AXT INC
Form 10-K
March 16, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2010

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number: 000-24085

AXT, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-3031310
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4281 Technology Drive, Fremont, California	94538
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (510) 683-5900
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.001 par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act o Yes x No

Indicate by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. o Yes x No

Indicate by checkmark 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 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. x Yes o 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). o Yes o No

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by checkmark 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 Act. (Check one):

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing sale price of $4.51 for the common stock on June 30, 2010 as reported on the Nasdaq Global Market, was approximately $112,107,000. Shares of common stock held by each officer, director and by each person who owns 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not a conclusive determination for other purposes.

As of February 25, 2011, 32,104,538 shares, $0.001 par value, of the registrant's common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the registrant's 2011 annual meeting of stockholders to be filed with the Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this form are incorporated by reference into Part III of this Form 10-K report. Except for those portions specifically incorporated by reference herein, such document shall not be deemed to be filed with the Commission as part of this Form 10-K.

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PART I

This Annual Report (including the following section regarding Management's Discussion and Analysis of Financial Condition and Results of Operations) contains forward-looking statements regarding our business, financial condition, results of operations and prospects. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates" similar expressions or variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this Annual Report. Additionally, statements concerning future matters such as industry trend, the development of new products, enhancements or technologies, sales levels, expense levels and other statements regarding matters that are not historical are forward-looking statements.

Although forward-looking statements in this Annual Report reflect the good faith judgment of our management, such statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties and actual results and outcomes may differ materially from the results and outcomes discussed in or anticipated by the forward-looking statements. Factors that could cause or contribute to such differences in results and outcomes include without limitation those discussed under the heading "Risk Factors" in Item 1A below, as well as those discussed elsewhere in this Annual Report. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report. We undertake no obligation to revise or update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this Annual Report. Readers are urged to carefully review and consider the various disclosures made in this Annual Report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations and prospects.

Item 1. Business

AXT, Inc. ("AXT", "we," "us," and "our" refer to AXT, Inc. and all of its subsidiaries) is a leading developer and producer of high-performance compound and single element semiconductor substrates, including substrates made from gallium arsenide (GaAs), indium phosphide (InP) and germanium (Ge). We currently sell the following substrate products in the sizes and for the applications indicated:

Substrates	Substrate Diameter	Applications
GaAs (semi-insulating)	2", 3", 4", 5", 6"	Power amplifiers and radio frequency integrated circuits for wireless handsets (cell phones) Direct broadcast television High-performance transistors Satellite communications
GaAs (semi-conducting)	2", 3", 4"	High brightness light emitting diodes Lasers Optical couplers
InP	2", 3", 4"	Broadband and fiber optic communications
Ge	2", 4"	Satellite and terrestrial solar cells Optical applications

We manufacture all of our semiconductor substrates using our proprietary vertical gradient freeze (VGF) technology. Most of our revenue is from sales of GaAs substrates. We manufacture all of our products in the People's Republic of China (PRC or China), which generally has favorable costs for facilities and labor compared with comparable facilities in the United States, Europe or Japan. We also have five joint ventures in China that provide us pricing

advantages, reliable supply and shorter lead-times for raw materials central to our final manufactured products. We consolidate, for accounting purposes, three of these joint ventures and have equity interests of 25% in each of the other two. We use our direct sales force in the United States and independent sales representatives in Europe and Asia to market our substrates. Our ten largest customers for 2010 were: Avago Technologies Trading Ltd., AZUR Space Solar Power GmbH, Beijing China Crystal Technology, Ltd., Hitachi Cable, Ltd., the IQE group, Nan Da Guang Dang, Osram Opto Semiconductors GmbH, Sumika Electronic Materials, Inc, Sumitomo Chemical Co., Ltd. and Visual Photonics Epitaxy Co. As the demand for compound semiconductor substrates is expected to increase, we believe that we are well-positioned to leverage our PRC-based manufacturing capabilities and access to favorably priced raw materials to increase our market share.

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Following very challenging industry conditions in the first half of 2009, we began to see stronger sales and improved gross margins in the second half of 2009. Positive industry trends in the wireless device, LED and solar cell markets, as well as increased demand worldwide in 2010, and we believe continued advantages in our manufacturing and cost structure give us confidence in our ability to continue to drive positive results in our business in 2011. Our qualification efforts in both gallium arsenide and germanium substrates have been successful and we are pleased with our increasing diversification in these areas. While the volatile business and financial markets are prompting us to continue to take a conservative approach to our business, we remain optimistic about our business.

We were incorporated in California in December 1986 and reincorporated in Delaware in May 1998. We changed our name from American Xtal Technology, Inc. to AXT, Inc. in July 2000. Our principal corporate office is located at 4281 Technology Drive, Fremont, California 94538, and our telephone number at this address is (510) 683-5900.

Industry Background

Certain electronic and opto-electronic applications have performance requirements that exceed the capabilities of conventional silicon substrates and often require high-performance compound or single element substrates. Examples of higher performance non-silicon based substrates include GaAs, InP, gallium nitride (GaN), silicon carbide (SiC) and Ge.

For example, power amplifiers and radio frequency integrated circuits for wireless handsets and other wireless devices are made with semi-insulating GaAs substrates. Semi-conducting GaAs substrates are used to create opto-electronic products including high brightness light emitting diodes (HBLEDs) which are often used to backlight wireless handsets and liquid crystal display (LCD) TVs and for automotive, signage, display and lighting applications InP is a high performance semiconductor substrate used in broadband and fiber optic applications. Ge substrates are used in emerging applications such as solar cells for space and terrestrial photovoltaic applications.

Our business and operating results depend in significant part upon capital expenditures of semiconductor designers and manufacturers, which in turn depend upon the current and anticipated market demand for products incorporating semiconductors from these designers and manufacturers. Our business also depends in part on worldwide economic conditions. The severe recession in the United States and in other key international economies in recent years have decreased market demand for products incorporating semiconductors, but we began to see improvement in the demand environment for our products worldwide in the second half of 2009 that contributed to our strengthening revenue results. In 2010, there continued to be areas of opportunity for our business. One of the most interesting areas was the growth of smart phones and other sophisticated Internet-connected devices, such as tablets and netbooks that supported more advanced features and access to new web-based applications and services. In addition to improving sales of these products, the benefit to AXT from the sales of more feature-rich, sophisticated devices was that they required greater gallium arsenide content in order to meet the speed and functionality requirements that consumers had come to expect.

As we move into 2011, we expect that the demand for gallium arsenide product will be driven by the proliferation of wireless-enabled devices and the increasing rollout of 3G and 4G smartphones that support substantially faster download speeds. This network upgrade enabled full performance capability of the video, gaming and Internet browsing capabilities of these next generation handsets and wireless devices and drove increases in wireless subscribers in major geographic areas around the world as well as a compelling upgrade cycle for new devices.

The LED market has experienced growth in 2010 in a broad range of applications, such as backlighting, signage, general illumination and automotive. LED-based products are becoming increasingly common as the technology offers benefits in terms of cost, efficiency and performance over older technologies. AXT has historically focused its efforts in the high-end market and while we plan to continue to do so, we are also exploring opportunities to

participate in the lower-end market as well. To date, this market has been geared towards novelty products and has therefore been very margin constrained. However, volumes were high and grew rapidly in 2010. In the future, we believe that this market will provide the entry into general illumination applications, as these applications will need lower cost LED devices in order to gain critical mass. Industry leaders have been making significant product development noted by the declining selling prices of LED-based light bulbs and we believe it will be important to have a presence in this market as it develops.

The concentrator photovoltaic (CPV) market for germanium also continued to grow in 2010, albeit from a smaller base. Growth in the global solar industry is expected in 2011 as there is increasing interest in the replacement of fossil fuel resources with sustainable alternatives such as solar power and solar modules and a renewed interest in renewable energy technology, particularly in the United States and Europe. At the same time, we believe that improvements in conversion efficiency for germanium are occurring, which we believe will enable this technology to become more affordable and therefore, more widely utilized, in the future.

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The AXT Advantage

We believe that we benefit from the following advantages:

Low-cost manufacturing operation in the PRC. Since 2004, we have manufactured all of our products in China, which generally has favorable costs for facilities and labor compared to comparable facilities in the United States or Europe. As of December 31, 2010, approximately 1,277 of our 1,302 employees (including employees at our consolidated joint ventures) are in China. Our primary competitors have their manufacturing operations in Germany or Japan.

Favorable access to raw materials. Our joint ventures in China provide us favorable pricing, reliable supply and shorter lead-times for raw materials central to our final manufactured products. These materials include gallium, arsenic, germanium, germanium dioxide, paralytic boron nitride crucibles and boron oxide. As a result, we believe that our joint ventures will enable us to meet potential increases in demand from our customers by providing a more stable supply of raw materials at lower prices.

Flexible manufacturing infrastructure. Our total manufacturing space in China is approximately 190,000 square feet, 160,000 square feet of which we currently use and we are currently preparing the remaining 30,000 square feet for increased wafer processing. We believe that our competitors typically purchase crystal growing furnaces from original equipment manufacturers. In contrast, we design and build our own VGF crystal growing furnaces, which we believe should allow us to increase our production capacity more quickly and cost effectively.

Given these advantages, when the worldwide economies continued to improve in 2010 after the recovery from the worldwide recession, we experienced increased demand for our compound semiconductor substrates. We believe that we are well-positioned to leverage our PRC-based manufacturing capabilities and access to favorably priced raw materials to increase our revenue and market share.

Strategy

Our goal is to become the leading worldwide supplier of high-performance compound and single element semiconductor substrates. Key elements of our strategy include:

Continue to provide customers high and consistent quality products and service. We seek to improve our manufacturing processes continually in order to meet and exceed our customers' high product quality standards, ensure on-time delivery of our products and optimize the cost of ownership. We expect to continue to improve our manufacturing processes in 2011 by adding new facilities, some additional equipment, automating additional processes, and streamlining performance. In addition, we plan to continue to enhance our support functions, including service and applications engineering.

Increase market share. We intend to leverage our product quality, competitive pricing and lead times both to establish relationships with new customers and to increase our market share with current customers in the integrated circuits for wireless devices and HBLED markets. We also intend to explore opportunities to participate in the low-end LED market, where volumes are high and grew rapidly in 2010.

Flexible capacity to meet customers' increasing demand for substrates. Since 2006, we have tripled our 6-inch semi-insulating gallium arsenide substrate capacity in order to scale with increasing demand. As we enter 2011, we continue to see increasing demand for all sizes of our GaAs substrates and are reviewing our GaAs substrate capacity in order to make appropriate adjustments. We are in the process of building out our remaining 30,000 sq ft production space and expect to begin construction of a new 80,000 sq ft facility in Beijing. We will also begin designing a new

manufacturing building for future expansion.

In 2010, we continued to experience a noticeable increase in demand for our Ge substrates due to improving economic conditions as well as new customer qualifications. As a result, we increased our Ge substrate capacity in 2010 and will closely follow future demand increases and adjust our production capacity accordingly.

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Establish leadership in emerging substrate applications. We intend to expand our served markets by exploring new opportunities for our substrates and we continue to work with our customers to enhance our substrate product offering. We are also working on the development of a 6" Ge substrate because the larger usable area in a 6-inch wafer over a 4-inch wafer will substantially reduce the cost of Ge solar cell manufacturing, which we believe is essential for commercial adoption of Ge solar cell technology for terrestrial applications.

Technology enhancements. We continue to focus on technology development in the areas of VGF technology enhancement. We are working to increase the VGF ingot length and improve our single crystal yield rate. We also continue to work to improve our wafer processing technologies to give us better yield, lower production costs and better quality and performance for our customers.

Technology

There are basically three technologies for crystal growth in our business: Vertical Gradient Freeze (VGF), Liquid Encapsulated Czochralski (LEC), and Czochralski (CZ). Our core technologies include our proprietary VGF technique used to produce high-quality crystals that are processed into compound substrates, and the technologies of our joint venture companies, which enable us to manufacture a range of products that are used in the manufacture of compound semiconductor substrates or can be sold as raw materials to third parties.

Our VGF technique is designed to control the crystal-growth process with minimal temperature variation and is the current technique we use to produce our GaAs, InP and Ge substrates. Unlike traditional techniques, our VGF technique places the hot compound melt above the cool crystal, and minimizes the temperature gradient between the crystal and the melt which reduces the turbulence at the interface of the melt and the solid crystal. In comparison, in the LEC technique the melt and crystal are inverted, there is a higher temperature gradient between the melt and the crystal, and more turbulence at the interface of the melt and solid crystal. These aspects of the VGF technique enable us to grow crystals that have a relatively low defect density and high uniformity. The crystal and the resulting substrate are mechanically strong, resulting in lower breakage rates during a customer's manufacturing process. Since the temperature gradient is controlled electronically rather than by physical movement, the sensitive crystal is not disturbed as it may be during some competitors' VGF-like growth processes. In addition, the melt and growing crystal are contained in a closed chamber, which isolates the crystal from the outside environment to reduce potential contamination. This substrate isolation allows for more precise control of the gallium-to-arsenic ratio, resulting in better consistency and uniformity of the crystals.

Our VGF technique offers several benefits for producing our GaAs substrates when compared to traditional crystal growing technologies. The Horizontal Bridgman (HB) technique is the traditional method for producing semi-conducting GaAs substrates for opto-electronic applications, but because of the techniques used to hold the GaAs melt, the HB technique cannot be used cost-effectively to produce substrates greater than three inches in diameter. In addition, the HB technique houses the GaAs melt in a quartz container during the growth process, which can contaminate the GaAs melt with silicon impurities, making it unsuitable for producing semi-insulating GaAs substrates.

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Our VGF technique also offers advantages over the LEC technique for producing semi-insulating GaAs substrates for wireless applications. Unlike the VGF technique, the LEC technique can result in greater turbulence in the melt, and at a temperature gradient that is significantly higher than the VGF technique, which can cause LEC-grown crystals to have a higher dislocation density than VGF-grown crystals, resulting in a higher rate of breakage during the device manufacturing process. However, the LEC technique can be useful for GaAs semi-conducting substrates since the LED application specifications and requirements are less stringent than those of wireless applications.

Products

We design, develop, manufacture and distribute high-performance semiconductor substrates. We make semi-insulating GaAs substrates used in applications such as amplifiers and switches for wireless devices, and semi-conducting GaAs substrates used to create opto-electronic products including HBLEDs, which are often used to backlight wireless handsets and LCD TVs and for automotive, signage, display and lighting applications. InP is a high-performance semiconductor substrate used in broadband and fiber optic applications. Ge substrates are used in emerging applications such as triple junction solar cells for space and terrestrial photovoltaic applications and for optical applications.

The table below sets forth our products and selected applications:

Product	Applications	
Substrates	Electronic	Opto-electronic
GaAs	Cellular phones	LEDs
	Direct broadcast television	Lasers
	High-performance transistors	Optical couplers
	Satellite communications	
InP	Fiber optic communications	Lasers
	Satellite communications	
	High-performance transistors	
	Automotive collision avoidance radar	
Ge	Satellite and terrestrial solar cells	Optical applications

Substrates. We currently sell compound substrates manufactured from GaAs and InP, as well as single-element substrates manufactured from Ge. We supply GaAs substrates in two-, three-, four-, five- and six-inch diameters. We supply InP substrates in two-, three- and four-inch diameters, and Ge substrates in two- and four-inch diameters.

Materials. We participate in five joint ventures in China that sell raw materials used by us in substrate manufacturing and by others. These joint ventures produce products including 99.99% pure gallium (4N Ga), high purity gallium, arsenic, and germanium, germanium dioxide, paralytic boron nitride (pBN) crucibles, and boron oxide (B2O3). In 2010 and 2009, sales of raw materials by these joint ventures to third parties were approximately $14.9 million and $6.4 million, respectively.

The primary costs of manufacturing compound semiconductor substrates are labor, raw materials and manufacturing equipment such as crystal growing furnaces. Accordingly, substrate manufacturers, including AXT, are continuing to shift production to larger wafers to reduce manufacturing costs.

Customers

We sell our compound semiconductor substrates and materials worldwide. Our top ten revenue producing customers in 2010 by revenue were:

Avago Technologies Trading Ltd.	Nan Da Guang Dang
AZUR Space Solar Power GmbH	Osram Opto Semiconductors GmbH
Beijing China Crystal Technology, Ltd.	Sumika Electronic Materials Co., Ltd.
Hitachi Cable, Ltd.	Sumitomo Chemical Co., Ltd.
IQE Group	Visual Photonics Epitaxy Co.

Historically, we have sold a significant portion of our products in any particular period to a limited number of customers. IQE Group (IQE, Inc., IQE RF, LLC, IQE (Europe) Limited, MBE Technology Pte. Ltd.) represented approximately 19% of our revenue for the year ended December 31, 2010. One customer represented greater than 10% of revenue for the year ended December 31, 2009, at 15%, and one customer represented greater than 10% of revenue for the year ended December 31, 2008 at 19%. Our top five customers represented 40% of our revenue for the year ended December 31, 2010, 41% of our revenue for the year ended December 31, 2009, and 46% of our revenue for the year ended December 31, 2008. We expect that sales to a small number of customers will continue to comprise a significant portion of our revenue in the future.

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We buy raw materials from our joint ventures. In addition, there were two third party customers for the raw materials from our joint ventures that accounted for greater than 10% of revenue from raw materials sales at 21% and 19% for the year ended December 31, 2010, and three third party customers for our raw materials that accounted for greater than 10% of revenue from raw materials sales at 18%, 13% and 11% for the year ended December 31, 2009 and two third party customers for our raw materials that accounted for greater than 10% of revenue from raw materials sales at 28% and 16% for the year ended December 31, 2008. Our joint ventures are a key strategic benefit for us as they give us a strong competitive advantage of allowing our customers to work with one supplier for all their substrate and raw material requirements. Our raw materials customers include chemical companies; additionally, we sell raw materials to some of our competitors of our substrate business.

Manufacturing, Raw Materials and Supplies

We believe that our operating results reflect our manufacturing efficiency and high product yields and we continually emphasize quality and process control throughout our manufacturing operations. We manufacture all of our products at our facilities in Beijing, China, which generally has favorable costs for facilities and labor compared to our previous manufacturing in the United States. We believe that our capital investment and subsequent operating costs are lower for our manufacturing facilities in China relative to the previous facilities in the United States. Although some of our manufacturing operations are fully automated and computer monitored or controlled, enhancing reliability and yield, we expect to continue to improve our processes and increase the number of automated processes in 2011. We use proprietary equipment in our substrate manufacturing operations to protect our intellectual property and control the timing and pace of capacity additions. All of our manufacturing facilities are ISO 9001 or 9002 certified. In January 2006, our Beijing facility successfully passed the ISO 14001 certification audit.

We have five joint ventures in China that provide us favorable pricing, reliable supply and shorter lead-times for raw materials central to our manufactured products including gallium, arsenic, germanium, germanium dioxide, pyrolitic boron nitride crucibles, and boron oxide. We believe that these joint ventures and investments will be advantageous in procuring materials to support our growth and cost management goals. In addition, we purchase supply parts, components and raw materials from several other domestic and international suppliers. We depend on a single or limited number of suppliers for certain critical materials used in the production of our substrates, such as quartz tubing, and polishing solutions. We generally purchase these materials through standard purchase orders and not pursuant to long-term supply contracts. Although we seek to maintain sufficient inventory levels of certain materials to guard against interruptions in supply and to meet our near term needs, and have to date been able to obtain sufficient supplies of materials in a timely manner, in the future, we may experience shortages of certain key materials, such as gallium.

Sales and Marketing

We advertise in trade publications, distribute promotional materials, conduct marketing and sales programs, and participate in industry trade shows and conferences in order to raise market awareness of our products.

We sell our substrate products directly to customers through our direct sales force in the U.S. and through independent sales representatives in France, Germany, Japan, South Korea, Taiwan and the United Kingdom. Our direct sales force is knowledgeable in the use of compound and single-element substrates. Our applications engineers work with customers during all stages of the substrate manufacturing process, from developing the precise composition of the substrate through manufacturing to processing the substrate to the customer’s specifications. We believe that maintaining a close relationship with customers and providing them with ongoing engineering support improves customer satisfaction and will provide us with a competitive advantage in selling other substrates to our customers.

Operator

Next is Richard Newitter with Leerink.

Richard Newitter - *Leerink Partners - Analyst*

Hello. Thanks for taking the questions. Congrats on the deal.

And, Bob, congrats on the Augment approval.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Thanks, Rich.

Richard Newitter - *Leerink Partners - Analyst*

Just two quick follow-ups.

It s been asked a few times, but maybe kind of a different way. You both carry total ankle portfolios. If I m hearing you correctly, you are saying that there is enough demand for both products; and there are enough nuance differences between the two that you feel like keeping both full-product portfolios on board is the correct strategy going forward?

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OCTOBER 27, 2014 / 9:30PM, WMGI - Wright Medical Group Inc and Tornier N.V. Merger Call

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Yes. As I said, there is a lot of surgeon preference that goes on. The physicians get used to products, and they are very sticky. I have noticed in orthopedics, as opposed to really some of the businesses I have been in, medical devices is these products are very, very sticky. Doctors get involved with a product, and they stick with it.

So we will try to maximize both portfolios. And if things change where doctors prefer one or the other or a new product comes out, that may change. But in the immediate future, I think we intend to fully maximize both portfolios.

Richard Newitter - *Leerink Partners - Analyst*

And then going back to another question that was asked on the call about being able to leverage the various call points given that you have dedicated sales forces dealing with different specialists and different orthopedic sub specialties in shoulder, foot, and ankle.

Is there another way to think about it? That you are seeing a shift to the decision making at the institutional level going towards hospital administrator, and in some way they re looking to work with fewer vendors and this will position you in that context? Is there something kind of beyond the just cross-selling or typical-cross selling?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

There are two things. First of all, I don t see any leverage between the two different sales forces, Upper and Lower. I think those are separate because, just as you said, there are different call points.

I do think that with our size that we are going to have and having the portfolio of Upper, Lower, and Biologics, is that we may be more effective in contract negotiations than we ever could be separately. And the bigger competitors use this to their advantage. And I think both companies have been successful in still selling into these big institutions.

But I do think that this will give us an advantage that we didn t have, a potential advantage anyway, in terms of contracting.

Richard Newitter - *Leerink Partners - Analyst*

Great. And then just one last one.

Bob, your Q4 guidance it looks like is stepping down a touch as well. You said that you ve identified issues with 3Q; 4Q is off to a solid start. Is that just there is some bleeding into the fourth quarter, or can you just describe that?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

It s primarily the trajectory. We are off a lower trajectory than we had anticipated. I think that s the most of it.

Richard Newitter - *Leerink Partners - Analyst*

Okay. Thanks.

Operator

Next is Glenn Novarro with RBC.

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OCTOBER 27, 2014 / 9:30PM, WMGI - Wright Medical Group Inc and Tornier N.V. Merger Call

Glenn Novarro - *RBC Capital Markets - Analyst*

Hello. Good afternoon.

Bob, just to start with you. Just one more question on your fourth-quarter guidance. I think Dave, when he gave his guidance for 4Q, I think I heard him say he is assuming some disruption created by the announcement of this deal. Do you assume any disruption in your business in the fourth quarter by this announcement?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Yes, but it s hard to quantify. I can t give you how much. There will be some, what I would call, distraction around this. There have been different sales reps or even distributors that have gone from Wright to Tornier and vice versa.

And I m not sure how they re feeling about this, although they should feel fine. But they might feel a little bit threatened, given that they might have recently changed companies. So I think that just history leads me to believe to plan for some distraction that may have some financial impact.

And we have included and I can t say what the exact number is because no one knows but certainly we said this is going to have some effect. We just don t know how much, and it s in our guidance.

Glenn Novarro - *RBC Capital Markets - Analyst*

Just one follow up for both Bob, for you and for David as we re looking at our models for each company separately. Obviously, Augment now goes into the right model; but Infinity was going to be a big driver. Can you give us an update on how that launch is?

And then for Dave, as I m looking into our model back end of next year and into 2016, we had Simplicity being a nice lift in the growth rate. So maybe if each of you could talk about how these products are going to affect the longer-term outlook? Thank you.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

I will talk about Infinity, and Dave can talk about his product.

Infinity is off to a great start. Even in Q3, we had excess of 20% growth in Infinity. The momentum is strong. Usually you get the benefit like a quarter after you launch it.

We just launched it in Q3, and so that was a terrific start. We ve trained I forget how many. But the leading indicator of success in these products is how many people you get trained.

So we ve trained just about all our sales force now and a great deal of surgeons. So we re looking in Q4 to that actually to ramp up even further; and as we get into next year, to continue going. So that s a strong product. It has a great trajectory, and we think it s going to keep on going.

Dave, you want to comment?

Dave Mowry - *Tornier - President & CEO*

Thanks, Bob.

Hello, Glenn. Thanks for the question.

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Simplicity, for those of you who follow Tornier, is the less invasive shoulder platform that we had done an FDA IDE trial on. It s a 510-K approval product with IDE support. We are wrapping up the enrollment following up on the patients. The two-year follow up concludes here in November, and we ll be submitting to the FDA our 510-K with clinical results.

Our anticipated completion and approval is about mid year of 2015. And we are preparing right now for the ramp with set builds, as well as training programs et cetera, for the launch of that product. A significant portion of that unfortunately will cannibalize some of our existing total shoulder market.

However, we also believe that Simplicity will recruit in a significant portion of folks that are looking to add younger patients that have the opportunity to have earlier intervention. So we re really excited about Simplicity. And a lot of energy and focus is going into the preparation for it.

Glenn Novarro - *RBC Capital Markets - Analyst*

Okay. Thanks and congratulations.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Thanks.

Operator

Next is Raj Denhoy with Jefferies.

Raj Denhoy - *Jefferies & Company - Analyst*

Hello. Good evening.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Hello, Raj.

Raj Denhoy - *Jefferies & Company - Analyst*

A lot has already been asked, but I just wanted to follow up on revenue growth. From what we heard from other questions, it sounds like a lot of the acceleration, if not most of the acceleration in mid teens, is Augment-based. And so I m curious if there s anything you ve learned through the last year, plus with the FDA, that has changed at all your expectations for that product?

Certainly you re still putting out the same revenue target. But if it all changed how you think about that product at this point?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

No. I think first of all, I would say that in the short term, I think we will be successful when final labeling is approved to have a broad enough label to do just about everything we thought we would be able to do. So it s meeting our expectations.

Longer term, I think that we should all think and this is new, but we have been thinking about this a lot is this is really a platform technology. And what we plan to do is to star other clinical trials.

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We have an IDE approved for the injectable product for elbows that we will ramp up. We put that on hold while we were in the state of limbo. And also we feel that we should start a clinical trial for Upper in the shoulder see what use it can be there.

So we think that we re just at the beginning stages of Augment. It s a very unique product now with this pending PMA approval. I think it s really going to serve us well, and the combined Company is going to have a tremendous result from this.

Raj Denhoy - *Jefferies & Company - Analyst*

To that point, I mean so much has changed in the last year. I only ask this because, again, unless I m mistaken, so much of the acceleration comes from that product. But a year ago, the FDA didn t really want anything do with it. And now it sounds like you re expecting approval in six months and potentially expanding indications and everything. And so maybe you could just describe what s changed so dramatically at the agency.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

First of all, I think that the core business of both companies is driving most of the growth and particularly from Wright, total ankle accelerating into very strong in the foreseeable future. That s driving most of the growth.

And on the Tornier side, they re very strong and a lot of momentum in their shoulder business. And that s going to continue for the foreseeable future. So I think both of those things are driving most of the growth.

What happened in the agency with Augment, I think, is you might recall the whole history how we got the non-approval letter a year ago. We were going to go through dispute resolution panel. The agency contacted us and said perhaps an amendment might work.

We worked through that. We had a team of people that were outstanding, both internal and external, to drive that; get them the data that they needed to approve the product. And in some cases, it was a little bit different data that was included in the original PMA. So the FDA had new things to look at, to consider; and all that went well.

It was very hard as we went through the process for me to handicap. And I kept on saying this I don t know how this is all going to come out. But what I did notice was a very positive interaction between the agency and the Company.

And that meant that calls were returned promptly, negotiations were done well. It wasn t any of the gamesmanship that sometimes you get. That made me feel good. I can t say it was a surprise that we got approved. But I wouldn t have been surprised if it went the other way either, given the history with Augment. A great result.

Raj Denhoy - *Jefferies & Company - Analyst*

That s helpful. Congratulations.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Thanks.

Operator

Next is Mike Matson with Needham.

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Mike Matson - *Needham & Company - Analyst*

Hello. Thanks for taking my question. I guess I just want go back to the cost synergies, that $40 million to $45 million. My math indicates it s about 78% of your combined operating expenses.

I know that s consistent with some of the deals we have seen in the space among the larger companies. But your operating expenses on both sides are considerably higher as a percentage of sales. So I guess I would have thought you would be able to get some more significant cost synergies just from the leverage effect of having more revenue over fixed cost and so forth. Can you comment on that?

Lance Berry - *Wright Medical Group, Inc. - SVP & CFO*

Sure, Mike. This is Lance.

I guess we ve looked at it a slightly different way. First thing I think to think about is we have talked about on the call is these businesses are really very complementary not redundant, not lots of overlap. So that does reduce some the target areas for cost synergies, but is really helpful for revenue which is the most important thing.

The other thing is when you look at the Tornier large joint business, that s really almost a part of the business that s not even applicable to view from a synergy opportunity standpoint. So if you look at the $40 million to $45 million, that s about 15% to 16% of Tornier s extremity products revenue. We think that s a very healthy synergy number for these two businesses, given their complementary nature as opposed to something that was highly overlapping. And we think something that we can put a good plan around to go achieve, while still driving high-growth revenue in both businesses.

Mike Matson - *Needham & Company - Analyst*

Okay. Thanks.

And then just on the total ankle. I know there has already been some commentary, but the 25% number seems pretty low to me, I guess. Because from what I remember, and I might be wrong, but I think your growth rate was considerably higher than that in the year. And now this is the first quarter after Infinity was launched.

I understand it is just getting out there, but I guess I would have hoped that it was at least able sustain the kind of growth we are seeing. So if I m wrong, let me know. Maybe the growth is lower than I thought in the first half.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

No. It was 50% better than Q3 last year, right?

Lance Berry - *Wright Medical Group, Inc. - SVP & CFO*

No. We grew 50% in Q3 last year.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

That s right. So the comp was pretty and I think the comp was pretty tough. And I also think, Mike, that as I said, you get the benefit the quarter after the launch; you don t get it in the quarter.

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And in the quarter that you launch the product, you re still doing a lot of training. But I know that I sat through last week a whole bunch of what we call quarterly business reviews with district managers. And they have very strong cases reserved for the rest of Q4.

Mike Matson - *Needham & Company - Analyst*

All right. Thanks a lot.

Operator

Next is Jason Wittes with Brean.

Jason Wittes - *Brean Capital, LLC - Analyst*

Hello, thanks for fitting me in. Just a couple follow ups here. and congratulations as well on the deal and the Augment approval.

First off, just to push you a little bit on your comments at the very beginning about this quarter s performance and the changes you made. You mentioned something refocusing on the core. Could you just kind of explain what you mean by that?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

We have met, or even maybe exceeded, our expectations on total ankle. But on our core foot and ankle products the plates and screws and all that kind of stuff that s what fell short. And it seems like we needed to improve our execution in that area. We made some organizational structural changes in Q3 that we think addresses that.

Jason Wittes - *Brean Capital, LLC - Analyst*

Does that mean a shift a little bit more towards the plates and screws away from total ankle, or your just ?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

That s where we fell short. was in the core foot and ankle. Currently, that s a larger business than total ankle.

Jason Wittes - *Brean Capital, LLC - Analyst*

Right. So I guess I m asking, does that mean you felt maybe you expended too many resources on total ankle and maybe you need to pull back a little bit and refocus?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

No. I see what you re saying. That s why the refocus. No, it s not that. It s that the commercial organization and again, I am in charge of this organization. I take responsibility.

We did not execute particularly in the first parts of Q3 in booking the number of cases that we needed to book to show the growth that we needed to show. And we fell short.

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Jason Wittes - *Brean Capital, LLC - Analyst*

I understand. And then just a couple of questions on Augment. One, in terms of the label I know there is discussion to be had. But it sounds like it s basically going to be for all fusions, and there is really no black box warning or anything like that to be worried about. Is that ?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

There is no black box warning. It s for hind foot fusions.

Dave Mowry - *Tornier - President & CEO*

Ankle and hind foot.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Ankle and hind foot fusions, yes.

Jason Wittes - *Brean Capital, LLC - Analyst*

Okay. And then you mentioned cost effectiveness in the slides. Does that could you kind of just give a little more detail on that? I assume there is some kind of price involved where you feel it s cost-effective verses harvesting. What can you say about the cost effectiveness and about ASP that you re looking to get in the market place?

Lance Berry - *Wright Medical Group, Inc. - SVP & CFO*

Yes, Jason. We have done some work on this (inaudible) even pre Wright acquisition had done work on this to try and compare really, auto graft is not a no-cost procedure. There are things that go along with that, and particularly if you start bringing in the cost of complications from the second site.

And so when you do that, you can kind of prove on overall economic basis that these things are similar. Whereas Augment offers, obviously, large patient benefits. And that s where the cost effectiveness comes in.

And we ve talked about pricing. We think we can price it at a premium to a lot of the other things that are in the market today but still at a discount to infuse, which is you know pretty highly priced and is still used on foot and ankle for certain particular specific situations.

Jason Wittes - *Brean Capital, LLC - Analyst*

Okay. Did you ever put out a rough ASP for that?

Lance Berry - *Wright Medical Group, Inc. - SVP & CFO*

No.

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Jason Wittes - *Brean Capital, LLC - Analyst*

Okay. Great. Thanks and congratulations again.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Thanks.

Operator

Next is Mark Landy with Summer Street Research.

Mark Landy - *Summer Street Research Partners - Analyst*

Good evening. Congratulations to everybody and thanks for squeezing me in.

Lance, a quick one for you. If I m not mistaken, you wrote down the Biomedics acquisition. At some point will you have to write it up again, or how will that be handled?

Lance Berry - *Wright Medical Group, Inc. - SVP & CFO*

That s a broad statement, so I d be careful with generalities. But in general, once you write things down, you don t write them back up. So the intangibles and things like that, those are written off for Augment. And we actually wrote off quite a bit of inventory also. So that will be helpful once the product is approved, as far as profitability is concerned.

Mark Landy - *Summer Street Research Partners - Analyst*

Yes, that s where I was going; so you kind of get to pass on that.

And then, obviously, cash distribution to the CVR holders when you get approval so around six months or kind of the early part of next year? Is that correct?

Lance Berry - *Wright Medical Group, Inc. - SVP & CFO*

Yes, Bob said first half is what we ought to be looking at first half 2015.

Mark Landy - *Summer Street Research Partners - Analyst*

Sure.

Bob, I think that you had kind of stopped everything. You mentioned some of the restarting of the clinical trials. There was work that was already done with protocols in place. There was work completed on the injectable on tendinosis.

Are you still going to look at those protocols, review them, make sure they meet Wright medical standards? Or do you just start those up again? How do you progress with those?

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Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Right now, as I said, this is new. We put a hold to everything, obviously, while this thing was in flux with FDA. And I think we ll take a look at everything. Our main focus though, I have to tell you, is to get the current product that is approved, and will be approved, on the market as quickly as we can. And then we ll start looking at this as to how we can expand this. I do know that we do have an IDE that was active that we stopped enrolling patients on after we got the not approval letter last September. That could probably be the first candidate to get started.

Mark Landy - *Summer Street Research Partners - Analyst*

And then just, Bob, I guess Dave was asked on his viewpoint of large joints. I don t know if you had an opportunity to respond. It s 9% of the combined business. Obviously, you got rid of the last business you had there. How do you view the large joints?

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

This is I agree with Dave. This is very different than the business that we sold off. This is a business that is primarily in Europe and is contained. It does produce cash flow and EBITDA.

So I don t have a psychological aversion to large joints, if that s what you re getting at. But I do think that, as Dave said, this is something that will be constantly under review like everything else in terms of what s a strategic fit long term and judgments will be made. But there is nothing immediately that we re going go out and do that s any different than what s currently happening.

Mark Landy - *Summer Street Research Partners - Analyst*

Okay. Thanks and congratulations to all again.

Dave Mowry - *Tornier - President & CEO*

Thanks, Mark.

Operator

We have no further questions. So I ll pass it over to you, Bob, for any closing comments.

Bob Palmisano - *Wright Medical Group, Inc. - President & CEO*

Thank you, Operator.

We want to reiterate our excitement for this transaction, which represents an exciting transformation and next chapter for both companies. We believe there is a bright future ahead for the new combined Wright. Dave and I wish to thank the collective teams at Tornier and Wright for working so closely together to get us to where we are today.

Obviously, a lot of work lies ahead of us. But we are extremely excited about the opportunity to bring our two companies together to create the premier high-growth extremities Biologics company. And so on behalf of the management teams at Tornier and Wright, I want to thank you for joining us today. We appreciate your interest and continued support.

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Operator

Great. Thanks for your time and your participation. Have a great rest of the day.

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Important Additional Information and Where to Find It

In connection with the proposed merger, Tornier plans to file with the U.S. Securities and Exchange Commission (SEC) a registration statement on Form S-4 that will include a joint proxy statement of Wright and Tornier that also constitutes a prospectus of Tornier. Wright and Tornier will make the joint proxy statement/prospectus available to their respective shareholders. **Investors are urged to read the joint proxy statement/prospectus when it becomes available, because it will contain important information.** The registration statement, definitive joint proxy statement/prospectus and other documents filed by Tornier and Wright with the SEC will be available free of charge at the SEC s website (www.sec.gov) and from Tornier and Wright. Requests for copies of the joint proxy statement/prospectus and other documents filed by Wright with the SEC may be made by contacting Julie Tracy, Senior Vice President and Chief Communications Officer by phone at (901) 290-5817 or by email at julie.tracy@wmt.com, and request for copies of the joint proxy statement/prospectus and other documents filed by Tornier may be made by contacting Shawn McCormick, Chief Financial Officer by phone at (952) 426-7646 or by email at shawn.mccormick@tornier.com.

Wright, Tornier, their respective directors, executive officers and employees may be deemed to be participants in the solicitation of proxies from Wright s and Tornier s shareholders in connection with the proposed transaction. Information about the directors and executive officers of Wright and their ownership of Wright stock is set forth in Wright s annual report on Form 10-K for the fiscal year ended December 31, 2013, which was filed with the SEC on February 27, 2014 and its proxy statement for its 2014 annual meeting of stockholders, which was filed with the SEC on March 31, 2014. Information regarding Tornier s directors and executive officers is contained in Tornier s annual report on Form 10-K for the fiscal year ended December 29, 2013, which was filed with the SEC on February 21, 2014, and its proxy statement for its 2014 annual general meeting of shareholders, which was filed with the SEC on May 16, 2014. These documents can be obtained free of charge from the sources indicated above. Certain directors, executive officers and employees of Wright and Tornier may have direct or indirect interest in the transaction due to securities holdings, vesting of equity awards and rights to severance payments. Additional information regarding the participants in the solicitation of Wright and Tornier shareholders will be included in the joint proxy statement/prospectus.

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