1,149,286	1,237,877	\$ 16.23	\$ 16.31
Shares underlying options exercisable at end of the period	713,515	456,477	\$ 16.40	\$ 16.53

Table of Contents

The following summarizes information for share options outstanding as of September 27, 2013 under the 2010 Plan:

	Number of Shares Underlying Options	Exercise Price Per Share	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
	40,000	\$ 13.77	3.90	
	576,677	16.83	4.05	
	30,000	15.05	4.10	
	28,344	25.50	4.30	
	7,400	26.16	4.35	
	10,400	23.62	4.60	
	168,824	15.16	4.89	
	251,231	14.12	5.12	
	27,560	19.36	5.37	
	5,550	18.60	5.42	
	3,300	12.83	5.62	
Options outstanding	1,149,286		4.46	\$ 772
Options exercisable	713,515		4.36	\$ 395

As of September 27, 2013, \$613 of estimated share-based compensation expense related to share options under the 2010 Plan remains to be recorded. That cost is expected to be recorded over an estimated amortization period of 1.69 years.

Restricted share units

Restricted share units are one type of share-based award that may be granted under the 2010 Plan. Restricted share units granted to non-employee directors generally cliff vest 100% on the first of January, following the next annual meeting of shareholders, approximately 1 year from the grant date, provided the director continues to serve through such date. Restricted share units granted to employees generally vest in 4 equal installments over 4 years on each anniversary of the vesting commencement date.

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

	Number of Shares Underlying Restricted Share Units Three Months Ended		Weighted-Average Grant Date Fair Value Per Share Three Months Ended	
	September 27, 2013	September 28, 2012	September 27, 2013	September 28, 2012
Unvested balance at beginning of the period	545,668	168,275	\$ 12.81	\$ 14.44
Granted	407,698	239,881	14.76	12.53
Issued	(96,077)		12.26	
Forfeited	(3,505)		14.04	
Unvested balance at end of the period	853,784	408,156	\$ 13.80	\$ 13.32

As of September 27, 2013, \$7,598 of estimated share-based compensation expense related to restricted share units under the 2010 Plan remains to be recorded. That cost is expected to be recorded over an estimated amortization period of 3.44 years.

Edgar Filing: Fabrinet - Form 10-Q

For the three months ended September 27, 2013, the Company withheld an aggregate of 5,916 shares upon the vesting of restricted share units, based upon the closing share price on the vesting date to settle the employees' minimum statutory obligation for the applicable income and other employment taxes. The Company then remitted cash of \$90 to the appropriate taxing authorities, and presented it in a financing activity within the condensed consolidated statements of cash flows. The payment had the effect on shares issued by the Company as it reduced the number of shares that would have been issued on the vesting date and was recorded as a reduction of additional paid-in capital.

Table of Contents**11. Shareholders equity***Share capital*

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

For the three months ended September 27, 2013, Fabrinet issued 8,563 ordinary shares upon the exercise of options, for cash consideration at a weighted average exercise price of \$4.99 per share, and 90,161 ordinary shares upon the vesting of restricted share units, net of shares withheld.

For the three months ended September 28, 2012, Fabrinet issued 25,408 ordinary shares upon the exercise of options, for cash consideration at a weighted average exercise price of \$4.90 per share.

All such issued shares are fully paid.

12. Commitments and contingencies*Bank guarantees*

As of September 27, 2013 and June 28, 2013, there were outstanding bank guarantees given by banks on behalf of Fabrinet Thailand for electricity usage and other normal business amounting to \$335 and \$336, respectively.

Operating lease commitments

The Company leases a portion of certain land and buildings for its facilities in China and New Jersey, under operating lease arrangements that expire in various calendar years through 2020. Rental expense under these operating leases amounted to \$209 and \$194 for the three months ended September 27, 2013 and September 28, 2012, respectively.

As of September 27, 2013, the future minimum lease payments due under non-cancelable leases were as follows at the end of each fiscal year below:

2014	629
2015	838
2016	792
2017	777
2018	777
Thereafter	683
Total minimum operating lease payments	\$ 4,496

Purchase obligations

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

As of September 27, 2013, there were no outstanding capital expenditure commitments.

Indemnification of directors and officers

Edgar Filing: Fabrinet - Form 10-Q

Cayman Islands law does not limit the extent to which a company's memorandum and articles of association may provide for indemnification of directors and officers, except to the extent any such provision may be held by the Cayman Islands courts to be contrary to public policy, such as to provide indemnification against civil fraud or the

Table of Contents

consequences of committing a crime. Fabrinet's amended and restated memorandum and articles of association provide for indemnification of directors and officers for actions, costs, charges, losses, damages and expenses incurred in their capacities as such, except that such indemnification does not extend to any matter in respect of any fraud or dishonesty that may attach to any of them.

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

13. Business segments and geographic information

Operating segments are defined as components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is Fabrinet's chief executive officer. As of September 27, 2013, the Company operated and internally managed a single operating segment. Accordingly, the Company does not accumulate discrete information with respect to separate product lines and does not have separate reportable segments.

The Company operates primarily in three geographic regions: North America, Asia-Pacific and Europe. The following tables present total revenues by geographic regions:

	Three Months Ended	
	September 27, 2013	September 28, 2012
North America	\$ 78,797	\$ 71,090
Asia-Pacific	57,996	55,345
Europe	34,758	32,190
	\$ 171,551	\$ 158,625

Total revenues are attributed to a particular geographic area based on the bill-to location of the customer. As of September 27, 2013, the Company had approximately \$354 of long-lived assets based in North America, with the substantial remainder of assets based in Asia-Pacific.

14. Income related to flooding

The Company suspended production at all of its manufacturing facilities in Thailand from October 17, 2011 through November 14, 2011 because of severe flooding in Thailand. The Company never resumed, and has permanently ceased, production at its Chokchai facility. For the three months ended September 27, 2013 and September 28, 2012, the Company recognized income related to flooding of \$6,597 and \$4,820, respectively, which consisted of insurance proceeds. Although the Company has submitted all five of its claims for losses, four of which have been settled, the Company expects that it will take some additional time to reach final settlement with its insurers of the remaining equipment claim. Despite the Company's diligent efforts to file and settle its claims, there are many reasons one claim is still pending more than 21 months after the flooding, including the extent of the losses filed in Thailand and the complicated nature of the Company's pending claim, which includes owned and consigned property. The Company will continue to aggressively pursue its pending claim to achieve a timely resolution.

In the three months ended September 27, 2013, the Company received from its insurers an interim payment of \$6,597 against the Company's claim for owned and customer-owned inventory losses. In the three months ended September 28, 2012, the Company received from its insurers a full and final payment of \$79 against the Company's claim for damage to its building at Pinehurst and an interim payment of \$4,741 against the Company's claim for business interruption losses. The Company will continue to recognize insurance recoveries if and when they become realizable and probable.

A number of exclusions and limitations in the Company's policies (such as coinsurance, facilities location sub-limits and policy covenants) may reduce the aggregate amount the Company ultimately recovers for its losses from its insurers. In addition, the Company's insurers could reject the

Edgar Filing: Fabrinet - Form 10-Q

valuation methodologies the Company has used to estimate certain of its losses, in whole or in part, and apply different valuation methodologies, which could also reduce the Company's aggregate recovery amount for the remaining equipment claim. The Company believes that it will ultimately recover a majority of its losses.

Table of Contents

During the three months ended September 27, 2013, the Company fulfilled its obligations to a customer in accordance with the settlement agreement entered into during the third quarter of fiscal 2013 by making a final cash payment to such customer of \$3,750 and by transferring equipment, with an aggregate value of \$2,290, to such customer. Accordingly, the Company's liability to such customer for any and all flood-related losses has been satisfied in full. Also, during the three months ended September 27, 2013, the Company fulfilled its obligations to a customer's insurers in accordance with the settlement agreement entered into during the fourth quarter of fiscal 2013 by making a final payment of \$2,167. Accordingly, the Company's liability to such insurer for damages to customer-owned inventory, which occurred during the flooding, has been satisfied in full. The Company also entered into other flood-related settlements of \$47 during the three months ended September 27, 2013.

During the three months ended September 28, 2012, the Company entered into a settlement agreement with one of its customers regarding the Company's liability for the customer's losses as a result of the flooding and made an initial payment to such customer of \$4,000.

15. Subsequent events

In the first week of October 2013, the Company authorized a customer to return a number of units of its product manufactured at our Pinehurst facility due to functional failure. After investigation, the Company found that the affected products were produced during the first quarter of fiscal 2014. While this may cause the Company to incur certain costs and expenses, the Company is still working with the customer to determine the extent and impact of the product failures. Accordingly, at the issuance date of these unaudited condensed financial statements, the Company cannot accurately estimate the costs and expenses that it may incur as a result of the product failures.

Table of Contents

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

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

our goals and strategies;

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

our expectation that the portion of our future revenues attributable to customers in regions outside of North America will remain flat as compared to the portion of our revenues that came from customers in regions outside of North America during the first quarter of fiscal 2014;

our expectation that we will incur significant incremental costs of revenue as a result of our continued diversification into the industrial lasers and sensors markets and other end-markets outside of the optical communications market or our further development of customized optics and glass manufacturing capabilities;

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

our expectation that our fiscal 2014 SG&A expenses will increase on an absolute dollar basis and remain flat as a percentage of revenue compared to fiscal 2013;

our expectation that, other than incremental costs associated with growing our business generally, we will not incur material incremental SG&A expenses as a result of our continued diversification into the industrial lasers and sensors markets and other end-markets outside of the optical communications market or our further development of customized optics and glass manufacturing capabilities;

our expectation that our employee costs will increase in Thailand and the PRC;

our future capital expenditures and our needs for additional financing;

expansion of our manufacturing capacity, including into new geographies;

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

Edgar Filing: Fabrinet - Form 10-Q

our ability and our customers' and suppliers' ability to respond successfully to technological or industry developments;

our suppliers' estimates regarding future costs;

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

our plans to diversify our sources of revenues;

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

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

the impact that the October and November 2011 flooding in Thailand may continue to have on our business, results of operations and liquidity, including our ability to recover amounts from our insurance carriers; and

competition in our existing and new markets.

Table of Contents

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

Overview

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

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

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

Thailand Flooding

We suspended production at all of our manufacturing facilities in Thailand from October 17, 2011 through November 14, 2011 because of severe flooding in Thailand. We never resumed, and have permanently ceased, production at our Chokchai facility.

Although we have submitted all five of our claims for losses, four of which have been settled, we expect that it will take some additional time to reach final settlement with our insurers of the remaining equipment claim. Despite our diligent efforts to file and settle our claims, there are many reasons one claim is still pending more than 21 months after the flooding, including the extent of the losses filed in Thailand and the complicated nature of the pending claim, which includes owned and consigned property. We will continue to aggressively pursue our pending claim to achieve a timely resolution.

In the three months ended September 27, 2013, we received from our insurers an interim payment of \$6.6 million against our claim for owned and customer-owned inventory losses. In the three months ended September 28, 2012, we received from our insurers a full and final payment of \$0.1 million against our claim for damage to our building at Pinehurst and an interim payment of \$4.7 million against our claim for business interruption losses. We will continue to recognize insurance recoveries if and when they become realizable and probable.

A number of exclusions and limitations in our policies (such as coinsurance, facilities location sub-limits and policy covenants) may reduce the aggregate amount that we ultimately recover for our losses from our insurers. In addition, our insurers could reject the valuation methodologies we have used to estimate certain of our losses, in whole or in part, and apply different valuation methodologies, which could also reduce our aggregate recovery amount for the remaining equipment claim. We believe that we will ultimately recover a majority of our losses.

During the three months ended September 27, 2013, we fulfilled our obligations to a customer in accordance with the settlement agreement entered into during the third quarter of fiscal 2013 by making a final cash payment to such customer of \$3.8 million and by transferring equipment, with an aggregate value of \$2.3 million, to such customer. Accordingly, our liability to such customer for any and all flood-related losses has been satisfied in full. Also, during the three months ended September 27, 2013, we fulfilled our obligations to a customer's insurers in accordance with the settlement agreement.

Table of Contents

entered into during the fourth quarter of fiscal 2013 by making a final payment of \$2.2 million. Accordingly, our liability to such insurer for damages to customer-owned inventory, which occurred during the flooding, has been satisfied in full. We also entered into other flood-related settlements of \$0.05 million during the three months ended September 27, 2013.

During the three months ended September 28, 2012, we entered into a settlement agreement with one of our customers regarding our liability for the customer's losses as a result of the flooding and made an initial payment to such customer of \$4.0 million.

Revenues

Our total revenues increased by \$12.9 million, or 8.1%, to \$171.6 million for the three months ended September 27, 2013, as compared to \$158.6 million for the three months ended September 28, 2012. This increase was primarily due to an increase in customer demand for our optical communications manufacturing services during the three months ended September 27, 2013.

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

Revenues by Geography

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

The percentage of our revenues generated from the bill-to location outside of North America decreased from 55.2% in the three months ended September 28, 2012 to 54.1% in the three months ended September 27, 2013, primarily as a result of a decrease in sales volume attributable to our customers in regions outside of North America. We expect that the portion of our future revenues attributable to customers in regions outside North America will remain flat as compared to the first quarter of fiscal 2014.

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

	Three Months Ended	
	September 27, 2013	September 28, 2012
North America	45.9%	44.8%
Asia-Pacific	33.8	34.9
Europe	20.3	20.3
	100.0%	100.0%

Our Contracts

We enter into supply agreements with our customers that generally have an initial term of up to three years, subject to automatic renewals for subsequent one-year terms unless expressly terminated. Although there are no minimum purchase requirements in our supply agreements, our customers do provide us with rolling forecasts of their demand requirements. Our supply agreements generally include provisions for pricing and periodic review of pricing, consignment of our customer's unique production equipment to us and the sharing of benefits from cost-savings derived from our efforts. We are generally required to purchase materials, which may include long lead-time materials and materials that are subject to minimum order quantities and/or non-cancelable or non-returnable terms, to meet the stated demands of our customers. After procuring materials, we manufacture products for our customers based on purchase orders that contain terms regarding product quantities, delivery locations and delivery dates. Our customers generally are obligated to purchase finished goods that we have manufactured according to

their demand requirements. Materials that are not consumed by our

Table of Contents

customers within a specified period of time, or are no longer required due to a product's cancellation or end-of-life, are typically designated as excess or obsolete inventory under our contracts. Once materials are designated as either excess or obsolete inventory, our customers are typically required to purchase such inventory from us even if they have chosen to cancel production of the related products.

Cost of Revenues

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

A second significant element of our cost of revenues is employee costs, including: indirect employee costs related to design, configuration and optimization of manufacturing processes for our customers, quality testing, materials testing and other engineering services; and direct costs related to our manufacturing employees. Direct employee costs include employee salaries, insurance and benefits, merit-based bonuses, recruitment, training and retention. Historically, our employee costs have increased primarily due to increases in the number of employees necessary to support our growth and, to a lesser extent, costs to recruit, train and retain employees. Salary levels in Thailand and the PRC, the fluctuation of the Thai baht and RMB against our functional currency, the U.S. dollar, and our ability to retain our employees significantly impact our cost of revenues. We expect our employee costs to increase as wages continue to increase in Thailand and the PRC. For example, effective April 1, 2012, the Thai government increased minimum daily wages from 215 Thai baht to 300 Thai baht. Wage increases may impact our ability to sustain our competitive advantage and may reduce our profit margin. We seek to mitigate these cost increases through improvements in employee productivity, employee retention and asset utilization.

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

During the three months ended September 27, 2013, discretionary merit-based bonus awards were available to our non-executive employees. Charges included in cost of revenues for bonus distributions to non-executive employees were \$0.6 million and \$0.5 million for the three months ended September 27, 2013 and September 28, 2012, respectively.

Share-based compensation expense included in cost of revenues was \$0.3 million and \$0.3 million for the three months ended September 27, 2013 and September 28, 2012, respectively.

We expect to incur significant incremental costs of revenue as a result of our continued diversification into the industrial lasers and sensors markets and other end-markets outside of the optical communications market or our further development of customized optics and glass manufacturing capabilities. We also expect to incur incremental costs of revenue as a result of our planned expansion into new geographic markets, though we are not able to determine the amount of these incremental expenses.

Selling, General and Administrative Expenses

Our selling, general and administrative expenses, or SG&A expenses, primarily consist of corporate employee costs for sales and marketing, general and administrative and other support personnel, including research and development expenses related to the design of customized optics and glass, travel expenses, legal and other professional fees, share-based compensation expense, and other general expenses not related to cost of revenues. In fiscal 2014, we expect our SG&A expenses will increase on an absolute dollar basis and remain flat as a percentage of revenue compared to fiscal 2013.

The compensation committee of our board of directors approved a fiscal 2014 executive incentive plan with quantitative objectives, based on achieving certain revenue and gross margin percentage targets for our fiscal year ending June 27, 2014, as well as qualitative objectives, based on achieving individual performance goals. Bonuses under our fiscal 2014 executive incentive plan are payable after the end of fiscal 2014. In fiscal 2013, the compensation committee approved a fiscal 2013 executive incentive plan with quantitative objectives, based on achieving certain revenue and earnings per share targets for our fiscal year ended June 28, 2013. No bonuses were earned under our fiscal 2013 executive incentive plan. However, the compensation committee awarded discretionary bonuses to our executive employees in the three months ended September 27, 2013.

Table of Contents

Charges included in SG&A expenses for bonus distributions to non-executive and executive employees were \$0.8 million and \$0.5 million for the three months ended September 27, 2013 and September 28, 2012, respectively.

Share-based compensation expense included in SG&A expenses was \$1.3 million and \$0.9 million for the three months ended September 27, 2013 and September 28, 2012, respectively.

Other than incremental costs associated with growing our business generally, we do not expect to incur material incremental SG&A expenses as a result of our planned expansion into new geographic markets, our continued diversification into the industrial lasers and sensors markets and other end-markets outside of the optical communications market or our further development of customized optics and glass manufacturing capabilities.

Additional Financial Disclosures

Foreign Exchange

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

In addition, we are exposed to foreign exchange risk in connection with the credit facility and cross currency swap arrangements we entered into with TMB Bank Public Company Limited (the Bank) in May 2011 for the construction of Pinehurst Building 6. The terms of the contract with the Bank provide the following facilities: (1) a term loan facility for up to Thai baht 960 million (equal to \$30.0 million) with a fixed interest rate of 5.28% per annum, (2) a hedging facility for currency interest rate swaps with a notional amount of \$30.0 million, and (3) a settlement limit of Thai baht 65 million, subject to certain terms and conditions as set forth therein. As of March 30, 2012, we had drawn down the entire \$30.0 million available under the term loan facility. Borrowings and interest under the term loan are scheduled to be repaid on a quarterly basis between September 2011 and March 2017. As of September 27, 2013, we had outstanding borrowings under the term loan facility of \$21.0 million. Under the terms of the cross currency swap arrangement, amounts drawn in Thai baht were converted to U.S. dollars for repayment by us on a quarterly basis at the floating rate of 3-month U.S. LIBOR plus 2.8% per annum.

In order to manage the risks arising from fluctuations in foreign currency exchange rates, we use derivative financial instruments. We may enter into short-term forward foreign currency contracts or put option contracts to help manage currency exposures associated with certain assets and liabilities, primarily short-term obligations. The forward exchange contracts have generally ranged from one to six months in original maturity, and no forward exchange contract has had an original maturity greater than one year. All foreign currency exchange contracts are recognized on the balance sheet at fair value. As we do not apply hedge accounting to these instruments, the derivatives are recorded at fair value through earnings. The gains and losses on our forward contracts generally offset losses and gains on the assets, liabilities and transactions economically hedged and, accordingly, generally do not subject us to the risk of significant accounting losses.

Table of Contents

As of September 27, 2013 and June 28, 2013, we had outstanding foreign currency assets and liabilities in Thai baht and RMB as follows:

	September 27, 2013			June 28, 2013		
	Currency	\$	%	Currency	\$	%
(in thousands, except percentages)						
Assets						
Thai baht	949,868	30,415	64.5	567,561	18,232	51.6
RMB	103,155	16,774	35.5	105,680	17,104	48.4
		47,189	100.0		35,336	100.0
Liabilities						
Thai baht	673,375	21,562	84.9	585,364	18,804	88.4
RMB	23,548	3,829	15.1	15,308	2,478	11.6
		25,391	100.0		21,282	100.0

The Thai baht assets represent cash and cash equivalents, trade accounts receivable, deposits and other current assets. The Thai baht liabilities represent trade accounts payable, accrued expenses and other payables. We manage our exposure to fluctuations in foreign exchange rates by the use of foreign currency contracts and offsetting assets and liabilities denominated in the same currency in accordance with management's policy. As of September 27, 2013, there were \$14.0 million in selling forward contracts and \$14.0 million in put option contracts outstanding on the Thai baht payables and as of June 28, 2013, there were \$23.0 million in selling forward contracts and \$5.0 million in put option contracts outstanding on the Thai baht payables.

The RMB assets represent cash and cash equivalents, accounts receivable and other current assets. The RMB liabilities represent trade accounts payable, accrued expenses and other payables. As of September 27, 2013 and June 28, 2013, we did not have any selling RMB to U.S. dollar forward contracts.

As of September 27, 2013 and June 28, 2013, unrealized gain from the fair market value of derivatives amounted to \$0.4 million and \$0.8 million, respectively.

Currency Regulation and Dividend Distribution

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

Foreign Currency Administration Rules, as amended on August 5, 2008, or the Exchange Rules;

Administration Rules of the Settlement, Sale and Payment of Foreign Exchange (1996), or the Administration Rules; and

Notice on Perfecting Practices Concerning Foreign Exchange Settlement Regarding the Capital Contribution by Foreign-invested Enterprises, as promulgated by the State Administration of Foreign Exchange, or SAFE, on August 29, 2008, or Circular 142.

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

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

Edgar Filing: Fabrinet - Form 10-Q

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

Table of Contents

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

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

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

Income Tax

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

Throughout the period of our operations in Thailand, we have generally received income tax and other incentives from the Thailand Board of Investment. Preferential tax treatment from the Thai government in the form of a corporate tax exemption is currently available to us from July 2010 through June 2015 on income generated from the manufacture of products at Pinehurst Building 5, and from July 2012 through June 2020 on income generated from the manufacture of products at Pinehurst Building 6. Such preferential tax treatment is contingent on, among other things, the export of our customers' products out of Thailand and our agreement not to move our manufacturing facilities out of our current province in Thailand for at least 15 years. In addition, in December 2011, the Thailand Revenue Department announced a reduction in corporate income tax rates for tax periods beginning on or after January 1, 2012. As a result of the announcement, corporate income tax rates for our Thai subsidiary will be reduced from 30% in fiscal 2012 to 23%, 20% and 20% in fiscal 2013, fiscal 2014 and fiscal 2015, respectively.

Our subsidiary in China has been granted a tax privilege to reduce its corporate income tax rate from 25% to 15%. This privilege is retroactive to January 1, 2011 and valid until December 31, 2013, subject to renewal at the end of each three-year period. Presently, we are preparing an application to renew this tax privilege and plan to submit it upon expiration of the existing tax privilege.

Critical Accounting Policies and Use of Estimates

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

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the fiscal year ended June 28, 2013. There were no material changes to our critical accounting policies during the three months ended September 27, 2013.

Table of Contents**Results of Operations**

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

	Three Months Ended	
	September 27, 2013	September 28, 2012
	(in thousands)	
Revenues	\$ 171,551	\$ 158,625
Cost of revenues	(152,906)	(140,903)
Gross profit	18,645	17,722
Selling, general and administrative expenses	(6,694)	(5,859)
Income related to flooding	6,597	4,820
Operating income	18,548	16,683
Interest income	364	188
Interest expense	(206)	(286)
Foreign exchange gain, net	1,088	277
Other income	184	190
Income before income taxes	19,978	17,052
Income tax expense	(781)	(1,033)
Net income	\$ 19,197	\$ 16,019

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

	Three Months Ended	
	September 27, 2013	September 28, 2012
Revenues	100.0%	100.0%
Cost of revenues	(89.1)	(88.8)
Gross profit	10.9	11.2
Selling, general and administrative expenses	(3.9)	(3.7)
Income related to flooding	3.8	3.0
Operating income	10.8	10.5
Interest income	0.2	0.1
Interest expense	(0.1)	(0.2)
Foreign exchange gain, net	0.6	0.2
Other income	0.1	0.1
Income before income taxes	11.6	10.7
Income tax expense	(0.5)	(0.6)
Net income	11.2%	10.1%

Edgar Filing: Fabrinet - Form 10-Q

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

	Three Months Ended	
	September 27, 2013	September 28, 2012
	(in thousands)	
Optical communications	\$ 124,528	\$ 109,589
Lasers, sensors and other	47,023	49,036
Total	\$ 171,551	\$ 158,625

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

Table of Contents***Comparison of Three Months Ended September 27, 2013 to Three Months Ended September 28, 2012***

Total revenues. Our total revenues increased by \$12.9 million, or 8.1%, to \$171.6 million for the three months ended September 27, 2013, as compared to \$158.6 million for the three months ended September 28, 2012. This increase was primarily due to an increase in customer demand for our optical communications manufacturing services during the three months ended September 27, 2013. Revenues from optical communications products represented 72.6% of our total revenues for the three months ended September 27, 2013, as compared to 69.1% for the three months ended September 28, 2012.

Cost of revenues. Our cost of revenues increased by \$12.0 million, or 8.5%, to \$152.9 million, or 89.1% of total revenues, for the three months ended September 27, 2013, as compared to \$140.9 million, or 88.8% of total revenues, for the three months ended September 28, 2012. This increase was primarily due to an increase in revenues during the three months ended September 27, 2013. Cost of revenues also included share-based compensation expense of \$0.3 million for the three months ended September 27, 2013, as compared to \$0.3 million for the three months ended September 28, 2012.

Gross profit. Our gross profit increased by \$0.9 million, or 5.2%, to \$18.6 million, or 10.9% of total revenues, for the three months ended September 27, 2013, as compared to \$17.7 million, or 11.2% of total revenues, for the three months ended September 28, 2012. The increase in absolute dollars was primarily related to an increase in revenues during the three months ended September 27, 2013.

SG&A expenses. Our SG&A expenses increased by \$0.8 million, or 14.3%, to \$6.7 million, or 3.9% of total revenues, for the three months ended September 27, 2013, as compared to \$5.9 million, or 3.7% of total revenues, for the three months ended September 28, 2012. Our SG&A expenses increased in absolute dollars and as a percentage of revenues due primarily to a \$0.2 million increase in accrued executive bonuses for the three months ended September 27, 2013, as compared to the three months ended September 28, 2012, the recognition of expenses in connection with our effort to grow our business of \$0.1 million for the three months ended September 27, 2013, and a \$0.1 million increase in business development and research and development spending for the three months ended September 27, 2013, as compared to the three months ended September 28, 2012. We also recorded share-based compensation charges of \$1.3 million for the three months ended September 27, 2013, as compared to \$0.9 million for the three months ended September 28, 2012.

Income related to flooding. In the three months ended September 28, 2013, we recognized \$6.6 million of income related to flooding which consisted of an interim payment from our insurers against our claim for owned and customer-owned inventory losses. In the three months ended September 28, 2012, we recognized \$4.8 million of income related to flooding, which consisted of a payment of \$0.1 million from our insurers in full and final settlement of our claim for damage to our buildings at Pinehurst and an interim payment of \$4.7 million from our insurers against our claim for business interruption losses.

Operating income. Our operating income increased by \$1.9 million to \$18.5 million, or 10.8% of total revenues, for the three months ended September 27, 2013, as compared to \$16.7 million, or 10.5% of total revenues, for the three months ended September 28, 2012.

Interest income. Our interest income increased by \$0.2 million to \$0.4 million for the three months ended September 27, 2013, as compared to \$0.2 million for the three months ended September 28, 2012. This increase was due to increase in cash and cash equivalent balances and an increase in interest rates.

Interest expense. Our interest expense decreased by \$0.1 million to \$0.2 million for the three months ended September 27, 2013, as compared to \$0.3 million for the three months ended September 28, 2012. This decrease was due to repayment of long-term loan balances during the period.

Income before income taxes. We recorded income before income taxes of \$20.0 million for the three months ended September 27, 2013, as compared to income before income taxes of \$17.1 million for the three months ended September 28, 2012.

Income tax expense. Our provision for income tax reflects an effective tax rate of 3.9% for the three months ended September 27, 2013, as compared to an effective tax rate of 6.1% for the three months ended September 28, 2012. The decrease in effective tax rate for the three months ended September 27, 2013 was primarily due to the absence of additional reserves for uncertain tax positions for the three months ended September 27, 2013, as compared to \$183 of additional reserves for uncertain tax positions for the three months ended September 28, 2012.

Table of Contents

Net income. We recorded net income of \$19.2 million, or 11.2% of total revenues, for the three months ended September 27, 2013, as compared to \$16.0 million, or 10.1% of total revenues, for the three months ended September 28, 2012.

Liquidity and Capital Resources

Cash Flows and Working Capital

We have primarily financed our operations through cash flow from operations. As of September 27, 2013, we had approximately \$163.9 million in cash and cash equivalents and approximately \$26.5 million of outstanding debt. As of September 28, 2012, we had approximately \$115.4 million in cash and cash equivalents and approximately \$36.2 million of outstanding debt.

Our cash and cash equivalents primarily consist of cash on hand, demand deposits and liquid investments with original maturities of three months or less which are placed with banks and other financial institutions. The weighted average interest rate on our cash and cash equivalents was 1.0% and 0.8%, respectively, for the three months ended September 27, 2013 and September 28, 2012, respectively.

Although our insurance premiums are reduced in fiscal 2014, we continue to pay significantly more for our property and casualty insurance for our operations in Thailand as compared to premiums paid in periods prior to the flooding.

As of September 27, 2013, we and our insurers had settled four of our five claims for flood-related losses. For the three months ended September 27, 2013, we recognized \$6.6 million of income related to flooding, which consisted of an interim payment of \$6.6 million from our insurers against our claim for owned and customer-owned inventory losses. For the three months ended September 28, 2012, we recognized \$4.8 million of income related to flooding, which consisted of a full and final payment of \$0.1 million from our insurers against our claim for damage to our building at Pinehurst and an interim payment of \$4.7 million against our claim for business interruption losses. We will continue to recognize insurance recoveries if and when they become realizable and probable.

A number of exclusions and limitations in our policies (such as coinsurance, facilities location sub-limits and policy covenants) may reduce the aggregate amount that we ultimately recover for our losses from our insurers. In addition, our insurers could reject the valuation methodologies we have used to estimate certain of our losses, in whole or in part, and apply different valuation methodologies, which could also reduce our aggregate recovery amount for the remaining equipment claim. We believe that we will ultimately recover a majority of our losses.

During the three months ended September 27, 2013, we fulfilled our obligations to a customer in accordance with the settlement agreement entered into during the third quarter of fiscal 2013 by making a final cash payment to such customer of \$3.8 million and by transferring equipment, with an aggregate value of \$2.3 million, to such customer. Accordingly, our liability to such customer for any and all flood-related losses has been satisfied in full. Also, during the three months ended September 27, 2013, we fulfilled our obligations to a customer's insurers in accordance with the settlement agreement entered into during the fourth quarter of fiscal 2013 by making a final payment of \$2.2 million. Accordingly, our liability to such insurer for damages to customer-owned inventory, which occurred during the flooding, has been satisfied in full. We also entered into other flood-related settlements of \$0.05 million during the three months ended September 27, 2013.

During the three months ended September 28, 2012, we entered into a settlement agreement with one of our customers regarding our liability for the customer's losses as a result of the flooding and made an initial payment to such customer of \$4.0 million.

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

We believe that our current manufacturing capacity is sufficient to meet anticipated production requirements for at least the next 12 months. We maintain a long-term credit facility associated with construction of production facilities at our Pinehurst campus in Thailand that will come due within the next 42 months. We anticipate that our internally generated working capital, along with our cash and cash equivalents will be adequate to repay this obligation.

Table of Contents

The following table shows our net cash provided by operating activities, net cash used in investing activities and net cash used in financing activities for the periods indicated:

	Three Months Ended	
	September 27, 2013	September 28, 2012
	(in thousands)	
Net cash provided by operating activities	\$ 18,137	\$ 5,949
Net cash used in investing activities	(1,253)	(4,047)
Net cash used in financing activities	(2,464)	(2,293)
Net increase (decrease) in cash and cash equivalents	14,420	(391)
Cash and cash equivalents, beginning of period	149,716	115,507
Cash and cash equivalents, end of period	163,860	115,394

Operating Activities

Net cash provided by operating activities increased by \$12.2 million, or 204.6%, to \$18.1 million for the three months ended September 27, 2013, as compared to net cash provided by operating activities of \$5.9 million for the three months ended September 28, 2012. This increase was primarily due to an increase in net income from operations and improvement in cash collections from customers and a decrease in cash payments to vendors.

Investing Activities

Net cash used in investing activities decreased by \$2.8 million, or 69.0%, to \$1.3 million for the three months ended September 27, 2013, as compared to \$4.0 million for the three months ended September 28, 2012. This decrease in net cash used in investing activities was primarily due to a decrease in new equipment purchases and a decrease in construction-related payables on Pinehurst Building 6 for the three months ended September 27, 2013, as compared to the three months ended September 28, 2012.

Financing Activities

Net cash used in financing activities increased by \$0.2 million, or 7.5%, to \$2.5 million for the three months ended September 27, 2013, as compared to \$2.3 million for the three months ended September 28, 2012. This increase in net cash used in financing activities was primarily due to a decrease in proceeds from employee share option exercises and an increase in payments of withholding taxes related to net share settlement of restricted share units.

Table of Contents**Off-Balance Sheet Commitments and Arrangements**

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

Recent Accounting Pronouncements

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***Interest Rate Risk***

We had cash and cash equivalents totaling \$163.9 million and \$149.7 million as of September 27, 2013 and June 28, 2013, respectively. Our exposure to interest rate risk primarily relates to the interest income generated by excess cash invested in highly liquid investments with maturities of three months or less from the original dates of purchase. The cash and cash equivalents are held for working capital purposes. We have not used derivative financial instruments in our investment portfolio. We have not been exposed nor do we anticipate being exposed to material risks due to changes in market interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates had declined by 10 basis points during the three months ended September 27, 2013 and September 28, 2012, our interest income would have decreased by approximately \$0.04 million and \$0.03 million, respectively, assuming consistent investment levels.

Interest rate risk also refers to our exposure to movements in interest rates associated with our interest bearing liabilities. The interest bearing liabilities are denominated in U.S. dollars and the interest expense is based on the Singapore Inter-Bank Offered Rate, or SIBOR, and the London Inter-Bank Offered Rate, or LIBOR, plus an additional margin, depending on the lending institution. If the SIBOR and the LIBOR had increased by 100 basis points during the three months ended September 27, 2013 and September 28, 2012, our interest expense would have increased by approximately \$0.1 million and \$0.1 million, respectively, assuming consistent borrowing levels.

Foreign Currency Risk

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

As a consequence, our gross profit margins, operating results, profitability and cash flows are adversely impacted when the dollar depreciates relative to the Thai baht or the RMB. We have a particularly significant currency rate exposure to changes in the exchange rate between the Thai baht and the U.S. dollar. We must translate foreign currency-denominated results of operations, assets and liabilities for our foreign subsidiaries to U.S. dollars in our unaudited condensed consolidated financial statements. Consequently, increases and decreases in the value of the U.S. dollar compared to such foreign currencies will affect our reported results of operations and the value of our assets and liabilities on our unaudited condensed consolidated balance sheets, even if our results of operations or the value of those assets and liabilities has not changed in its original currency. These transactions could significantly affect the comparability of our results between financial periods or result in significant changes to the carrying value of our assets, liabilities and shareholders' equity.

In addition, we are exposed to foreign exchange risk in connection with the credit facility and cross currency swap arrangements we entered into with TMB Bank Public Company Limited (the "Bank") in May 2011 for the construction of Pinehurst Building 6. The terms of the contract with the Bank provide the following facilities: (1) a term loan facility for up to Thai baht 960 million (equal to \$30.0 million) with a fixed interest rate of 5.28% per annum, (2) a hedging facility for currency swaps with a notional amount of \$30.0 million, and (3) a settlement limit of Thai baht 65 million, subject to certain terms and conditions as set forth therein. As of March 30, 2012, we had drawn down the entire \$30.0 million

Table of Contents

available under the term loan facility. Borrowings and interest under the term loan are scheduled to be repaid on a quarterly basis between September 2011 and March 2017. As of September 27, 2013, we had outstanding borrowings under the term loan facility of \$21.0 million. Under the terms of the cross currency interest rate swap arrangement, all amounts drawn down in Thai baht were converted to U.S. dollars for repayment by us on a quarterly basis at the floating rate of 3-month U.S. LIBOR plus 2.8% per annum.

We attempt to hedge against these exchange rate risks by entering into hedging contracts that are typically one to six months in duration, leaving us exposed to longer term changes in exchange rates. We realized foreign currency gain of \$1.1 million and \$0.3 million during the three months ended September 27, 2013 and September 28, 2012, respectively. As foreign currency exchange rates fluctuate relative to the U.S. dollar, we expect to incur foreign currency translation adjustments and may incur foreign currency exchange losses. For example, a 10% weakening in the U.S. dollar against the Thai baht and the RMB as of September 27, 2013 and June 28, 2013 would have resulted in an increase in our net dollar position of approximately \$2.4 million and \$1.8 million, respectively. We cannot give any assurance as to the effect that future changes in foreign currency rates will have on our condensed consolidated financial position, operating results or cash flows.

Credit Risk

Credit risk refers to our exposures to financial institutions, suppliers and customers that have in the past and may in the future experience financial difficulty, particularly in light of recent conditions in the credit markets and the global economy. As of September 27, 2013, our cash and cash equivalents were held in deposits and highly liquid investment products with maturities of three months or less with banks and other financial institutions having credit ratings of A minus or above. We generally monitor the financial performance of our suppliers and customers, as well as other factors that may affect their access to capital and liquidity. Presently, we believe that we will not incur material losses due to our exposures to such credit risk.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three months ended September 27, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

Table of Contents**ITEM 1A. RISK FACTORS**

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

Risks Related to Our Business

Severe flooding in Thailand during October and November 2011, which resulted in the temporary suspension of production at our Pinehurst facilities and the permanent cessation of production at our Chokchai facility, has had and may continue to have a material and adverse effect on our business, financial condition and results of operations in the near-term.

The consequences of the October and November 2011 flooding in Thailand, including the temporary suspension of production at our Pinehurst facilities and permanent cessation of production at our Chokchai facility, have adversely affected and may continue to adversely affect our business, results of operations and financial condition in the near-term. Material risks and uncertainties include, but are not limited to, the following:

Insurance. Prior to January 1, 2012, we maintained insurance coverage that provided for reimbursement of losses resulting from flood damage. Under the terms of our policies that were in effect during the flooding, our property and casualty insurance covered loss or damage to our property and third-party property over which we have custody and control (the latter of which we refer to as consigned property), as well as losses associated with business interruption and building damage, subject to a number of exclusions and limitations (such as coinsurance, facilities location sub-limits and policy covenants). We have completed our assessment of losses and recorded known losses in our consolidated statements of operations. As of September 27, 2013, we had submitted all five of our claims for flood-related losses to our insurers and finally settled four of such claims. In the three months ended September 27, 2013, we received from our insurers an interim payment of \$6.6 million against our claim for owned and customer-owned inventory losses.

A number of exclusions and limitations in our policies (such as coinsurance, facilities location sub-limits and policy covenants) may reduce the aggregate amount that we will ultimately collect for our losses. In addition, our insurers could reject the valuation methodologies we have used to estimate certain of our losses, in whole or in part, and apply different valuation methodologies, which could also reduce our aggregate recovery amount for our remaining claim. We believe that we will ultimately recover a majority of our losses. There has been a substantial delay between when we have paid for flood-related expenses and when we have received proceeds from our insurers as reimbursement for these expenses. The insurance claims process has required a significant amount of time from management, and we expect this to continue until our remaining claim has been resolved.

Further, as a result of the flooding in Thailand, our property and casualty insurance premiums continue to significantly exceed premiums paid in periods prior to the flooding.

Customers. Some customers may choose to manufacture products internally or relocate their production to manufacturers outside of Thailand because of the fear of future flooding in Thailand. The fear of future flooding may also make it more difficult for us to win business from new customers, or force us to offer more attractive payment terms in order to maintain business with existing customers. These consequences would materially and adversely affect our business, financial condition and results of operations.

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

We have depended, and will continue to depend, upon a relatively small number of customers for a significant percentage of our total revenues. During the three months ended September 27, 2013 and September 28, 2012, we had two customers that each contributed 10% or more of our total revenues, respectively. These customers together accounted for 50% and 48% of our total revenues, respectively, during the periods. Dependence on a small number of customers means that a reduction in orders from, a loss of, or other adverse actions by any one of these customers would reduce our revenues and could have a material adverse effect on our business, operating results and share price.

Edgar Filing: Fabrinet - Form 10-Q

Further, our customer concentration increases the concentration of our accounts receivable and our exposure to payment default by any of our key customers. Many of our existing and potential customers have substantial debt burdens, have experienced financial distress or have static or declining revenues, all of which may have been exacerbated by the impact of the flooding in Thailand, the recent conditions in the credit markets, and the continual uncertainty in the global

Table of Contents

economies. Certain of our customers have gone out of business, been acquired, or announced their withdrawal from segments of the optics market. We generate significant accounts payable and inventory for the services that we provide to our customers, which could expose us to substantial and potentially unrecoverable costs if we do not receive payment from our customers.

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

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

Consolidation in the markets we serve has resulted in a reduction in the number of potential customers for our services. In July 2012, Oclaro, Inc. and Opnext, Inc., both of which were our customers at the time, merged. In September 2013, Oclaro, Inc. announced that it had signed a definitive agreement to sell its Gallium Arsenide laser diode business to II-IV Incorporated, and in October 2013, Oclaro, Inc. announced that it had signed a definitive agreement to sell its fiber amplifier and micro-optics business to II-IV Incorporated. In some cases, consolidation among our customers has led to a reduction in demand for our services as customers acquired the capacity to manufacture products in-house.

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

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

Natural disasters, such as the October and November 2011 flooding in Thailand, where most of our manufacturing operations are located, could severely disrupt our manufacturing operations and increase our supply chain costs. These events, over which we have little or no control, could cause a decrease in demand for our services, make it difficult or impossible for us to manufacture and deliver products and for our suppliers to deliver components allowing us to manufacture those products, require large expenditures to repair or replace our facilities, or create delays and inefficiencies in our supply chain. For example, the October and November 2011 flooding in Thailand forced us to temporarily shut down all of our manufacturing facilities in Thailand and cease production permanently at our Chokchai facility in Thailand, which adversely affected our ability to meet our customers' demands during fiscal 2012. In some countries in which we operate, including the PRC and Thailand, potential outbreaks of infectious diseases such as the H1N1 influenza virus, severe acute respiratory syndrome (SARS) or bird flu could disrupt our manufacturing operations, reduce demand for our customers' products and increase our supply chain costs. In addition, increased international political instability, evidenced by the threat or occurrence of terrorist attacks, enhanced national security measures, conflicts in the Middle East and Asia, strained international relations arising from these conflicts and the related decline in consumer confidence and economic weakness, may hinder our ability to do business. Any escalation in these events or similar future events may disrupt our operations and the operations of our customers and suppliers, and may affect the availability of materials needed for our manufacturing services. Such events may also disrupt the transportation of materials to our manufacturing facilities and finished products to our customers. These events have had, and may continue to have, an adverse impact on the U.S. and world economy in general, and customer confidence and spending in particular, which in turn could adversely affect our total revenues and operating results. The impact of these events on the volatility of the U.S. and world financial markets also could increase the volatility of the market price of our ordinary shares and may limit the capital resources available to us, our customers and our suppliers.

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

The occurrence of one or more natural disasters, such as tropical storms and floods, in Thailand, where most of our manufacturing operations are located, could adversely affect our operations and financial performance. Any losses that we would incur could have a material adverse effect on our business for an indeterminate period of time.

Our current property and casualty insurance covers loss or damage to our property and third-party property over which we have custody and control, as well as losses associated with business interruption, subject to specified exclusions and limitations such as coinsurance, facilities

Edgar Filing: Fabrinet - Form 10-Q

location sub-limits and other policy limitations and covenants. This includes flood insurance for property and business interruption with an aggregate limit of approximately \$25 million in excess coverage after payment of deductibles by us. Even with insurance coverage, natural disasters or other catastrophic events, including acts of war, could cause us to suffer substantial losses in our operational capacity and could also lead to a loss of opportunity and to a potential adverse impact on our relationships with our existing customers resulting from our inability to produce products for them, for which we would not be compensated by existing insurance. This in turn could have a material adverse effect on our financial condition and results of operations.

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

Our future success as a provider of precision optical, electro-mechanical and electronic manufacturing services for the optical communications market depends on the continued growth of the optics industry and, in particular, the continued expansion of global information networks, particularly those directly or indirectly dependent upon a fiber optics infrastructure. As part of that growth, we anticipate that demand for voice, video, text and other data services delivered

Table of Contents

over high-speed connections (both wired and wireless) will continue to increase. Without network and bandwidth growth, the need for enhanced communications products would be jeopardized. Currently, demand for network services and for broadband access, in particular, is increasing but growth may be limited by several factors, including, among others: (i) relative strength or weakness of the global economy or certain countries or regions, (ii) an uncertain regulatory environment, and (iii) uncertainty regarding long-term sustainable business models as multiple industries, such as the cable, traditional telecommunications, wireless and satellite industries, offer competing content delivery solutions. The optical communications market also has experienced periods of overcapacity, some of which have occurred even during periods of relatively high network usage and bandwidth demands. If the factors described above were to slow, stop or reverse the expansion in the optical communications market, our business, financial condition and operating results would be negatively affected.

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

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

our ability to acquire new customers and retain our existing customers by delivering superior customer service;

the cyclical nature of the optical communications market, as well as the lasers and sensors markets;

competition;

our ability to achieve favorable pricing for our services;

our ability to manage our headcount and other costs; and

changes in the relative mix in our revenues.

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

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

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

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

Edgar Filing: Fabrinet - Form 10-Q

Our current and prospective customers tend to evaluate our capabilities against the merits of their internal manufacturing as well as the capabilities of third-party manufacturers. We believe the internal manufacturing capabilities of current and prospective customers are our primary competition. This competition is particularly strong when our customers have excess manufacturing capacity, as was the case when the markets that we serve experienced a downturn from 2001 through 2004 and again in 2008 and 2009, that resulted in underutilized capacity. Many of our potential customers continue to have excess manufacturing capacity at their facilities. In addition, as a result of the October and November 2011 flooding in Thailand, some of our customers began manufacturing products internally or using other third-party manufacturers that were not affected by the flooding. If our customers choose to manufacture products internally rather than to outsource production to us, or choose to outsource to a third-party manufacturer, our business, financial condition and operating results could be harmed.

Table of Contents

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

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

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

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

In addition, we make significant decisions, including production schedules, component procurement commitments, personnel needs and other resource requirements, based on our estimate of our customers' requirements. The short-term nature of our customers' commitments and the possibility of rapid changes in demand for their products reduce our ability to accurately estimate the future requirements of our customers. Inability to forecast the level of customer orders with certainty makes it difficult to allocate resources to specific customers, order appropriate levels of materials and maximize the use of our manufacturing capacity. This could also lead to an inability to meet a spike in production demand, all of which could harm our business, financial condition and operating results.

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

We provide manufacturing services to companies, and rely on suppliers, that have in the past and may in the future experience financial difficulty, particularly in light of recent conditions in the credit markets and the overall economy that affected access to capital and liquidity. As a result, we devote significant resources to monitor receivables and inventory balances with certain of our customers. If our customers experience financial difficulty, we could have difficulty recovering amounts owed to us from these customers, or demand for our services from these customers could decline. If our suppliers experience financial difficulty, we could have trouble sourcing materials necessary to fulfill production requirements and meet scheduled shipments. Any such financial difficulty could adversely affect our operating results and financial condition by resulting in a reduction in our revenues, a charge for inventory write-offs, a provision for doubtful accounts, and an increase in working capital requirements due to increases in days in inventory and in days in accounts receivable.

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

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

Table of Contents

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

Also, we have significant exposure to changes in the exchange rate between the RMB and the U.S. dollar. The expenses of our PRC subsidiary are denominated in RMB. Currently, RMB are convertible in connection with trade- and service-related foreign exchange transactions, foreign debt service and payment of dividends. The PRC government may at its discretion restrict access in the future to foreign currencies for current account transactions. If this occurs, our PRC subsidiary may not be able to pay us dividends in U.S. dollars without prior approval from the PRC State Administration of Foreign Exchange. In addition, conversion of RMB for most capital account items, including direct investments, is still subject to government approval in the PRC. This restriction may limit our ability to invest the earnings of our PRC subsidiary. As of September 27, 2013, the U.S. dollar had depreciated approximately 4.3% against the RMB since September 30, 2011. There remains significant international pressure on the PRC government to adopt a substantially more liberalized currency policy. Any further and more significant appreciation in the value of the RMB against the U.S. dollar could negatively impact our operating results.

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

We rely on a single source or a limited number of suppliers for critical materials used in a significant number of the products we manufacture. We generally purchase these single or limited source materials through standard purchase orders and do not maintain long-term supply agreements with our suppliers. We generally use a rolling 12 month forecast based on anticipated product orders, customer forecasts, product order history, backlog, and warranty and service demand to determine our materials requirements. Lead times for the parts and components that we order vary significantly and depend on factors such as manufacturing cycle times, manufacturing yields and the availability of raw materials used to produce the parts or components. Historically, we have experienced supply shortages resulting from various causes, including reduced yields by our suppliers, which prevented us from manufacturing products for our customers in a timely manner. Our revenues, profitability and customer relations could be harmed by a stoppage or delay of supply, a substitution of more expensive or less reliable parts, the receipt of defective parts or contaminated materials, an increase in the price of supplies, or an inability to obtain pricing reduction in price from our suppliers in response to competitive pressures.

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

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

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

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

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

Table of Contents

Our customers are located throughout the world. Total revenues from the bill to location of customers outside of North America accounted for 54.1% and 55.2% of our total revenues for the three months ended September 27, 2013 and September 28, 2012, respectively. We expect that the portion of our future revenues attributable to customers in regions outside of North America will remain flat as compared to the portion of our revenues that came from customers in regions outside of North America during the first quarter of fiscal 2014. Our customers also depend on international sales, which further exposes us to the risks associated with international operations. In addition, our international operations and sales subject us to a variety of domestic and foreign trade regulatory requirements.

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

The majority of our assets and manufacturing operations are located in Thailand. Therefore, political, social, business and economic conditions in Thailand have a significant effect on our business. In March 2013, Thailand was assessed as a medium-high political risk by AON Political Risk, a risk management, insurance and consulting firm. Any changes to tax regimes, laws, exchange controls or political action in Thailand may harm our business, financial condition and operating results.

In September 2006, Thailand experienced a military coup that overturned the existing government, and in 2008, political unrest and demonstrations in Bangkok sparked a series of violent incidents that resulted in several deaths and numerous injuries. In April 2009, anti-government demonstrations in Bangkok caused severe traffic congestion and numerous injuries, and in March 2010, protestors again held demonstrations calling for new elections. These demonstrations in recent years in Bangkok and other parts of Thailand, which escalated in violence through May 2010, resulted in the country's worst political violence in nearly two decades with numerous deaths and injuries, as well as destruction of property. Certain hotels and businesses in Bangkok were closed for weeks as the protestors occupied Bangkok's commercial center, and governments around the world issued travel advisories urging their citizens to avoid non-essential travel to Bangkok.

Any succession crisis in the Kingdom of Thailand could cause new or increased instability and unrest. In the event that a violent coup were to occur or the current political unrest were to worsen, such activity could prevent shipments from entering or leaving the country and disrupt our ability to manufacture products in Thailand, and we could be forced to transfer our manufacturing activities to more stable, and potentially more costly, regions. Further, the Thai government recently raised the minimum wage standards for labor and could repeal certain promotional certificates that we have received or tax holidays for certain export and value added taxes that we enjoy, either preventing us from engaging in our current or anticipated activities or subjecting us to higher tax rates. A new regime could nationalize our business or otherwise seize our assets. Future political instability such as the coup that occurred in September 2006 or the demonstrations that occurred during 2008, 2009 and 2010 could harm our business, financial condition and operating results.

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

We anticipate that we will continue to invest in our customized optics manufacturing facilities located in Fuzhou, China. Because these operations are located in the PRC, they are subject to greater political, legal and economic risks than the geographies in which the facilities of many of our competitors and customers are located. In particular, the political and economic climate in the PRC (both at national and regional levels) is fluid and unpredictable. In March 2013, the PRC was assessed as a medium political risk by AON Political Risk. A large part of the PRC's economy is still being operated under varying degrees of control by the PRC government. By imposing industrial policies and other economic measures, such as control of foreign exchange, taxation, import and export tariffs, environmental regulations, land use rights, intellectual property and restrictions on foreign participation in the domestic market of various industries, the PRC government exerts considerable direct and indirect influence on the development of the PRC economy. Many of the economic reforms carried out by the PRC government are unprecedented or experimental and are expected to change further. Any changes to the political, legal or economic climate in the PRC could harm our business, financial condition and operating results.

Our PRC subsidiary is a wholly foreign-owned enterprise and is therefore subject to laws and regulations applicable to foreign investment in the PRC, in general, and laws and regulations applicable to wholly foreign-owned enterprises, in particular. The PRC has made significant progress in the promulgation of laws and regulations pertaining to

Table of Contents

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

Our business and operations would be adversely impacted in the event of a failure of our information technology infrastructure.

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

Despite our implementation of security measures, our systems are vulnerable to damages from computer viruses, natural disasters, unauthorized access and other similar disruptions. Any system failure, accident or security breach could result in disruptions to our operations. To the extent that any disruptions or security breach results in a loss or damage to our data, or inappropriate disclosure of confidential information, it could harm our business. In addition, we may be required to incur significant costs to protect against damage caused by these disruptions or security breaches in the future.

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

Volatility and disruption in the capital and credit markets, depressed consumer confidence, and negative global economic conditions have affected levels of business and consumer spending. Concerns about the potential default of various national bonds and debt backed by individual countries as well as the politics impacting these, could negatively impact the U.S. and global economies and adversely affect our financial results. In particular, recent economic uncertainty in Europe has led to reduced demand in some of our customers' optical communications product portfolios. If economic conditions in Europe do not recover or if they continue to deteriorate, our operating results could be harmed.

In addition, the Budget Control Act of 2011, which raised the U.S. national debt ceiling and put into effect a series of actions for deficit reduction, may trigger automatic reductions in U.S. government spending, known as sequestration, beginning in 2013. Sequestration or other significant cuts in U.S. government spending could adversely affect demand for our customers' products, which could adversely affect our future results.

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

Table of Contents

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

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

We most recently expanded our manufacturing capacity at our Thailand facilities in April 2012 with the completion of Pinehurst Building 6. However, we also determined, during fiscal 2012, that we would not resume manufacturing operations at our Chokchai campus, which we leased. We may continue to devote significant resources to the expansion of our manufacturing capacity, and any such expansion will be expensive, will require management's time and may disrupt our operations. In the event we are unsuccessful in our attempts to expand our manufacturing capacity, our business, financial condition and operating results could be harmed.

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

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

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

the quality of input, materials and equipment;

the quality and feasibility of our customer's design;

the repeatability and complexity of the manufacturing process;

the experience and quality of training of our manufacturing and engineering teams; and

the monitoring of the manufacturing environment.

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

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

We manufacture products to our customers' specifications, and our manufacturing processes and facilities must comply with applicable statutory and regulatory requirements. In addition, our customers' products and the manufacturing processes that we use to produce them are often complex. As a result, products that we manufacture may at times contain manufacturing or design defects, and our manufacturing processes may be subject to errors or fail to be in compliance with applicable statutory or regulatory requirements. Additionally, not all defects are immediately

Edgar Filing: Fabrinet - Form 10-Q

detectible. The testing procedures of our customers are generally limited to the evaluation of the products that we manufacture under likely and foreseeable failure scenarios. For various reasons (including, among others, the occurrence of performance problems that are unforeseeable at the time of testing or that are detected only when products are fully deployed and operated under peak stress conditions), these products may fail to perform as expected after their initial acceptance by a customer. For example,

Table of Contents

in October 2013, the Company authorized a customer to return a number of units of its product manufactured at our Pinehurst facility due to functional failure. After investigation, we found that the affected products were produced during the first quarter of fiscal 2014. While this may cause us to incur certain costs and expenses, we are still working with the customer to determine the extent and impact of the product failure.

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

Product liability claims may include liability for personal injury or property damage. Product warranty claims may include liability to pay for a recall, repair or replacement of a product or component. Although liability for these claims is generally assigned to our customers in our contracts, even where they have assumed liability, our customers may not, or may not have the resources to, satisfy claims for costs or liabilities arising from a defective product. Additionally, under one of our contracts, in the event the products we manufacture do not meet the end-customer's testing requirements or otherwise fail, we may be required to pay penalties to our customer, including a fee during the time period that the customer or end-customer's production line is not operational as a result of the failure of the products that we manufacture, all of which could harm our business, operating results and customer relations. If we engineer or manufacture a product that is found to cause any personal injury or property damage or is otherwise found to be defective, we could incur significant costs to resolve the claim. While we maintain insurance for certain product liability claims, we do not maintain insurance for any recalls and, therefore, would be required to pay any associated costs that are determined to be our responsibility. A successful product liability or product warranty claim in excess of our insurance coverage or any material claim for which insurance coverage is denied, limited, is not available or has not been obtained could harm our business, financial condition and operating results.

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

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

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

Table of Contents

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

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

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

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

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

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

The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as well as other rules implemented by the SEC and the New York Stock Exchange (NYSE), impose various requirements on public companies, including requiring changes in corporate governance practices. These and proposed corporate governance laws and regulations under consideration may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management's attention from other business concerns, it could have a material adverse effect on our business, financial condition and results of operations. The Sarbanes-Oxley Act requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually and disclosure controls and procedures quarterly. While we were able to assert in our Form 10-K for the fiscal year ended June 28, 2013, that our internal control over financial reporting was effective as of June 28, 2013, we cannot predict the outcome of our testing in future periods. If we are unable to assert in any future reporting periods that our internal control over financial reporting is effective (or if our independent registered public accounting firm is unable to express an opinion on the effectiveness of our internal controls), we could lose investor confidence in the accuracy and completeness of our financial reports, which would have an adverse effect on our share price.

Given the nature and complexity of our business and the fact that some members of our management team are located in Thailand while others are located in the U.S., control deficiencies may periodically occur. While we have ongoing measures and procedures to prevent and remedy such deficiencies, if they occur there can be no assurance that we will be successful or that we will be able to prevent material weaknesses or significant deficiencies in our internal control over financial reporting in the future. Moreover, if we or our independent registered public accounting firm identify deficiencies in our internal control over financial reporting that are deemed to be material weaknesses in future periods, the market price of our ordinary shares could decline and we could be subject to potential delisting by the NYSE and review by the NYSE, the SEC, or other regulatory authorities, which would require the expenditure by us of additional financial and management resources. As a result, our shareholders could lose confidence in our financial reporting, which would harm our business and the market price of our ordinary shares.

Table of Contents

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

We base our tax position upon the anticipated nature and conduct of our business and upon our understanding of the tax laws of the various countries in which we have assets or conduct activities. However, our tax position is subject to review and possible challenge by tax authorities and to possible changes in law, which may have retroactive effect. Fabrinet (the Cayman Islands Parent) is an exempted company incorporated in the Cayman Islands. We maintain manufacturing operations in Thailand, the PRC and the U.S., any of which jurisdictions could assert tax claims against us. We cannot determine in advance the extent to which some jurisdictions may require us to pay taxes or make payments in lieu of taxes. Preferential tax treatment from the Thai government in the form of a corporate tax exemption is currently available to us from July 2010 through June 2015 on income generated from the manufacture of products at Pinehurst Building 5 and from July 2012 through June 2020 on income generated from the manufacture of products at Pinehurst Building 6. Such preferential tax treatment is contingent on, among other things, the export of our customers' products out of Thailand and our agreement not to move our manufacturing facilities out of our current province in Thailand for at least 15 years. We will lose this favorable tax treatment in Thailand unless we comply with these restrictions, and as a result we may delay or forego certain strategic business decisions due to these tax considerations. In addition, we benefit from recent reductions in corporate tax rates in Thailand for fiscal years 2013 to 2015. Effective October 21, 2011, our subsidiary in China was granted a tax privilege to reduce its corporate income tax rate from 25% to 15%. This privilege is retroactive to January 1, 2011 and valid until December 31, 2013, subject to renewal at the end of each three-year period. Presently, we are preparing an application to renew this tax privilege and plan to submit it upon expiration of the existing tax privilege.

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

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

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

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

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

we may lose key employees of the acquired companies or divisions;

we may issue additional ordinary shares, which would dilute our current shareholders' percentage ownership in us;

we may incur indebtedness to pay for the transactions;

Edgar Filing: Fabrinet - Form 10-Q

we may assume liabilities, some of which may be unknown at the time of the transactions;

we may record goodwill and non-amortizable intangible assets that will be subject to impairment testing and potential periodic impairment charges;

we may incur amortization expenses related to certain intangible assets;

Table of Contents

we may devote significant resources to transactions that may not ultimately yield anticipated benefits;

we may incur greater than expected expenses or lower than expected revenues;

we may assume obligations with respect to regulatory requirements, including environmental regulations, which may prove more burdensome than expected; or

we may become subject to litigation.

Acquisitions are inherently risky, and we can provide no assurance that our previous or future acquisitions will be successful or will not harm our business, financial condition and operating results.

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

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

Furthermore, if we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our shareholders could be significantly diluted, and these newly-issued securities may have rights, preferences or privileges senior to those of existing shareholders. If adequate additional funds are not available or are not available on acceptable terms, if and when needed, our ability to fund our operations, take advantage of unanticipated opportunities, develop or enhance our manufacturing services, hire additional technical and other personnel, or otherwise respond to competitive pressures could be significantly limited.

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

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

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

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

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

Table of Contents

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

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

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

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

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

We have loan agreements for our long-term debt obligations, which contain financial ratio covenants that may limit management's discretion with respect to certain business matters. These covenants require us to maintain a specified debt-to-equity ratio and debt service coverage ratio (earnings before interest and depreciation and amortization plus cash on hand minus short-term debt), which may restrict our ability to incur additional indebtedness and limit our ability to use our cash. In the event of our default on these loans or a breach of a covenant, the lenders may immediately cancel the loan agreement, deem the full amount of the outstanding indebtedness immediately due and payable, charge us interest on a monthly basis on the full amount of the outstanding indebtedness and, if we cannot repay all of our outstanding obligations, sell the assets pledged as collateral for the loan in order to fulfill our obligation. We may also be held responsible for any damages and related expenses incurred by the lender as a result of any default. Any failure by us or our subsidiaries to comply with these agreements could harm our business, financial condition and operating results.

Energy price increases may negatively impact our results of operations.

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

Risks Related to Ownership of Our Ordinary Shares

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

Our revenues, expenses and results of operations have fluctuated in the past and are likely to do so in the future from quarter to quarter and year to year due to the risk factors described in this section and elsewhere in this Quarterly Report on Form 10-Q. In addition to market and industry factors, the price and trading volume of our ordinary shares may fluctuate in response to a number of events and factors relating to us, our competitors, our customers and the markets we serve, many of which are beyond our control. Factors such as variations in our total revenues, earnings and cash flow, announcements of new investments or acquisitions, changes in our pricing practices or those of our competitors, commencement or outcome of litigation, sales of ordinary shares by us or our principal shareholders, fluctuations in market prices for our services and general market conditions could cause the market price of our ordinary shares to change substantially. Any of these factors may

Edgar Filing: Fabrinet - Form 10-Q

result in large and sudden changes in the volume and price at which our ordinary shares trade. For example, during October 2011, when some of the worst flooding in Thailand occurred, our share price fell from \$20.03 per share on October 10, 2011 to \$11.95 per share on October 26, 2011, a 40% decrease. Among other things, volatility and weakness in our share price could mean that investors may not be able to sell their shares at or above the prices they paid. Volatility and weakness could also impair our ability in the future to offer our ordinary shares or convertible securities as a source of additional capital and/or as consideration in the acquisition of other businesses.

Table of Contents

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

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

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

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

Based upon estimates of the value of our assets, which are based in part on the trading price of our ordinary shares, we do not expect to be a passive foreign investment company, or PFIC, for U.S. federal income tax purposes for the taxable year 2013 or for the foreseeable future. However, despite our expectations, we cannot assure you that we will not be a PFIC for the taxable year 2013 or any future year because our PFIC status is determined at the end of each year and depends on the composition of our income and assets during such year. If we are a PFIC, our U.S. investors will be subject to increased tax liabilities under U.S. tax laws and regulations and to burdensome reporting requirements.

We are controlled by a small group of existing shareholders, whose interests may differ from the interests of our other shareholders.

As of September 27, 2013, our existing shareholders Asia Pacific Growth Fund III, L.P. (and its affiliates) and Mr. Mitchell our chief executive officer and chairman of the board of directors (including his children), owned approximately 18.1% and 5.7%, respectively, of our outstanding ordinary shares. Accordingly, they will have significant influence in determining the outcome of any corporate transaction or other matter submitted to our shareholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets, election of directors and other significant corporate actions. The interests of these shareholders may differ from the interests of our other shareholders.

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

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

establish a classified board of directors;

prohibit our shareholders from calling meetings or acting by written consent in lieu of a meeting;

limit the ability of our shareholders to propose actions at duly convened meetings; and

authorize our board of directors, without action by our shareholders, to issue preferred shares and additional ordinary shares.

These provisions could have the effect of depriving you of an opportunity to sell your ordinary shares at a premium over prevailing market prices by discouraging third parties from seeking to acquire control of us in a tender offer or similar transaction.

Table of Contents

Our shareholders may face difficulties in protecting their interests because we are incorporated under Cayman Islands law.

Our corporate affairs are governed by our amended and restated memorandum and articles of association, by the Companies Law (as amended) of the Cayman Islands and the common law of the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors under the laws of the Cayman Islands are not as clearly established as under statutes or judicial precedent in existence in jurisdictions in the U.S. Therefore, you may have more difficulty in protecting your interests than would shareholders of a corporation incorporated in a jurisdiction in the U.S., due to the comparatively less developed nature of Cayman Islands law in this area.

The Companies Law permits mergers and consolidations between Cayman Islands companies and between Cayman Islands companies and non-Cayman Islands companies. Dissenting shareholders have the right to be paid the fair value of their shares (which, if not agreed between the parties, will be determined by the Cayman Islands court) if they follow the required procedures, subject to certain exceptions. Court approval is not required for a merger or consolidation which is effected in compliance with these statutory procedures.

In addition, there are statutory provisions that facilitate the reconstruction and amalgamation of companies, provided that the arrangement is approved by a majority in number of each class of shareholders and creditors with whom the arrangement is to be made, and who must in addition represent three-fourths in value of each such class of shareholders or creditors, as the case may be, that are present and voting either in person or by proxy at a meeting convened for that purpose. The convening of the meeting and subsequently the arrangement must be sanctioned by the Grand Court of the Cayman Islands. A dissenting shareholder has the right to express to the court the view that the transaction ought not to be approved.

When a takeover offer is made and accepted by holders of 90.0% of the shares within four months, the offeror may, within a two-month period, require the holders of the remaining shares to transfer such shares on the terms of the offer. An objection can be made to the Grand Court of the Cayman Islands but this is unlikely to succeed unless there is evidence of fraud, bad faith or collusion.

If the arrangement and reconstruction is thus approved, the dissenting shareholder would have no rights comparable to appraisal rights, which would otherwise ordinarily be available to dissenting shareholders of a corporation incorporated in a jurisdiction in the U.S., providing rights to receive payment in cash for the judicially determined value of the shares. This may make it more difficult for you to assess the value of any consideration you may receive in a merger or consolidation or to require that the offeror give you additional consideration if you believe the consideration offered is insufficient.

Shareholders of Cayman Islands exempted companies have no general rights under Cayman Islands law to inspect corporate records and accounts or to obtain copies of lists of shareholders. Our directors have discretion under our amended and restated memorandum and articles of association to determine whether or not, and under what conditions, our corporate records may be inspected by our shareholders, but are not obliged to make them available to our shareholders. This may make it more difficult for you to obtain the information needed to establish any facts necessary for a shareholder motion or to solicit proxies from other shareholders in connection with a proxy contest.

Subject to limited exceptions, under Cayman Islands law, a minority shareholder may not bring a derivative action against the board of directors.

Certain judgments obtained against us by our shareholders may not be enforceable.

The Cayman Islands Parent is a Cayman Islands exempted company and substantially all of our assets are located outside of the United States. In addition, some of our directors and officers are nationals and residents of countries other than the United States. A substantial portion of the assets of these persons is located outside of the United States. As a result, it may be difficult to effect service of process within the United States upon these persons. It may also be difficult to enforce in U.S. courts judgments obtained in U.S. courts based on the civil liability provisions of the U.S. federal securities laws against us and our officers and directors who are not resident in the United States and the substantial majority of whose assets are located outside of the United States. In addition, there is uncertainty as to whether the courts of the Cayman Islands, Thailand or the PRC would recognize or enforce judgments of U.S. courts against us or such persons predicated upon the civil liability provisions of the securities laws of the United States or any state. In particular, a judgment in a U.S. court would not be recognized and accepted by Thai courts without a re-trial or examination of the merits of the case. In addition, there is uncertainty as to whether such Cayman Islands, Thai or PRC courts would be competent to hear original actions brought in the Cayman Islands, Thailand or the PRC against us or such persons predicated upon the securities laws of the United States or any state.

Table of Contents

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Sales of Unregistered Securities

Not applicable.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Not applicable.

ITEMS 3, 4 and 5 are not applicable and have been omitted.

ITEM 6. EXHIBITS

The exhibits listed in the accompanying Exhibit Index are filed or incorporated by reference as part of this Quarterly Report on Form 10-Q.

Table of Contents

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 5, 2013.

FABRINET

By: /s/ TOH-SENG NG
Name: **Toh-Seng Ng**
Title: **Executive Vice President, Chief**

Financial Officer

(Principal Financial and Accounting Officer)

Table of Contents**EXHIBIT INDEX**

Exhibit Number	Description	Incorporated by reference herein			
		Form	Exhibit No.	Filing Date	File No.
10.1+	Description of Fiscal 2014 Executive Incentive Plan	Item 5.02 of Form 8-K	N/A	August 12, 2013	001-34775
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
32.1	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				
101.INS	XBRL Instance.				
101.SCH	XBRL Taxonomy Extension Schema.				
101.CAL	XBRL Taxonomy Extension Calculation Linkbase.				
101.DEF	XBRL Taxonomy Extension Definition Linkbase.				
101.LAB	XBRL Taxonomy Extension Label Linkbase.				
101.PRE	XBRL Taxonomy Extension Presentation Linkbase.				
+ Indicates management contract or compensatory plan.					