FORM S-1 · REGISTRATION STATEMENT

Terayon Communication Systems

IPO priced 1998-08-18 · $13.00 a share · TERN



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AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON JUNE 16, 1998 REGISTRATION NO. 333-

SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549

FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

TERAYON COMMUNICATION SYSTEMS (EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

CALIFORNIA (PRIOR TO 3661 77-0328533 REINCORPORATION) (PRIMARY STANDARD INDUSTRIAL (I.R.S. EMPLOYER DELAWARE (AFTER CLASSIFICATION CODE NUMBER) IDENTIFICATION NUMBER) REINCORPORATION) (STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION) 2952 BUNKER HILL LANE SANTA CLARA, CA 95054 (408) 727-4400 (ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES) DR. ZAKI RAKIB CHIEF EXECUTIVE OFFICER TERAYON COMMUNICATION SYSTEMS 2952 BUNKER HILL LANE SANTA CLARA, CA 95054 (408) 727-4400 (NAME, ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF AGENT FOR SERVICE) COPIES TO: JAMES C. GAITHER NEIL WOLFF KARYN R. SMITH YOICHIRO TAKU PETER M. O. WONG NOGA DEVECSERI SPIRA COOLEY GODWARD LLP WILSON SONSINI GOODRICH & ROSATI ONE MARITIME PLAZA PROFESSIONAL CORPORATION 20TH FLOOR 650 PAGE MILL ROAD SAN FRANCISCO, CA 94111 PALO ALTO, CA 94304 (415) 693-2000 (650) 493-9300 APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO THE PUBLIC: AS SOON AS PRACTICABLE AFTER THE REGISTRATION STATEMENT BECOMES EFFECTIVE. IF ANY OF THE SECURITIES BEING REGISTERED ON THIS FORM ARE TO BE OFFERED ON A DELAYED OR CONTINUOUS BASIS PURSUANT TO RULE 415 UNDER THE SECURITIES ACT, CHECK THE FOLLOWING BOX. [_] IF THIS FORM IS FILED TO REGISTER ADDITIONAL SECURITIES FOR AN OFFERING PURSUANT TO RULE 462(B) UNDER THE SECURITIES ACT, CHECK THE FOLLOWING BOX AND LIST THE SECURITIES ACT REGISTRATION STATEMENT NUMBER OF THE EARLIER EFFECTIVE REGISTRATION STATEMENT FOR THE SAME OFFERING. [_] IF THIS FORM IS A POST-EFFECTIVE AMENDMENT FILED PURSUANT TO RULE 462(C) UNDER THE SECURITIES ACT, CHECK THE FOLLOWING BOX AND LIST THE SECURITIES ACT REGISTRATION STATEMENT NUMBER OF THE EARLIER EFFECTIVE REGISTRATION STATEMENT NUMBER FOR THE SAME OFFERING. [_] IF THIS FORM IS A POST-EFFECTIVE AMENDMENT FILED PURSUANT TO RULE 462(D) UNDER THE SECURITIES ACT, CHECK THE FOLLOWING BOX AND LIST THE SECURITIES ACT REGISTRATION NUMBER OF THE EARLIER EFFECTIVE REGISTRATION STATEMENT FOR THE SAME OFFERING. [_] IF DELIVERY OF THE PROSPECTUS IS EXPECTED TO BE MADE PURSUANT TO RULE 434, CHECK THE FOLLOWING BOX. [_] CALCULATION OF REGISTRATION FEE

TITLE OF EACH CLASS OF SECURITIES TO BE REGISTERED	PROPOSED MAXIMUM AGGREGATE OFFERING PRICE(1)	AMOUNT OF REGISTRATION FEE
COMMON STOCK, $.001 PAR VALUE	$50,000,000	$14,750

(1) ESTIMATED SOLELY FOR THE PURPOSE OF CALCULATING THE AMOUNT OF THE REGISTRATION FEE IN ACCORDANCE WITH RULE 457 UNDER THE SECURITIES ACT OF 1933. THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT THAT SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933, AS AMENDED, OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

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+INFORMATION CONTAINED HEREIN IS SUBJECT TO COMPLETION OR AMENDMENT. A   +
+REGISTRATION STATEMENT RELATING TO THESE SECURITIES HAS BEEN FILED WITH THE   +
+SECURITIES AND EXCHANGE COMMISSION. THESE SECURITIES MAY NOT BE SOLD NOR MAY +
+OFFERS TO BUY BE ACCEPTED PRIOR TO THE TIME THE REGISTRATION STATEMENT   +
+BECOMES EFFECTIVE. THIS PROSPECTUS SHALL NOT CONSTITUTE AN OFFER TO SELL OR   +
+THE SOLICITATION OF AN OFFER TO BUY NOR SHALL THERE BE ANY SALE OF THESE   +
+SECURITIES IN ANY STATE IN WHICH SUCH OFFER, SOLICITATION OR SALE WOULD BE   +
+UNLAWFUL PRIOR TO THE REGISTRATION OR QUALIFICATION UNDER THE SECURITIES LAWS +
+OF ANY SUCH STATE.   +
++

SUBJECT TO COMPLETION
JUNE 16, 1998

SHARES

[LOGO OF TERAYON COMMUNICATION SYSTEMS APPEARS HERE]

COMMON STOCK

ALL OF THE SHARES OF COMMON STOCK OF TERAYON COMMUNICATION SYSTEMS ("TERAYON" OR THE "COMPANY") ARE BEING SOLD BY THE COMPANY. PRIOR TO THIS OFFERING, THERE HAS BEEN NO PUBLIC MARKET FOR THE COMMON STOCK. IT IS CURRENTLY ESTIMATED THAT THE INITIAL PUBLIC OFFERING PRICE WILL BE BETWEEN $ AND $ PER SHARE. SEE "UNDERWRITING" FOR INFORMATION RELATING TO THE METHOD OF DETERMINING THE INITIAL PUBLIC OFFERING PRICE.

THE COMMON STOCK OFFERED HEREBY INVOLVES A HIGH DEGREE OF RISK. SEE "RISK FACTORS" BEGINNING ON PAGE 5.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	PRICE TO PUBLIC	UNDERWRITING DISCOUNTS AND COMMISSIONS(1)	PROCEEDS TO COMPANY(2)
Per Share.....	$	$	$
Total(3).....	$	$	$

(1) SEE "UNDERWRITING" FOR INFORMATION RELATING TO INDEMNIFICATION OF THE UNDERWRITERS AND OTHER MATTERS. (2) BEFORE DEDUCTING EXPENSES PAYABLE BY THE COMPANY, ESTIMATED AT $1,100,000. (3) THE COMPANY HAS GRANTED TO THE UNDERWRITERS A 30-DAY OPTION TO PURCHASE UP TO ADDITIONAL SHARES OF COMMON STOCK SOLELY TO COVER OVER- ALLOTMENTS, IF ANY. TO THE EXTENT THAT THE OPTION IS EXERCISED, THE UNDERWRITERS WILL OFFER THE ADDITIONAL SHARES AT THE PRICE TO PUBLIC AS SHOWN ABOVE. IF THE OPTION IS EXERCISED IN FULL, THE TOTAL PRICE TO PUBLIC, UNDERWRITING DISCOUNTS AND COMMISSIONS AND PROCEEDS TO COMPANY WILL BE $, $ AND $, RESPECTIVELY. SEE "UNDERWRITING."

THE SHARES OF COMMON STOCK ARE OFFERED BY THE SEVERAL UNDERWRITERS, SUBJECT TO PRIOR SALE, WHEN, AS AND IF DELIVERED TO AND ACCEPTED BY THEM, AND SUBJECT TO THE RIGHT OF THE UNDERWRITERS TO REJECT ANY ORDER IN WHOLE OR IN PART. IT IS EXPECTED THAT DELIVERY OF THE SHARES OF COMMON STOCK WILL BE MADE AT THE OFFICES OF BT ALEX. BROWN INCORPORATED, BALTIMORE, MARYLAND, ON OR ABOUT , 1998.

BT ALEX. BROWN

HAMBRECHT & QUIST

SALOMON SMITH BARNEY

THE DATE OF THIS PROSPECTUS IS , 1998.

[GRAPHIC CONSISTING OF A DEPICTION OF THE FOLLOWING COMPONENTS OF BROADBAND COMMUNICATIONS SOLUTIONS:

S-CDMA CABLE MODEM SYSTEM STANDARDS-BASED MODEM SYSTEM TECHNOLOGY LEADERSHIP SET-TOP BOXES IP & CIRCUIT TELEPHONY] TERACOMM, TERALINK, TERAPRO, TERAVIEW AND TERAYON ARE TRADEMARKS OF THE COMPANY. ALL OTHER TRADEMARKS OR SERVICE MARKS APPEARING IN THIS PROSPECTUS ARE THE PROPERTY OF THEIR RESPECTIVE OWNERS.

CERTAIN PERSONS PARTICIPATING IN THIS OFFERING MAY ENGAGE IN TRANSACTIONS THAT STABILIZE, MAINTAIN OR OTHERWISE AFFECT THE PRICE OF THE COMMON STOCK OF THE COMPANY, INCLUDING OVER-ALLOTMENT, ENTERING STABILIZING BIDS, EFFECTING SYNDICATE COVERING TRANSACTIONS OR IMPOSING PENALTY BIDS, IN CONNECTION WITH THE OFFERING. FOR A DESCRIPTION OF THESE ACTIVITIES, SEE "UNDERWRITING."

[GATEFOLD]

[GRAPHIC DEPICTING THE COMPONENTS OF THE TERACOMM SYSTEM AND POTENTIAL USERS OF THE SYSTEM] CAPTIONS:

SYNCHRONOUS-CODE DIVISION MULTIPLE ACCESS ("S-CDMA") TECHNOLOGY. TERAYON'S S-CDMA TECHNOLOGY ALLOWS CABLE OPERATORS TO PROVIDE RELIABLE TWO-WAY BROADBAND COMMUNICATIONS UTILIZING MORE OF THE EXISTING UPSTREAM BANDWIDTH THAN ALTERNATIVE BROADBAND ACCESS TECHNOLOGIES.

FLEXIBLE ARCHITECTURE. THE COMPANY'S SYSTEM CAN BE DEPLOYED ON ANY CABLE INFRASTRUCTURE, FROM PURE COAXIAL SYSTEMS TO HYBRID FIBER/COAX ("HFC") UPGRADED SYSTEMS, PROVIDING CABLE OPERATORS WITH A COST- EFFECTIVE BROADBAND ACCESS SOLUTION.

ECONOMIC ADVANTAGE. THE TERAYON SYSTEM DOES NOT REQUIRE COSTLY CABLE INFRASTRUCTURE UPGRADES, FILTERS OR NEW CABLE DROPS, ALLOWING CABLE OPERATORS TO PROVIDE BROADBAND ACCESS SERVICES WITH LOW START-UP COSTS.

RESIDENTIAL AND COMMERCIAL SERVICES. THE TERACOMM SYSTEM ALLOWS CABLE OPERATORS TO PROVIDE TIERED LEVELS OF SERVICE WITH VARIOUS ACCESS SPEEDS AND PRIORITY CONNECTIONS, FROM LOWER MARGIN RESIDENTIAL INTERNET ACCESS TO HIGHER MARGIN COMMERCIAL SERVICE OFFERINGS.

Prospectus Summary

The following summary is qualified in its entirety by the more detailed information and the consolidated financial statements and notes thereto appearing elsewhere in this Prospectus. Except as set forth in the consolidated financial statements or as otherwise indicated herein, information in this Prospectus (i) gives effect to the reincorporation of the Company from California to Delaware to be effected prior to the closing of this offering, (ii) gives effect to the conversion of all of the Company's outstanding shares of Preferred Stock into shares of Common Stock, which will occur automatically upon the closing of this offering and (iii) assumes that the Underwriters' over-allotment option is not exercised. See "Description of Capital Stock" and "Underwriting." This Prospectus contains forward-looking statements that involve risks and uncertainties. Actual events or results could differ materially from those expressed in or implied by these forward-looking statements as a result of a number of factors, including those set forth under "Risk Factors" and elsewhere in this Prospectus.

The Company

Terayon develops, markets and sells cable modem systems that enable cable operators to cost-effectively deploy reliable two-way broadband access services. The Company's TeraComm system is designed to allow cable operators to minimize time-consuming and costly network infrastructure upgrades, achieve reduced time to market and provide a wide range of service levels to residential and commercial end users. Cable operators using the TeraComm system are able to provide additional revenue-generating services to end users, enabling cable operators to compete effectively in the emerging market for broadband access services.

In recent years, the volume of bandwidth intensive data, voice and video traffic across the Internet, corporate intranets and other public networks has increased dramatically. International Data Corporation ("IDC") estimates that the number of Internet users will increase from approximately 69

million at the end of 1997 to approximately 320 million by the end of 2002. IDC also estimates that the number of home office households will increase from approximately 35 million at the end of 1997 to approximately 40 million by the end of 1999. Although various technologies have emerged to address the need for broadband access, the existing cable infrastructure currently provides the highest available two-way transmission speeds and "always-on" availability. In addition, the existing cable infrastructure currently passes more than 95% of homes in the U.S. and a large number of small businesses.

The Company's TeraComm system, comprised of the TeraPro cable modem, the TeraLink 1000 Master Controller, the TeraLink Gateway and the TeraView Element Management and Provisioning Software, is based on Terayon's Synchronous Code Division Multiple Access ("S-CDMA") technology. S-CDMA enables reliable two-way broadband communications over both pure coaxial and hybrid fiber/coax ("HFC") cable infrastructure by maximizing resistance to noise that interferes with data transmissions over previously unusable frequency spectrum. Cable operators utilizing cable modems based on alternative technologies such as Time Division Multiple Access must typically upgrade their networks to an HFC architecture. The TeraComm system is designed to allow cable operators to minimize these costly and time-consuming network upgrades.

Terayon's objective is to be the leading provider of cable modem systems to cable operators seeking to provide broadband access services to residential and commercial end users. Key elements of the Company's strategy are to supply leading cable operators worldwide, establish relationships with industry leaders, expand worldwide distribution channels, provide superior customer service and support, adopt and advocate industry standards, and leverage its S- CDMA technology.

Terayon sells its products to cable operators through direct sales forces in North America, Latin America and Europe. The Company also distributes its products via distributors and systems integrators. Companies currently using or distributing the TeraComm system include Shaw Communications Inc., TCA Cable Systems and Crossbeam Networks Corporation, a wholly owned subsidiary of Sumitomo Corporation.

Terayon was incorporated in California in January 1993 and intends to reincorporate in Delaware prior to the closing of this offering. The Company's executive offices are located at 2952 Bunker Hill Lane, Santa Clara, California 95054 and its telephone number is (408) 727-4400.

The Offering

Common Stock offered by the Company..... shares Common Stock outstanding after the offering..... shares (1) Use of proceeds..... Working capital and other general corporate purposes Proposed Nasdaq National Market symbol..... TERN

Summary Consolidated Financial Data (In Thousands, Except Per Share Data)

	YEARS ENDED DECEMBER 31,				THREE MONTHS ENDED MARCH 31,	
	1994	1995	1996	1997	1997	1998
CONSOLIDATED STATEMENT OF OPERATIONS DATA:						
Revenues	$ 140	$ --	$ --	$ 2,118	$ --	$ 2,444
Cost of goods sold	--	676	--	6,462	178	4,134
Gross profit (loss)	140	(676)	--	(4,344)	(178)	(1,690)
Operating expenses						
Research and development	235	2,028	8,020	11,319	2,580	2,305
Sales and marketing	17	205	1,141	4,468	529	1,140
General and administrative	84	825	1,789	2,546	461	505
Total operating expenses	336	3,058	10,950	18,333	3,570	3,950
Loss from operations	(196)	(3,734)	(10,950)	(22,677)	(3,748)	(5,640)
Net interest income (expense)	--	68	253	128	91	(64)
Net loss	$ (196)	$ (3,666)	$(10,697)	$(22,549)	$ (3,657)	$ (5,704)
Pro forma basic and diluted net loss per share(2)				$ (2.07)		$ (0.48)
Shares used in pro forma basic and diluted net loss per share(2)				10,873		11,773

March 31, 1998 Actual as Adjusted(3)

CONSOLIDATED BALANCE SHEET DATA:		
Cash, cash equivalents and short-term investments	$ 109	$
Working capital (deficit)	(8,769)	
Total assets	8,226	
Long-term debt (less current portion)	34	
Accumulated deficit	(42,867)	
Total shareholders equity (net capital deficiency)	$ (6,821)	$

(1) Based on number of shares outstanding on March 31, 1998. Excludes as of June 11, 1998 (i) 2,489,232 shares issuable upon exercise of options outstanding at a weighted average exercise price of $2.46 per share; (ii) 38,462 shares of Common Stock issuable upon exercise of an outstanding warrant with an exercise price of $13.00 per share; (iii) 3,000,000 shares issuable upon exercise of an outstanding warrant with an exercise price of $6.50 per share; (iv) 2,363,746 shares reserved for future grants under the Company's stock option plans; and (v) 700,000 shares reserved for issuance pursuant to the Company's 1998 Employee Stock Purchase Plan. See "Management--Employee Benefit Plans" and Notes 8 and 13 of Notes to Consolidated Financial Statements.

(2) See Note 1 of Notes to Consolidated Financial Statements for an explanation of the method employed to determine the number of shares used to compute per share amounts.

(3) As adjusted to reflect (i) the sale of shares of Common Stock offered by the Company hereby at an assumed initial public offering price of $ per share and the application of the estimated net proceeds therefrom and (ii) the conversion of all outstanding shares of Preferred Stock into shares of Common Stock upon the closing of this offering. See "Use of Proceeds."

Risk Factors

The shares offered hereby involve a high degree of risk. The following risk factors should be considered carefully in addition to the other information in this Prospectus before purchasing the shares of Common Stock offered hereby. The discussion in this Prospectus contains certain forward-looking statements that involve risks and uncertainties, such as statements of the Company's plans, objectives, expectations and intentions. The cautionary statements made in this Prospectus should be read as being applicable to all related foward- looking statements wherever they appear in this Prospectus. The Company's actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include those discussed below as well as those discussed elsewhere herein. See "Information Regarding Forward-Looking Statements."

Early Stage of Development; History of Losses. The Company was incorporated in January 1993, began shipping products commercially in June 1997 and has only been shipping products in volume since the first quarter of 1998. Most commercial shipments of the Company's products through December 1997 were in limited quantities to customers deploying cable modems in pre-commercial trials. Accordingly, the Company has a very limited operating history, which makes the prediction of future operating results difficult. The Company has incurred significant losses since inception, including losses of $3.7 million, $10.7 million, $22.5 million and $5.7 million for 1995, 1996, 1997 and for the three months ended March 31, 1998, respectively. At March 31, 1998, the Company had an accumulated deficit of $42.9 million. The Company believes that it will continue to experience net losses for the foreseeable future. Because a majority of the Company's expenses are fixed in advance, the Company generally is unable to reduce its expenses significantly in the short term to compensate for any unexpected delay or decrease in anticipated revenues. As the Company increases its commercialization activities, it expects to increase expense levels in each of the next several quarters primarily to support increased sales and marketing and technical support costs. Accordingly, any significant delay in the Company's anticipated revenues or commercialization of new products would have an immediate adverse effect on the Company's business, operating results and financial condition. In addition, the Company has had negative gross margins since inception, and there can be no assurance that any growth in revenues will result in positive gross margins or operating profits.

The revenue and profit potential of the Company's business and industry are unproven, and the Company's limited operating history makes its future operating results difficult to predict. The Company has had limited experience selling its products to cable operators and only a limited number of cable operators have purchased the Company's products for commercial deployment. The market for the Company's products has only recently begun to develop, is rapidly changing and is characterized by an increasing number of competitors and competing technologies, as well as evolving industry

standards. See "-- Market Acceptance of Cable Modems; Competing Technologies," "--Dependence on Small Number of Customers," "--Ability to Market Effectively to Cable Operators," "--Highly Competitive Industry; Established Competitors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Fluctuations in Operating Results. The Company's quarterly revenues will be difficult to predict due to a number of factors and the Company expects to experience significant fluctuations in its operating results on a quarterly and an annual basis for the foreseeable future. Revenues will vary depending on the timing of orders and shipments. Orders by the same customer can vary in size over time, depending on whether the Company's products are intended for trial or commercial deployment purposes, and depending on the geographic area covered by the customer's deployment. Customers that have forecast deployment plans and product orders may delay orders for many customer-specific reasons, such as changes in customer marketing plans, delays in completing any infrastructure or billing system upgrades required to offer new services, variations in capital spending budgets and delays in obtaining regulatory approval for commercial deployment. Customers also may delay orders for industry-wide reasons such as the adoption of new technologies by cable operators, telephone or wireless telecommunications companies, or changes in U.S. and international regulations. For example, the Company's product shipments to date to a customer in Brazil have been significantly lower than anticipated due to delays in certain regulatory approvals in Brazil. There can be no assurance that similar delays will not occur in other countries in which the Company is marketing or planning to market its products. Any such delays would have a material adverse effect on the Company's operating results for a particular period. In addition, cable operators in certain parts of Asia are required to obtain licenses prior to deploying data services over cable, and delays in obtaining such licenses by the Company's customers could have an adverse impact on the Company's operating results for a particular period. Competitive factors may affect both Company revenues and profitability. Customers may delay orders due to new product announcements by the Company or its competitors. The Company's average selling prices for its products may be lower than expected as a result of competitive pricing pressures, the Company's promotional programs and customers who negotiate price reductions in exchange for longer term purchase commitments. The Company's expenses generally will vary from quarter to quarter depending on the level of actual and anticipated business activities. Research and development expenses will vary as the Company commences development of new products and as development programs move to wafer fabrication, which results in higher engineering expenses.

The timing and volume of customer orders are difficult to forecast because cable operators require a long sales cycle before placing orders. In addition, cable operators typically require delivery of products within 90 days. Accordingly, the Company has a limited backlog of orders, and net sales for any future quarter are difficult to predict. Supply, manufacturing or testing constraints could result in delays in the delivery of the Company's products. Further, sales generally are made pursuant to purchase orders, which can be rescheduled, reduced or cancelled with little or no penalty. Any delay in the product deployment schedule of one or more of the cable operators targeted by the Company would have an adverse effect on the Company's operating results for a particular period. In addition, due to the relatively large dollar size of the Company's typical transaction, any delay in the closing of a

transaction could have a significant impact on the Company's operating results for a particular period. See "--Limited Manufacturing Experience and Dependence on Contract Manufacturer" and "--Lengthy Sales Cycle."

A variety of factors affect the Company's gross margin, including average selling prices ("ASPs") of the Company's products, the sales mix of products, type of distribution channel, the volume of products manufactured and cost reduction measures. Historically, ASPs in the data communications industry have decreased over the life of individual products and technologies. The Company anticipates that unit ASPs of its products will decline in the future, which could cause a decrease in the gross margins for these products. The Company's gross margin also is affected by the sales mix of TeraLink 1000 Master Controllers, TeraLink Gateways and TeraPro cable modems, as the TeraPro cable modems have significantly lower margins than the TeraLink 1000 Master Controller and TeraLink Gateway headend products. The Company expects to achieve only nominal margins on the TeraPro cable modems and expects that sales of TeraPro cable modems will continue to constitute a significant portion of its revenues for the foreseeable future. See "--Erosion of Average Selling Prices" and "Management's Discussion and Analysis of Financial Condition and Results of Operations--Overview."

Market Acceptance of Cable Modems; Competing Technologies. The Company's future success, operating results and financial condition will be substantially dependent upon whether cable modems gain widespread commercial acceptance by cable operators and end users of broadband access services. Because cable operators have only recently begun to deploy broadband access services based on cable modem technology, the market for services based on such technology has not yet developed and the Company cannot accurately predict the future growth rate, if any, or the ultimate size of the cable modem market. Critical issues concerning the use of cable modems, including security, reliability, cost, ease of deployment and administration, and Quality of Service, remain largely unresolved and may adversely affect the Company's growth and the market acceptance of its products. The market for cable modems may be affected by the development of other technologies that enable the provisioning of broadband access services. Examples of such technologies include technologies that increase the efficiency of digital transmission over telephone companies' existing copper infrastructure, such as various Digital Subscriber Line technologies ("xDSL"), as well as Integrated Service Digital Network ("ISDN"). Similarly, broadband access services may be deployed over a number of other media, including fiber optic cable, direct broadcast satellite ("DBS"), Local Multipoint Distribution Service ("LMDS"), Multichannel Multipoint Distribution Service ("MMDS") and other wireless technologies. Broadband access services based on some of these competing technologies are already available and could materially limit acceptance of cable modem-based services. The Company also anticipates competition from all-digital systems, which may be offered from telecommunication or other service providers, such as the recently announced Integrated On-Demand Network from Sprint Corporation. The Company is unable to predict the effect of all-digital networks on competition among service providers who are introducing broadband access, and therefore the effect on the Company. The failure of broadband access services based on cable modem technology to gain widespread commercial

acceptance by cable operators and end users of broadband access services would have a material adverse effect on the Company's business, operating results and financial condition. See "Business--Industry Background."

Evolving Market; Rapid Technological Change; Market Acceptance of S- CDMA. The markets for the Company's products are characterized by rapid technological change, evolving industry standards, changes in end-user requirements and frequent new product introductions and enhancements, all of which are outside the control of the Company. The Company believes that its future success will depend upon its ability to enhance its existing products and to develop and introduce new products that meet a wide range of evolving cable operator end-user needs and achieve market acceptance. There can be no assurance that the Company's potential customers, specifically cable operators, will not adopt alternative technologies or deploy alternative services that are incompatible with the Company's products, which would have a material adverse affect on the Company's business, operating results and financial condition.

The demand for broadband access services has resulted in the development of several competing modulation techniques. The Company's products utilize a proprietary modulation technique known as Synchronous Code Division Multiple Access ("S-CDMA"), while several of the Company's competitors utilize modulation technologies known as Time Division Multiple Access ("TDMA") and Frequency Division Multiple Access ("FDMA"). The Company's headend equipment and cable modem products currently are not interoperable with the headend equipment and modems of other suppliers of broadband access products. As a result, potential customers who wish to purchase broadband access products from multiple suppliers may be reluctant to purchase the Company's products. While the Company believes that S-CDMA offers superior capabilities over TDMA and FDMA, there can be no assurance that major cable operators will adopt the Company's proprietary modulation technology. If major cable operators do not adopt products or technologies based on S-CDMA at all, or in the time frame anticipated by the Company, or if they adopt technologies based on competing modulation technologies rather than the Company's S-CDMA technology, the Company's business, operating results and financial condition would be materially adversely affected. Further, to the extent that competitors using TDMA or FDMA modulation technologies can incorporate functionality and capabilities currently found in S-CDMA, the value of the Company's proprietary S-CDMA technology would be diminished. See "Business--Industry Background."

Ability to Achieve Cost Reductions. Certain of the Company's competitors currently offer cable modems at prices lower than those of the Company's cable modems. Market acceptance of the Company's products, and the Company's future success, will depend in part on reductions in the unit cost of the Company's products. The Company expects that as headend equipment becomes more widely deployed, the price of cable modems and other products will decline. In particular, Company believes that the adoption of industry standards such as Data Over Cable Service Interface Specifications ("DOCSIS") will cause increased price competition for cable modems. However, there can be no assurance that the Company will be able to reduce the cost of its modems sufficiently to enable it to compete with other cable modem suppliers. While the Company has initiated cost reduction programs to offset pricing pressures on its products, there can be no assurance that these cost

reduction efforts will keep pace with competitive pricing pressures or lead to improved gross margins. If the Company is unable to obtain cost reductions, its gross margin and profitability will be adversely affected. Many of the Company's competitors are larger and manufacture products in significantly greater quantities than the Company intends to for the foreseeable future. Consequently, such competitors are likely to have more leverage in obtaining favorable pricing from suppliers and manufacturers. In order to remain competitive, the Company expects that it will have to significantly reduce the cost of manufacturing its cable modems through design and engineering changes. Reductions in such manufacturing costs will require the Company to utilize more highly integrated components in future products and may require the Company to enter into high volume or long-term purchase or manufacturing agreements. For example, the Company has developed and intends to introduce a single-board modem by the end of 1998, which the Company anticipates will provide cost savings over its current dual-board modem. There can be no assurance that the Company will be successful in redesigning its products, that any such redesign will be made on a timely basis and without introducing significant errors and product defects, or that any such redesign, including the single board modem, would result in sufficient cost reductions to allow the Company to significantly reduce the list price of its products or improve its gross margin. Moreover, there can be no assurance that volume purchase or manufacturing agreements will be available on terms that the Company considers acceptable. To the extent that the Company enters into a high volume or long- term purchase or manufacturing agreement and then decides that it cannot use the products or services offered by such agreement, the Company's business, operating results or financial condition could be materially adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations--Overview."

Limited Manufacturing Experience and Dependence on Contract Manufacturer. In the first quarter of 1998, the Company commenced volume shipments of its products and transitioned its manufacturing operations from CMC California, Inc. ("CMC") to Solectron Corporation ("Solectron"). The Company recorded a charge of $1.3 million for that quarter, relating to the write-off of obsolete inventory and the transition of manufacturing operations to a new contract manufacturer. Any interruption in Solectron's operations could adversely affect the Company's ability to meet its scheduled product deliveries to customers. The Company has had only limited experience manufacturing its products to date, and there can be no assurance that the Company, Solectron or any other manufacturer of the Company's products will be successful in increasing the volume of its manufacturing efforts. In addition, given the Company's lack of manufacturing experience, together with the complexity of the manufacturing process, there can be no assurance that the Company will not encounter difficulty in manufacturing its products in volume. The Company's limited operating history and the early stage of the cable modem market make it difficult for the Company to accurately forecast demand for its products. The Company's inability to accurately forecast the actual demand for its products could result in supply, manufacturing or testing capacity constraints. Such constraints could result in delays in the delivery of the Company's products or the loss of existing or potential customers, either of which could have a material adverse effect on the Company's business, operating results or financial condition. See "Business--Manufacturing."

Dependence on Component Availability and Key Suppliers. The Company manufactures all of its products using components or subassemblies procured from third-party suppliers. Certain of these components are available from a single source and others are available from limited sources. In addition, some of the components are custom parts produced to the Company's specifications. For example, the Company currently relies on VLSI Technology, Inc. ("VLSI") to supply a custom ASIC that is used in its products. Other components, such as the radio frequency ("RF") tuner and some surface acoustic wave filters are procured from sole source suppliers. Any interruption in the operations of vendors of sole sourced parts could adversely affect the Company's ability to meet its scheduled product deliveries to customers. There can be no assurance that delays in key component or product deliveries will not occur in the future due to shortages resulting from a limited number of suppliers, the financial or other difficulties of such suppliers or the possible limitation in component product availability due to significant worldwide demand for such components. For example, in the second half of 1997, the Company did not receive the full shipment of modems anticipated from its subcontract manufacturer because of problems experienced with one component that was not functioning according to its specifications. There can be no assurance that the Company will not experience similar supply problems in the future. In addition, all of the Company's sales are from products containing one or more components that are available from single supply sources. The Company also is dependent on semiconductor manufacturers and is affected by worldwide conditions in the semiconductor market. If the Company were unable to obtain a sufficient supply of components from its current sources, it could experience difficulties in obtaining alternative sources or in altering product designs to use alternative components. Resulting delays or reductions in product shipments could damage customer relationships and could adversely affect the Company's business, operating results or financial condition. Further, a significant increase in the price of one or more of these components could have a material adverse effect on the Company's gross margin or operating results. See "Business--Manufacturing."

Transition to New Manufacturing Process Technologies. The Company's future success will depend in part upon its ability to develop products that utilize new manufacturing process technologies. Manufacturing process technologies are subject to rapid change and require significant expenditures for research and development. The Company continuously evaluates the benefits of redesigning its integrated circuits using smaller geometry process technologies in order to improve performance and reduce costs. The Company believes that the transition of its products to integrated circuits with increasingly smaller geometries will be important to its competitive position. Other companies have experienced difficulty in migrating to new manufacturing processes and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. Moreover, the Company is dependent on its relationships with its third-party manufacturers to migrate to smaller geometry processes successfully. There can be no assurance that the Company will be able to migrate to new manufacturing process technologies successfully or on a timely basis. Any such failure by the Company could have a material adverse effect on its business, operating results or financial condition.

Dependence on Contract Manufacturer for Assembly and Testing. Substantially all of the Company's products are assembled and tested by Solectron using testing equipment produced by the Company. As a result of its dependence on Solectron for assembly and testing of its products, the Company does not

directly control product delivery schedules or product quality. Any product shortages or quality assurance problems could increase the costs of manufacture, assembly or testing of the Company's products and could have a material adverse effect on the Company's business, financial condition or results of operation. In addition, as manufacturing volume increases, the Company will need to procure and assemble additional testing equipment and provide it to Solectron. Due to the amount of time typically required to produce and assemble the testing equipment, the Company could experience significant delays in the shipment of its products if it is unable to provide such testing equipment to Solectron in a timely manner. Any delays in delivery of the Company's products could have a material adverse effect on the Company's business, operating results or financial condition. See "Business--Manufacturing."

Evolving Industry Standards. Market acceptance of the Company's products may be affected by the emergence and evolution of industry standards. Standards efforts currently under way include those of the Digital Audio Video Interactive Council ("DAVIC") in Europe and, in the United States, the Institute of Electrical and Electronic Engineers ("IEEE") 802.14 Committee and the Multimedia Cable Network System ("MCNS") consortium. MCNS, a consortium of top cable operators in the U.S. and Canada, has been dominant in establishing cable modem standards. MCNS has created a cable modem standard based on TDMA technology contributed by multiple vendors to a royalty-free intellectual property pool. This standard, known as DOCSIS, was completed in mid-1997 and was adopted as an international standard by the International Telecommunications Union in March 1998. While no company currently is offering DOCSIS-compliant products, current estimates from the industry and vendors predict that products based on the DOCSIS standard will begin to appear in mid-1998. The Company is developing a next- generation product, the Universal Cable Modem ("UCM"), to be compliant with the DOCSIS standard. There can be no assurance that the Company will develop an DOCSIS-compliant product at all or in a timely manner. The Company believes that the broad adoption of DOCSIS will cause increased competition in the North American market, which is likely to negatively affect the Company's gross margin. There can be no assurance that competitors will not develop DOCSIS-compliant products more quickly than the Company. Current customers of the Company that move to the DOCSIS platform could choose alternative cable modem suppliers or choose to purchase DOCSIS-compliant cable modems from multiple suppliers. Further, there can be no assurance that the DOCSIS standard will gain industry-wide acceptance. If the Company fails to deliver a DOCSIS-compliant product by the time DOCSIS gains industry-wide acceptance or if DOCSIS does not gain industry-wide acceptance, the Company's business operating results or financial condition could be adversely affected.

In addition to the current DOCSIS standard, the MCNS consortium has begun work on DOCSIS 2.0, a next-generation standard that is intended to enhance the current standard to include functionality already found in S-CDMA. The Company is actively working with MCNS, and other standards committees such as the IEEE 802.14 Committee, to advocate the inclusion of S-CDMA as the platform for DOCSIS 2.0. There can be no assurance that the Company will be successful in advocating S-CDMA's use in the next-generation standard. If the next- generation standard emerges without S-

CDMA as its platform, and if the standard emerges based on competing modulation technologies, S-CDMA could be isolated as a proprietary technology and the Company's business, operating results and financial condition would be materially adversely affected.

Dependence on Small Number of Customers. The Company's sales are highly concentrated, with three customers accounting for approximately 73% of the Company's revenues in 1997 and three customers accounting for approximately 62% of the Company's revenues in the first quarter of 1998. In 1997, sales to Telegate Ltd. ("Telegate"), Sumitomo Corporation ("Sumitomo") and NET Brasil S.A. ("NET Brasil") represented approximately 30%, 29% and 14%, respectively, of the Company's total revenues. In the first quarter of 1998, sales to Shaw Communications Inc. ("Shaw"), Sumitomo and Telegate represented approximately 37%, 13% and 12%, respectively, of the Company's total revenues. The Company believes that a substantial majority of its revenues will continue to be derived from sales to a relatively small number of customers for the foreseeable future. In addition, the Company believes that sales to these customers will be focused on a small number of projects. Ten cable operators in the United States own and operate facilities passing approximately 74% of total homes passed in 1997. Due to the concentration of the Company's market, any reduction, delay or loss of orders from a significant customer or customers would have a material adverse effect on the Company's business, operating results and financial condition. Major customers also are likely to have significant negotiating leverage and may attempt to change the terms, including pricing, upon which the Company and such customers do business. In addition, these customers may require longer payment terms than the Company has anticipated, which could require the Company to raise additional capital to meet its working capital requirements. There can be no assurance that any such capital would be available to the Company as required on reasonable terms or at all.

The Company markets its products to cable operators in the United States and internationally. Due to the consolidation affecting the cable industry, with a limited number of cable operators controlling an increasing number of cable systems, the Company believes that its sales will be largely dependent upon product acceptance by leading cable operators. If the Company's products are not widely deployed, its business, operating results and financial condition will be materially adversely affected. The Company's ability to increase its revenues in the future will also depend in part upon its ability to make sales to new customers. In the event that such sales do not occur, or if one or more of the Company's customers elect to purchase and market competing technologies or products, the Company's business, operating results and financial condition would be adversely affected.

Dependence on Cable Operators and Other Service Providers. The Company depends on cable operators to purchase its cable modem systems and to provide its cable modems to end users. Cable operators have a limited amount of available bandwidth over which they can offer robust data services, and there can be no assurance that they will choose to provide Internet access. If cable operators choose to provide such services, the Company will also be dependent on them to market such services to cable customers, to install the Company's equipment and to provide support to end-users. In addition, the Company will be highly dependent on cable operators to continue to maintain their cable infrastructure in such a manner that the Company will be able to provide consistently high performance and reliable services. The Company's success will also be dependent upon the acceptance

of its products by other providers of services to the cable industry, such as At Home Corporation ("@Home") and Time Warner Cable's Road Runner ("Road Runner"). If cable operators and other cable system service providers are unable to provide robust, high performance and reliable services, the Company's business, operating results and financial condition could be materially adversely affected. See "Business--Industry Background" and "--Customers."

Dependence on the Cable Industry to Upgrade to Two-Way Cable Infrastructure. Demand for the Company's products will depend to a significant degree upon the magnitude and timing of capital spending by cable operators for implementation of access systems for data transmission over cable networks. This involves the enabling of two-way transmission over existing coaxial cable networks and the eventual upgrade to HFC in areas of higher penetration of data services. In addition, few businesses in the United States currently have cable access. There can be no assurance that cable operators will choose to upgrade existing residential cable systems or install new cable systems to serve business locations. The success and future growth of the Company's business will also be subject to economic and other factors affecting the cable television industry generally, particularly its ability to finance substantial capital expenditures. The capital spending patterns of cable operators are dependent on a variety of factors, including availability of financing, cable operators' annual budget cycles, the status of federal, local and foreign government regulation and deregulation, overall demand for cable services, competitive pressures (including the availability of alternative data transmission and access technologies), discretionary consumer spending patterns and general economic conditions. The failure of cable operators to complete these upgrades in a timely and satisfactory manner, or at all, would limit the market for the Company's products and would have a material adverse effect on the Company's business, operating results and financial condition. In addition, cable spending can be subject to the effects of seasonality, with fewer upgrade projects typically occurring in the winter months. Capital spending levels in the cable industry in the United States have fluctuated significantly in the past, and the Company believes that such fluctuations will occur in the future. In recent periods, the United States cable market has been characterized by the acquisition of smaller and independent cable operators by large cable operators. The Company is unable to predict the effect, if any, that consolidation in the United States cable industry will have on overall capital spending patterns by cable operators. The effect on the Company of further industry consolidation also is uncertain. See "Business--Industry Background."

Ability to Market Effectively to Cable Operators. The Company believes that its growth and future success will be substantially dependent upon its ability to convince cable operators to adopt the Company's technologies, purchase the Company's products and effectively market the Company's products to end users. Cable operators are likely to prefer purchasing products from established manufacturing companies that can demonstrate the capability to supply large volumes of products on short notice. In addition, many cable operators may be reluctant to adopt technologies that have not gained acceptance among other cable operators, and such reluctance could result in lengthy product testing and acceptance cycles for the Company's products. Consequently, the impediments to the Company's initial sales may be even greater than those to later sales, if any. No established distribution network in the cable modem industry exists that would provide easy access by the Company to smaller

or geographically diverse cable operators. Therefore, the Company's initial sales to larger, more established cable operators are critical to the Company's business. Although the Company intends to establish strategic relationships with leading distributors worldwide, there can be no assurance that Company will be successful in establishing such relationships or that such distributors will be successful in marketing the Company's products to cable operators. Some competitors of the Company have already established relationships with certain cable operators, such as Motorola Inc.'s ("Motorola") relationships with Tele-Communications, Inc. ("TCI"), Time Warner Cable, Comcast Corporation and Cox Communications, Inc., which may further limit the Company's ability to sell products to such cable operators. It is likely that any such sales to cable operators will not be based on long- term contracts and that such customers will be able to terminate their relationships with the Company at any time. If the Company is unable to market and sell its products to a significant number of cable operators, or if one or more of the Company's current customers should cancel any relationship with the Company, the Company's business, operating results and financial condition would be materially adversely affected. See "Business--Strategy," "-- Customers" and "--Sales and Marketing."

Dependence on Products Under Development. The Company's future success will depend in part on its ability to develop, introduce and market new products or enhancements to existing products in a timely manner and to respond to competitive pressures, evolving industry standards or technological advances. For example, in November 1997, the Company announced the planned development of its next-generation product, the UCM. The UCM is in the early stages of design and development, and the Company does not anticipate shipment until 1999. The current design of the UCM requires ASIC fabrication at 0.2 micron line widths, which has only recently been used by wafer fabrication facilities for commercial production, increasing the risk that the Company's semiconductor device will require a time-consuming redesign at a larger geometry. The failure of the UCM or other future products to perform acceptably in testing and development could result in major engineering changes, increased development costs and significant delays in market introduction. In addition, it is possible that customers may delay purchasing the Company's current products in favor of next-generation products, which would have an adverse impact on the Company's operating results in the near term. There can be no assurance that the Company's engineering and product design efforts will be successful or that the Company will be successful in developing new products or commercializing its current or any future products. Any failure to release new products or to upgrade or redesign products on a timely basis could have a material adverse effect on the Company's business, operating results or financial condition. See "--Transition to New Manufacturing Process Technologies" and "Business--Products."

Erosion of Average Selling Prices. The cable equipment systems industry has been characterized, and is likely to continue to be characterized by, erosion of average selling prices due to a number of factors, including competition, rapid technological change and price performance enhancements. The Company anticipates that ASPs and gross margins for its products will decrease over product life cycles, due to competitive pressures and volume pricing agreements. Decreasing ASPs could cause the Company to experience decreased revenue even though the number of units sold could increase. As a result, the Company may experience substantial period-to-period fluctuations in future operating results due to ASP erosion. Therefore, the Company must continue to develop and introduce on a

timely basis next-generation products with enhanced functionalities that could be sold at higher gross margins. Failure to achieve the foregoing could cause the Company's revenue and gross margin to decline, which would have a material adverse effect on the Company's business, operating results and financial condition. See "Management's Discussion and Analysis of Financial Condition and Results of Operations--Overview."

Ability to Provide Customer Support. The Company's ability to achieve its planned sales growth and retain current and future customers will depend in part upon the quality of its customer support operations. The Company's customers generally require significant support and training with respect to the Company's TeraComm system, particularly in the initial deployment and implementation stage. To date, the Company has sold a limited number of products, and such sales have been concentrated in a small number of customers. The Company does not have any experience with widespread deployment of its products to a diverse customer base, and there can be no assurance that it will have adequate personnel to provide the levels of support that its customers may require during initial product deployment or on an ongoing basis. An inability to provide sufficient support to its customers could delay or prevent the successful deployment of the Company's products. In addition, failure to provide adequate support could have an adverse impact on the Company's reputation and relationship with its customers, could prevent the Company from gaining new customers and could have a material adverse effect on the Company's business, operating results or financial condition. See "Business--Customer Service and Technical Support."

Need to Develop Additional Distribution Channels. The Company presently markets its products to cable operators and systems integrators. The Company believes that much of the North American cable modem market may shift to a retail distribution model. Accordingly, the Company anticipates that it may need to redirect its marketing efforts in the future to sell its modems directly to retail distributors and end users, which would require the establishment of new distribution channels for its products. There can be no assurance that the Company will be able to establish such additional distribution channels or that, if the Company does establish additional channels, it will have the capital required or the ability to hire the additional personnel necessary to foster and enhance such distribution channels. In addition, if the cable modem market shifts to a retail distribution model, there can be no assurance that the Company will successfully establish a retail distribution presence. Failure by the Company to establish such distribution channels could have a material adverse affect on the Company's business, operating results or financial condition. To the extent that large consumer electronics companies enter the cable modem market, their well established retail distribution capabilities would provide them with a significant competitive advantage.

Lengthy Sales Cycle. The sales cycle associated with the Company's products is typically lengthy, often lasting six months to a year. The Company's customers typically conduct significant technical evaluations of competing technologies and early-stage trials prior to the commitment of capital and other resources. In addition, customers' internal procedures required to approve large capital expenditures and test, accept and deploy new technologies often delay purchasing decisions. Sales also generally are subject to customer trials, which typically last three months. Because of the lengthy sales cycle and the large size of customers' orders, if orders forecasted for a specific customer for a particular

quarter do not occur in that quarter, the Company's operating results for that quarter could be materially adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations--Overview."

Highly Competitive Industry; Established Competitors. The market for broadband access systems is extremely competitive and is characterized by rapid technological change. The Company's direct competitors in the cable modem arena include Bay Networks, Inc. ("Bay Networks"), Com21, Inc. ("Com21"), Hayes Microcomputer Products, Inc. ("Hayes"), Hybrid Networks, Inc. ("Hybrid"), Matsushita Electric Industrial Co., Ltd. (which markets products under the brand name "Panasonic") ("Matsushita"), Motorola, Phasecom Inc., Thomson Consumer Electronics, Inc. (which markets products under the brand name "RCA"), Samsung Corporation ("Samsung"), Scientific-Atlanta, Inc. ("Scientific-Atlanta"), Sony Corporation ("Sony"), 3Com Corporation ("3Com"), Toshiba Corporation ("Toshiba") and Zenith Electronics Corporation ("Zenith"), and there are many other potential market entrants. In addition, Bay Networks, Com21, Hybrid and Motorola introduced cable modems prior to the Company, and have established relationships and have worked with customers for a longer period of time than the Company. The principal competitive factors in this market include: product performance, features and reliability; price; size and stability of operations; breadth of product line; sales and distribution capability; technical support and service; relationships with cable operators; standards compliance; and general industry and economic conditions. Certain of these factors are outside of the Company's control. The existing conditions in the broadband access market could change rapidly and significantly as a result of technological changes, and the development and market acceptance of alternative technologies could decrease the demand for the Company's products or render them obsolete. There can be no assurance that these companies and other competitors will not introduce broadband access products that will be less costly or provide superior performance or achieve greater market acceptance than the Company's products.

The Company sells products that also compete with existing data access and transmission systems utilizing the telecommunications networks, such as those of 3Com. Additionally, the Company's controller and headend system products face intense competition from well-established companies such as Bay Networks, Cisco Systems, Inc. ("Cisco") and 3Com. Many of the Company's current and potential competitors have significantly greater financial, technical, marketing, distribution, customer support and other resources, as well as greater name recognition and access to customers than the Company. The anticipated widespread adoption of DOCSIS is likely to cause increased price competition in the North American market. Further, such adoption could result in lower sales of headend products by the Company in the North American market. Any such increased price competition or reduction in sales of headend products would result in downward pressure on the Company's gross margin, which could have a material adverse effect on the Company's business, operating results or financial condition. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not have a material adverse effect on its business, operating results and financial condition. See "--Market Acceptance of Cable Modems; Competing Technologies."

Dependence on Effective Management of Growth. The growth in the Company's business has placed, and is expected to continue to place, a significant strain on the Company's limited personnel, management and other resources. There can be no assurance that the Company's management, personnel, systems, procedures and controls will be adequate to support the Company's existing and future operations. The Company's ability to manage any future growth effectively will require it to attract, train, motivate, manage and retain employees successfully, to integrate new employees into its overall operations and to continue to improve its operational, financial and management systems. The Company has hired certain key employees and officers only recently, including its Vice President, Manufacturing Operations, and the Company filled the position of Chief Operating Officer in February 1998. The failure to manage its growth effectively could have a material adverse effect on the Company's business, operating results or financial condition. See "Business-- Employees" and "Management."

Dependence on the Internet and Internet Infrastructure Development. The commercial market for products designed for the Internet has only recently begun to develop, and the Company's success will depend in large part on increased use of the Internet to increase the need for high speed broadband access networks. Critical issues concerning the commercial use of the Internet, including security, reliability, cost, ease of access and quality of service, remain unresolved and are likely to affect the development of the market for the Company's products. The adoption of the Internet for commerce and communications, particularly by enterprises that have historically relied upon alternative means of commerce and communications, generally requires the acceptance of a new method of conducting business and exchanging information. In addition, the Company is dependent on the growth of the use of the Internet by businesses, particularly for applications that utilize multimedia content and thus require high bandwidth. The recent growth in the use of the Internet has caused frequent periods of performance degradation, requiring the upgrade of routers, telecommunications links and other components forming the infrastructure of the Internet by Internet service providers and other organizations with links to the Internet. Any perceived degradation in the performance of the Internet as a whole could undermine the benefits of the Company's products. Potentially increased performance provided by the products of the Company and others is ultimately limited by and reliant upon the speed and reliability of the Internet backbone itself. Consequently, the emergence and growth of the market for the Company's products will be dependent on improvements being made to the entire Internet infrastructure to alleviate overloading and congestion. If the Internet as a commercial or business medium fails to develop or develops more slowly than expected, the Company's business, operating results and financial condition could be materially adversely affected. See "Business-- Industry Background."

Risks of Product Returns, Product Liability and Product Defects. Products as complex as those offered by the Company frequently contain undetected errors or failures, especially when first introduced or when new versions are released. There can be no assurance that, despite testing by the Company, errors will not occur. The occurrence of such errors could result in product returns and other losses to the Company or its customers. Such occurrence could also result in the loss of or delay in market acceptance of the Company's products, which could have a material adverse effect on the Company's

business, operating results and financial condition. The Company's products generally carry a one- year warranty that includes factory and on-site repair services as needed for replacement of parts. Due to the recent introduction of the Company's products, the Company has limited experience with the problems that could arise with this generation of products. The Company's purchase agreements with its customers typically contain provisions designed to limit the Company's exposure to potential product liability claims, however, it is possible that the limitation of liability provision contained in the Company's purchase agreements may not be effective as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. Although the Company has not experienced any product liability claims to date, the sale and support of the Company's products entails the risk of such claims. In addition, any failure by the Company's products to properly perform could result in claims against the Company by its customers. The Company maintains insurance to protect against certain claims associated with the use of its products, but there can be no assurance that its insurance coverage would adequately cover any claim asserted against the Company. A successful claim brought against the Company that is in excess of, or excluded from, its insurance coverage, could have a material adverse effect on the Company's business, operating results or financial condition. In addition, even claims that ultimately are unsuccessful could result in the Company's expenditure of funds in litigation and management time and resources. There can be no assurance that the Company will not be subject to material claims in the future, that such claims will not result in liability in excess of its insurance coverage, that the Company's insurance will cover such claims or that appropriate insurance will continue to be available to the Company in the future at commercially reasonable rates.

Dependence on Proprietary Technology; Protection of Intellectual Property Rights. The Company relies on a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in its products. There can be no assurance that the Company's patent applications will be granted or, if granted, that the claims covered by the patents will not be reduced from those included in the Company's applications. Any patent might be subject to challenge in court and, whether or not challenged, might not be sufficiently broad to prevent third parties from developing equivalent technologies or products. The Company has entered into confidentiality and invention assignment agreements with its employees, and enters into non-disclosure agreements with certain of its suppliers, distributors and appropriate customers so as to limit access to and disclosure of its proprietary information. There can be no assurance that these statutory and contractual arrangements will prove sufficient to prevent misappropriation of the Company's technology or to deter independent third-party development of similar technologies. In addition, the laws of certain foreign countries might not protect the Company's products or intellectual property rights to the same extent as do the laws of the United States, and protection of such intellectual property might not be available in every country in which the Company's products might be manufactured, marketed or sold.

The Company expects that developers of cable modems will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows. The Company has received a letter from an individual claiming that the Company's technology infringes a

patent held by such individual. The Company has reviewed the allegations made by such individual and, after consulting with its patent counsel, does not believe that the Company's technology infringes any valid claim of such individual's patent. There can be no assurance that, if the issue were to be submitted to a court, such a court would not find that the Company's products infringe the patent, nor that the individual will not continue to assert infringement. If the Company is found to have infringed such individual's patent, the Company could be subject to substantial damages and/or an injunction preventing it from conducting its proposed business. In addition, there can be no assurance that other third parties will not assert infringement claims against the Company in the future. Any such claim, whether meritorious or not, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition. Litigation may also be necessary to enforce the Company's intellectual property rights. Any infringement claim or other litigation against or by the Company could have a material adverse effect on the Company's business, operating results or financial condition. See "Business--Technology" and "--Intellectual Property."

Risks of Doing Business in International Markets. Sales to customers outside of the United States accounted for approximately 88% and 90% of revenues in 1997 and the first quarter of 1998, respectively, and the Company expects sales to customers outside of the United States to continue to represent a significant percentage of the Company's revenues for the foreseeable future. International sales are subject to a number of risks, including changes in foreign government regulations and communications standards, export license requirements, tariffs and taxes, other trade barriers, difficulty in collecting accounts receivable, difficulty in managing foreign operations and political and economic instability. To the extent the Company's customers may be impacted by currency devaluations or general economic crises such as the economic crisis currently affecting many Asian and Latin American economies, the ability of such customers to purchase the Company's products could be materially adversely affected. Payment cycles for international customers are typically longer than those for customers in the United States. There also can be no assurance that foreign markets for the Company's products will not develop more slowly than currently anticipated. Foreign countries may decide not to construct cable infrastructure, place moratoria on building cable plants or terminate or delay construction of such facilities for a variety of reasons, including environmental issues, economic downturns, the availability of favorable pricing for other communications services or the availability and cost of related equipment. Any such action by foreign countries would reduce the market for the Company's products, which would materially adverse affect the Company's business, operating results and financial condition.

The Company anticipates that its foreign sales generally will be invoiced in U.S. dollars and, accordingly, the Company currently does not plan to engage in foreign currency hedging transactions. However, as the Company commences and expands its international operations, it may be paid in foreign currencies and exposure to losses in foreign currency transactions may increase. The Company may choose to limit such exposure by the purchase of forward foreign exchange contracts or through

similar hedging strategies. There can be no assurance that any currency hedging strategy would be successful in avoiding exchange-related losses. In addition, if the relative value of the U.S. dollar in comparison to the currency of the Company's foreign customers should increase, the resulting effective price increase of the Company's products to such foreign customers could result in decreased sales, which could have a material adverse impact on the Company's business, operating results and financial condition. See "Business--Customers."

Dependence on Key Personnel; Competitive Market for Personnel. Due to the specialized nature of the Company's business, the Company is highly dependent on the continued service of, and on the ability to attract and retain, qualified engineering, sales, marketing and senior management personnel, particularly the Company's Chairman, President and Chief Technical Officer, Shlomo Rakib, and its Chief Executive Officer and Chief Financial Officer, Zaki Rakib. The competition for such personnel is intense and the loss of any such persons would have a material adverse effect on the Company's business and operating results. In addition, an inability to hire additional qualified personnel as needed could impair the Company's ability to adequately manage and complete its existing sales commitments and to bid for and execute additional sales. Further, the Company must train and manage its growing employee base, which is likely to require increased levels of responsibility for both existing and new management personnel. There can be no assurance that the management personnel and systems currently in place will be adequate or that the Company will be able to assimilate new employees successfully. Highly skilled employees with the education and training required by the Company, especially employees with significant experience and expertise in both data networking and radio frequency design, are in high demand. There can be no assurance that the Company will be able to continue to attract and retain the qualified personnel necessary for the development of its business. The Company does not have "key person" insurance coverage for the loss of any of its employees. Any officer or employee of the Company can terminate his or her relationship with the Company at any time. See "Business--Employees" and "Management."

Significant Future Capital Requirements. The Company will require substantial capital resources to continue to develop, manufacture and market its products, to expand its product line and to fund its future operations. The Company's future capital requirements will depend on many factors, including, but not limited to, the evolution of the market for broadband access systems, the market acceptance of the Company's products, competitive pressure on the price of the Company's products, the levels at which the Company maintains inventory, the levels of promotion and marketing required to launch such products and attain a competitive position in the marketplace, the extent to which the Company invests in new technology and improvements on its existing technology, and the response of competitors to the Company's products. The Company also may require additional capital resources to enter into corporate partnerships, strategic alliances or joint ventures. There can be no assurance that such financing will be available when needed, if at all, or on terms favorable to the Company. Any additional equity financings will be dilutive to stockholders, and debt financings, if available, will affect operating results and may require the Company to agree to restrictive covenants. Failure to generate or raise sufficient funds may require the Company to delay or abandon some or all of its planned future

expansion or expenditure, which could have a material adverse effect on the Company's business, operating results and financial condition. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-- Liquidity and Capital Resources."

Regulation of the Communications Industry. The Company and its customers are subject to varying degrees of federal, state and local regulation. The jurisdiction of the Federal Communications Commission ("FCC") extends to the communications industry, including broadband access products such as those of the Company. The FCC has promulgated regulations that, among other things, set installation and equipment standards for communications systems. Although FCC regulations and other governmental regulations have not materially restricted the Company's operations, there can be no assurance that future regulations adopted by the FCC or other regulatory bodies will not have a material adverse effect on the Company. Further, regulation of the Company's customers may adversely impact the Company's business, operating results and financial condition. For example, FCC regulatory policies affecting the availability of cable services and other terms on which cable companies conduct their business, may impede the Company's penetration of certain markets. In addition, regulation of cable television rates may affect the speed at which cable operators upgrade their cable infrastructures to two-way HFC. Changes in, or the failure by the Company to comply with, applicable domestic and international regulations could have a material adverse effect on the Company's business, operating results and financial condition. In addition, the increasing demand for communications systems has exerted pressure on regulatory bodies worldwide to adopt new standards for such products and services, generally following extensive investigation of and deliberation over competing technologies. The delays inherent in this governmental approval process have in the past, and may in the future, cause the cancellation, postponement or rescheduling of the installation of communications systems by the Company's customers, which in turn may have a material adverse effect on the sale of products by the Company to such customers.

If other countries begin to regulate the cable modem industry more heavily or introduce standards or specifications with which the Company's products do not comply, the Company will be unable to offer products in those countries until its products comply with such standards or specifications and the Company may have to incur substantial costs in order to comply with such standards or specifications. For instance, should the DAVIC standards for ATM- based digital video be established internationally, the Company will be required to conform its cable modems in order to compete. Further, many countries do not have regulations for installation of cable modem systems or for upgrading existing cable network systems to accommodate the Company's products. Whether the Company currently operates in such a country or enters into the market in a country where no such regulations exist, there can be no assurance that such regulations will not be proposed at any time, and if imposed, that they would not place limitations on the country's cable operators' ability to upgrade to support the Company's products. There can be no assurance that the cable operators in such countries would be able to comply with such regulations or that compliance with such regulations would not require a long, costly process.

For example, the Company experienced delays in product shipments to a customer in Brazil due to delays in certain regulatory approvals in Brazil, and there can be no assurance that similar delays will not occur in other countries in which the Company markets or plans to market its products. In addition, the Company's customers in certain parts of Asia, such as Japan, are required to obtain licenses prior to selling the Company's products, and delays in obtaining such licenses could have an adverse impact on the Company's operating results. See "Business--Regulation."

Other Regulatory Approvals or Certifications. In the United States, in addition to complying with FCC regulations, the Company's products will be required to meet certain safety requirements. For example, the Company will be required to have its products certified by Underwriters Laboratory ("UL") in order to meet federal requirements relating to electrical appliances to be used inside the home. Outside of the United States, the Company's products will be subject to the regulatory requirements of each country in which the products are manufactured or sold. These requirements are likely to vary widely, and there can be no assurance that the Company will be able to obtain on a timely basis or at all such regulatory approvals as may be required for the manufacture, marketing and sale of its products. In addition to regulatory compliance, some cable industry participants may require certification of compatibility. Any delay in or failure to obtain such approvals or certifications could have a material adverse effect on the Company's business, operating results and financial condition. See "Business--Regulation."

Year 2000 Compliance. Many existing computer systems and applications and other control devices use only two digits to identify a year in the date field, without considering the impact of the upcoming change in the century. As a result, in less than two years, computer systems and applications used by many companies may need to be upgraded to comply with Year 2000 requirements. Significant uncertainty exists in the computer industry concerning the potential effects associated with such compliance. The Company relies on computer systems in operating and monitoring many significant aspects of its business, including financial systems (such as general ledger, accounts payable, accounts receivable, inventory and order management), customer services, infrastructure and network and telecommunications equipment. The Company also relies directly and indirectly on the systems of external business enterprises such as customers, suppliers, creditors, financial organizations and domestic and international governments. The Company currently estimates that its costs associated with Year 2000 compliance, including any costs associated with the consequences of incomplete or untimely resolution of Year 2000 compliance issues, will not have a material adverse effect on the Company's business, financial condition or results of operations in any given year. However, the Company has not extensively investigated and does not believe that it has fully identified the impact of Year 2000 compliance and has not concluded that it can resolve any issues that may arise in connection with Year 2000 compliance without disruption of its business or without incurring significant expense. In addition, even if the Company's internal systems are not materially affected by Year 2000 compliance issues, the Company could be affected through disruption in the operation of the enterprises with which the Company interacts. There can be no assurance that the Company's products will be Year 2000 compliant, that third-party products with which the Company's products interface

will be Year 2000 compliant or that any changes to third- party products made in response to Year 2000 compliance issues will not render the Company's products incompatible with such third-party products.

Control by Existing Stockholders and Management. Following the closing of this offering, the Company's directors, officers and their respective affiliates will beneficially own approximately % of the Company's outstanding Common Stock (% on a fully diluted basis). As a result, the Company's directors, officers and their respective affiliates, if they voted together, would be able to exercise significant influence over the election of members of the Company's Board of Directors and other corporate actions requiring stockholder approval have a significant impact on the management and direction of the Company. See "Principal Stockholders."

Management's Broad Discretion Over Use Of Proceeds of the Offering. The Company currently has no specific plans for a significant portion of the net proceeds of this offering. Consequently, the Company's management will have the discretion to allocate the net proceeds to uses that stockholders may not deem desirable, and there can be no assurance that the net proceeds can or will be invested to yield a significant return. Substantially all of the proceeds of the offering will be invested in short-term, interest-bearing, investment grade securities for an indefinite period of time. See "Use of Proceeds."

Absence of Prior Trading Market; Potential Volatility of Stock Price. Prior to this offering, there has been no public market for the Common Stock. There can be no assurance that an active trading market will develop or, if one develops, that it will be maintained. The initial public offering price of the Common Stock will be established by negotiation among the Company and the Underwriters. See "Underwriting" for factors to be considered in determining the initial public offering price. The market price of the shares of Common Stock could be subject to significant fluctuations in response to the Company's operating results and other factors, including general economic and market conditions. In addition, the stock market in recent years has experienced and continues to experience extreme price and volume fluctuations, which have affected the market price of the stock of many companies and which have often been unrelated or disproportionate to the operating performance of these companies. These fluctuations, as well as a shortfall in sales or earnings compared to securities analysts' expectations, changes in analysts' recommendations or projections or general economic and market conditions, may adversely affect the market price of the Common Stock. In the past, securities class action litigation has often been instituted following periods of volatility in the market price for a company's securities. Such litigation could result in substantial costs and a diversion of management attention and resources, which could have a material adverse effect on the Company's business, operating results and financial condition.

Anti-Takeover Provisions. The Company's Certificate of Incorporation (the "Certificate") authorizes the Board of Directors to issue up to five million shares of Preferred Stock and to determine the powers, designations, preferences, rights, qualifications, limitations and restrictions, including voting rights, of those shares without any further vote or action by the stockholders. The rights of the holders of Common Stock will be subject to, and may be adversely affected by, the rights of the holders of any Preferred Stock that may be issued in the future. The Certificate and Bylaws, among other things,

provide for a classified Board of Directors, require that stockholder actions occur at duly called meetings of the stockholders, limit who may call special meetings of stockholders and require advance notice of stockholder proposals and director nominations. These and other provisions could have the effect of making it more difficult for a third party to acquire a majority of the outstanding voting stock of the Company, discourage a hostile bid or delay, prevent or deter a merger, acquisition or tender offer in which the Company's stockholders could receive a premium for their shares, or a proxy contest for control of the Company or other change in the Company's management. See "Management" and "Description of Capital Stock."

Shares Eligible for Future Sale. The sale of a substantial number of shares of Common Stock in the public market following this offering could adversely affect the market price of the Common Stock. Upon the closing of this offering, the Company will have outstanding an aggregate of shares of Common Stock, assuming no exercise of outstanding options and warrants. The shares of Common Stock sold in this offering will be freely tradable without restriction under the Securities Act of 1933, as amended (the "Securities Act").

The remaining 12,575,637 shares of Common Stock are "Restricted Shares" and are subject to restrictions under the Securities Act. All of these Restricted Shares are subject to lock-up agreements pursuant to which the holders have agreed not to sell or otherwise dispose of any of their shares for a period of 180 days after the date of this Prospectus without the prior written consent of BT Alex. Brown Incorporated or, in certain instances, the Company. All or a portion of such shares may be released at any time and without notice. The Company has agreed with BT Alex. Brown Incorporated not to release any stockholder from any lock-up agreement between the Company and the stockholder without the prior written consent of BT Alex. Brown Incorporated. Approximately 11,646,310 Restricted Shares subject to lock-up agreements will become available for sale in the public market immediately following expiration of the 180-day lock-up period, subject to the volume and other limitations of Rule 144 and Rule 701 under the Securities Act, and the remaining Restricted Shares subject to lock-up agreements and other contractual restrictions will become eligible for sale at various times thereafter following the expiration of their respective one-year holding periods under Rule 144. In addition, certain stockholders of the Company have the right to register shares of Common Stock for sale in the public market, and the Company intends to register shares of Common Stock authorized for issuance under the Company's equity incentive plans shortly following the closing of this offering. See "Shares Eligible for Future Sale" and "Description of Capital Stock--Registration Rights."

Dilution; Absence of Cash Dividends. Purchasers of the shares of Common Stock offered hereby will experience immediate and substantial dilution in the net tangible book value of their investment from the initial public offering price. Additional dilution will occur upon exercise of outstanding options and warrants. See "Dilution" and "Shares Eligible for Future Sale." The Company has never paid any dividends and does not anticipate paying dividends in the foreseeable future. See "Dividend Policy."

Information Regarding Forward-looking Statements

When used in this Prospectus, the words "expects," "anticipates," "estimates," and similar expressions are intended to identify forward-looking statements. Such statements, which include but are not limited to statements under the captions "Risk Factors," "Use of Proceeds," "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Business" and elsewhere in this Prospectus as to the timing of availability of products under development; the Company's ability to commercialize new products; the acceptance and performance of the Company's products; demand for broadband access services; the ability of the Company to achieve cost reductions; the compliance of future products with various industry standards; the Company's ability to make sales to new customers; the Company's ability to develop, introduce and market new products in a timely manner; the Company's ability to provide sufficient customer support; the adequacy of capital resources; future fluctuations in operating expenses; future capital expenditures; the sufficiency of existing and potential cash resources and the use of the proceeds of this offering are subject to risks and uncertainties that could cause actual results to differ materially from those projected. The cautionary statements made in this Prospectus should be read as being applicable to all related forward-looking statements wherever they appear in this Prospectus. The Company assumes no obligation to update such forward-looking statements or to update the reasons actual results could differ materially from those anticipated in such forward-looking statements.

Use of Proceeds

The net proceeds to the Company from the sale of the shares of Common Stock offered by the Company, at an assumed initial public offering price of $ per share, are estimated to be approximately $ ($ if the Underwriters' over-allotment option is exercised in full), after deducting underwriting discounts and commissions and estimated offering expenses payable by the Company. The Company expects to use the net proceeds for general corporate purposes, including working capital. The amounts and timing of the Company's actual expenditures will depend upon numerous factors, including the status of the Company's product development and commercialization efforts, the amount of cash generated by the Company's operations, competition and sales and marketing activities. Pending application of the net proceeds as described above, the Company intends to invest the net proceeds of the offering in short-term, investment-grade, interest-bearing securities.

Dividend Policy

The Company has never paid any cash dividends on its capital stock. The Company currently anticipates that it will retain earnings to support operations and to finance the growth and development of the Company's business and does not anticipate paying cash dividends for the foreseeable future. In addition, the Company's credit agreement prohibits the payment of cash dividends without the lender's written consent.

Capitalization

The following table sets forth the capitalization of the Company as of March 31, 1998, (i) on an actual basis and (ii) as adjusted to reflect the conversion of all outstanding shares of Preferred Stock into Common Stock, to reflect the reincorporation of the Company from California to Delaware and to reflect the sale of shares of Common Stock offered by the Company hereby at an assumed initial public offering price of $ per share and the receipt of the estimated net proceeds therefrom.

MARCH 31, 1998 ACTUAL AS ADJUSTED (IN THOUSANDS) Current portion of long-term debt..... $ 2,518 $ Long-term debt, less current portion..... $ 34 Redeemable convertible preferred stock, no par value; authorized shares included in convertible preferred stock authorized actual, no shares authorized as adjusted; 100,000 shares issued and outstanding actual; no shares issued and outstanding as adjusted..... 1,494 -- Shareholders' equity (net capital deficiency) (1): Preferred stock, $.001 par value; 5,000,000 shares authorized as adjusted; no shares issued and outstanding as adjusted..... -- -- Convertible Preferred Stock, no par value; 10,000,000 shares authorized actual; no shares authorized as adjusted; 7,131,161 shares issued and outstanding, actual; no shares issued and outstanding, as adjusted.. 35,807 -- Common Stock, no par value; 20,000,000 shares authorized actual; 30,000,000 shares authorized as adjusted; 4,742,190 shares issued and outstanding actual; shares issued and outstanding as adjusted..... 661 Accumulated deficit..... (42,867) (42,867) Deferred compensation..... (362) (362) Shareholders' notes receivable..... (60) (60) Total shareholders' equity (net capital deficiency).... (6,821) Total capitalization (deficit)..... $ (5,293) $ (1) Excludes as of June 11, 1998 (i) approximately 2,489,232 shares issuable upon exercise of options outstanding at a weighted average exercise price of $2.46 per share, (ii) 38,462 shares of issuable upon exercise of an outstanding warrant with an exercise price of $13.00 per share, (iii) 3,000,000 shares issuable upon exercise of an outstanding warrant with an exercise price of $6.50 per share; (iv) approximately 2,363,746 shares reserved for future grants under the Company's stock option plans; and (v) 700,000 shares reserved for issuance pursuant to the Company's 1998 Employee Stock Purchase Plan. See "Management--Employee Benefit Plans" and Notes 8 and 13 of Notes to Consolidated Financial Statements.

Dilution

The net tangible book value (deficiency) of the Company at March 31, 1998 was approximately $(5,327,000) or $(0.44) per share. Pro forma net tangible book value (deficiency) per share is determined by dividing the Company's tangible net worth (tangible assets less liabilities) by the number of shares of Common Stock outstanding, after giving effect to the conversion of Preferred Stock upon completion of this offering. After giving effect to the sale by the Company of the shares of Common Stock offered hereby at an assumed initial public offering price of $ per share, after deducting estimated underwriting discounts and commissions and offering expenses, the pro forma net tangible book value of the Company as of March 31, 1998 would have been $, or $ per share. This represents

an immediate increase in net tangible book value of $ per share to existing stockholders and an immediate dilution in net tangible book value of $ per share to new investors purchasing shares at the assumed initial public offering price. The following table illustrates this per share dilution:

Assumed initial public offering price per share..... $ Pro forma net tangible book value (deficiency) per share as of March 31, 1998..... $(0.44) Increase per share attributable to this offering..... Pro forma net tangible book value per share after offering..... Dilution per share to new investors..... $ The following table summarizes, on a pro forma basis as of March 31, 1998, the difference between the number of shares of Common Stock purchased from the Company, the total consideration paid and the average price per share paid by the existing stockholders and by the new investors (at an assumed initial public offering price of $ per share for shares purchased in this offering, before deducting estimated underwriting discounts and commissions and offering expenses):

	SHARES PURCHASED(1)		TOTAL CONSIDERATION		
	NUMBER	PERCENT	AMOUNT	PERCENT	AVERAGE PRICE PER SHARE
Existing stockholders...	11,973,351	%	$38,337,000	%	$3.20
New investors.....					
Total.....		100.0%	$	100.0%	

(1) The foregoing computations assume no exercise of outstanding stock options. As of June 11, 1998, options were outstanding to purchase 2,489,232 shares at a weighted average exercise price of $2.46 per share and warrants were outstanding to purchase 3,038,462 shares at a weighted average exercise price of $6.58 per share. To the extent that outstanding options and warrants are exercised, there will be further dilution to new investors. See "Management--Employee Benefit Plans" and Note 8 of Notes to Financial Statements.

Selected Consolidated Financial Data

The consolidated statement of operations data for the years ended December 31, 1995, 1996 and 1997 and the consolidated balance sheet data as of December 31, 1996 and 1997, have been derived from the audited consolidated financial statements of the Company included elsewhere in this Prospectus that have been audited by Ernst & Young LLP, independent auditors. The consolidated statement of operations data for the year ended December 31, 1994 and the consolidated balance sheet data as of December 31, 1994 and 1995 have been derived from the audited consolidated financial statements of the Company not included herein. The consolidated statement of operations data for the period from January 20, 1993 (inception) to December 31, 1993 and the consolidated balance sheet data at December 31, 1993 have been derived from unaudited financial statements of the Company not included herein. The consolidated statement of operations data for the three months ended March 31, 1997 and 1998 and the consolidated balance sheet data at March 31, 1998 are derived from unaudited financial statements included elsewhere in this Prospectus and contain all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the financial position and results of operations for such periods. The results of operations for the three months ended March 31, 1998 are

not necessarily indicative of results to be expected for the full fiscal year. The data set forth below should be read in conjunction with the consolidated financial statements of the Company, including the notes thereto, and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Prospectus.

	PERIOD FROM JANUARY 20, 1993 (INCEPTION) TO DECEMBER 31,	YEARS ENDED DECEMBER 31,				THREE MONTHS ENDED MARCH 31,	
	1993	1994	1995	1996	1997	1997	1998
	(IN THOUSANDS, EXCEPT PER SHARE DATA)						
CONSOLIDATED STATEMENT OF OPERATIONS DATA:							
Revenues	$128	$ 140	$ --	$ --	$ 2,118	$ --	$ 2,444
Cost of goods sold	--	--	676	--	6,462	178	4,134
Gross profit (loss)	128	140	(676)	--	(4,344)	(178)	(1,690)
Operating expenses:							
Research and development	157	235	2,028	8,020	11,319	2,580	2,305
Sales and marketing	--	17	205	1,141	4,468	529	1,140
General and administrative	26	84	825	1,789	2,546	461	505
Total operating expenses	183	336	3,058	10,950	18,333	3,570	3,950
Loss from operations	(55)	(196)	(3,734)	(10,950)	(22,677)	(3,748)	(5,640)
Net interest income (expense)	--	--	68	253	128	91	(64)
Net loss	$(55)	$ (196)	$ (3,666)	$ (10,697)	$ (22,549)	$ (3,657)	$ (5,704)
Pro forma basic and diluted net loss per share(1)					$ (2.07)		$ (0.48)
Shares used in pro forma basic and diluted net loss per share(1)					10,873		11,773

DECEMBER 31, ---------- MARCH 31, 1993 1994 1995 1996 1997 1998 (IN THOUSANDS) CONSOLIDATED BALANCE SHEET DATA: Cash, cash equivalents and short-term invest- ments..... $ -- $ 27 $ 8,620 $ 12,864 $ 1,987 $ 109 Working capital (deficit)..... 3 (492) 6,934 9,971 (4,847) (8,769) Total assets..... 3 435 10,202 15,978 8,778 8,226 Long-term debt (less current portion)..... -- 98 439 1,255 44 34 Accumulated deficit..... (55) (251) (3,917) (14,614) (37,163) (42,867) Total shareholders' eq- uity (net capital defi- ciency)..... $ (6) $ (201) $ 7,955 $ 11,405 $ (1,174) $ (6,821) (1)See Note 1 of Notes to Consolidated Financial Statements for an explanation of the method employed to determine the number of shares used to compute per share amounts.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with "Selected Consolidated Financial Data" and the Company's Consolidated Financial Statements and Notes included elsewhere in this Prospectus. The discussion in this Prospectus contains forward-looking statements that involve risks and uncertainties, such as statements of the Company's plans, objectives, expectations and intentions. The cautionary statements made in this Prospectus should be read as being applicable to all related forward- looking statements wherever they appear in this Prospectus. The Company's actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include those discussed in "Risk Factors," as well as those discussed elsewhere herein. See "Risk Factors" and "Information Regarding Forward-Looking Statements."

Overview

Terayon develops, markets and sells cable modem systems based upon its S- CDMA technology. Since its inception in January 1993, the Company has focused on the development of its S-CDMA technology, as well as certain other core technologies, to enable broadband transmission of data over cable networks. The Company commenced the specifications and design of its first ASIC in October 1994 and produced the first version of this ASIC in June 1996. The Company concurrently developed an end-to-end broadband access system, the TeraComm system, around the ASIC. During late 1996 and through 1997, the Company commenced limited field trials of the TeraComm system with several cable operators. In the first quarter of 1998, the Company commenced volume shipments to a small number of cable operators. The Company recognized revenues of $2.1 million in the year ended December 31, 1997 and $2.4 million for the three months ended March 31, 1998. The Company generally recognizes product revenues upon shipment of products to customers. Future agreements with certain distribution partners may contain price protection provisions and certain return rights. The Company's existing agreements currently do not contain such provisions.

The Company sells its products both in the United States and internationally and markets its products primarily to cable operators and distributors. To date, a small number of customers has accounted for all of the Company's sales. In 1997, sales to Telegate, Sumitomo and NET Brasil represented 29.6%, 28.9% and 14.1%, respectively, of the Company's revenues. In the first quarter of 1998, sales to Shaw, Sumitomo and Telegate represented 36.7%, 13.4% and 11.5%, respectively, of the Company's revenues. The Company expects that sales to a limited number of customers will continue to account for a substantial portion of the Company's for the foreseeable future. If orders from significant customers are delayed, cancelled or otherwise fail to occur in any particular period, or if any significant customer delays payment or fails to pay, the Company could experience significant operating losses in such period. As a result, the Company expects to experience significant fluctuations in its operating results

on a quarterly and annual basis. See "Risk Factors-- Dependence on Small Number of Customers," "--Dependence on Cable Industry to Upgrade to Two-Way Cable Infrastructure" and "--Ability to Market Effectively to Cable Operators."

The market for broadband access products and services is intensely competitive and is characterized by rapid technological change, new product development and product obsolescence, evolving industry standards and significant price erosion of products over time. The Company has experienced and expects to continue to experience downward pressure on its unit ASPs. The Company has had negative gross margins since inception. While the Company has initiated cost reduction programs to offset pricing pressures on its products, there can be no assurance that these cost reduction efforts will continue to keep pace with competitive price pressures or lead to improved gross margin. If the Company is unable to reduce costs efficiently, its gross margin and profitability will continue to be adversely affected. The Company's gross margin also is affected by the sales mix of TeraLink 1000 Master Controllers, TeraLink Gateways and TeraPro cable modems, as the TeraPro modems have significantly lower margins than the TeraLink 1000 Master Controllers and TeraLink Gateway headend products. For the foreseeable future, the Company expects to achieve negative or nominal margins on TeraPro cable modems and expects that sales of TeraPro cable modems will continue to constitute a significant portion of its revenues. As a result of these factors, the Company's gross margins and operating results are likely to be adversely affected in the near term. See "Risk Factors--Market Acceptance of Cable Modems; Competing Technologies," "-- Ability to Achieve Cost Reductions," "--Limited Manufacturing Experience and Dependence on Contract Manufacturer," "--Erosion of Average Selling Prices" and "--Highly Competitive Industry; Established Competitors."

The Company's ability to generate revenues also depends on guaranteeing the availability of supplies from its sole sources, increasing the manufacturing and testing capacity of its products by a contractor while ensuring product quality, and continuing deployment of its products by existing and new customers. In the first quarter of 1998, the Company transitioned its manufacturing operations from CMC to Solectron. The Company recorded a charge of $1.3 million in the first quarter of 1998 relating to the write-off of obsolete inventory and the transition of manufacturing operations to Solectron. The Company currently tests and assembles the TeraLink 1000 Master Controller and the TeraLink Gateway headend equipment at its Santa Clara facility. Finished TeraPro cable modems are drop shipped by Solectron to Terayon customers. See "Risk Factors--Limited Manufacturing Experience and Dependence on Contract Manufacturer."

The Company sustained net losses of $3.7 million, $10.7 million, $22.5 million and $5.7 million for the years ended December 31, 1995, 1996 and 1997 and for the three months ended March 31, 1998, respectively. As a result, the Company had an accumulated deficit of $42.9 million as of March 31, 1998. The Company's operating expenses are based in part on its expectations of future sales, and the Company expects that a significant portion of its expenses will be committed in advance of sales. As a result, net income may be adversely affected by a reduction in sales if the Company is unable to adjust expenses quickly in response to any decrease in sales. The Company expects to increase significantly expenditures in technical development, sales and marketing and manufacturing as it engages in activities related to product enhancement, cost reduction and commercialization of new products.

Additionally, the Company expects to increase capital expenditures and other operating expenses in order to support and expand the Company's operations. As a result, the Company expects to continue to incur losses for the foreseeable future. There can be no assurance that the Company will achieve or sustain profitability in the future. See "Risk Factors--Early Stage of Development; History of Losses," "--Fluctuations in Operating Results" and "--Lengthy Sales Cycle."

Results of Operations

Three Months Ended March 31, 1997 and 1998

Revenues. The Company had no revenues for the three months ended March 31, 1997, as the Company did not commence selling its products until June 1997. For the three months ended March 31, 1998, the Company had revenues of $2.4 million, primarily due to sales of headend controllers, cable modems and, to a lesser extent, telephony modules.

Cost of Goods Sold. Cost of goods sold consists of direct product costs as well as the cost of the Company's manufacturing operations group, which cost consists of assembly, test and quality assurance for products, and associated costs of personnel and equipment. For the three months ended March 31, 1997, the Company incurred $178,000 in cost of goods sold related to the costs of the manufacturing operations group as it prepared for commercialization of the Company's products. The Company incurred $4.1 million in cost of goods sold for the three months ended March 31, 1998, which included a charge of $1.3 million relating to the write-off of obsolete inventory and the transition of manufacturing operations to Solectron.

Gross Profit (Loss). The Company incurred a gross loss of $178,000 for the three months ended March 31, 1997 due to costs associated with the Company's manufacturing operations group. The Company incurred a gross loss of $1.7 million for the three months ended March 31, 1998, primarily due to manufacturing costs spread over low volumes of products sold, together with a charge of $1.3 million relating to the write-off of obsolete inventory and the transition of manufacturing operations to Solectron.

Research and Development. Research and development expenses consist primarily of personnel costs, as well as design expenditures, equipment and supplies required to develop and enhance the Company's products. Research and development expenses decreased from $2.6 million in the three months ended March 31, 1997 to $2.3 million in the three months ended March 31, 1998 as a result of timing of the Company's development projects. The Company intends to continue to increase investment in research and development programs in future periods for the purpose of enhancing current products, reducing the cost of current products and developing new products.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries for sales, marketing and support personnel, and costs related to tradeshows, consulting and travel. Sales and marketing expenses increased from $529,000 in the three months ended March 31, 1997 to $1.1 million in the

three months ended March 31, 1998, primarily due to increased payroll costs related to additional sales and support personnel for commercial trials and deployment of the Company's products. The Company expects sales and marketing expenses to increase in the future as the Company expands its customer base.

General and Administrative. General and administrative expenses primarily consist of salary and benefits for administrative officers and support personnel, travel expenses, legal, accounting and consulting fees. General and administrative expenses increased from $461,000 in the three months ended March 31, 1997 to $505,000 in the three months ended March 31, 1998. The Company expects that general and administrative expenses will increase as a result of the additional reporting requirements imposed on the Company as a public company and increased infrastructure to support expanded activities of the Company.

Net Interest Income (Expense). Net interest income was $91,000 in the three months ended March 31, 1997 compared to net interest expense of $64,000 in the three months ended March 31, 1998. The decrease primarily was a result of lower interest income on lower average cash balances in the three months ended March 31, 1998.

Years Ended December 31, 1995, 1996 and 1997

Revenues. The Company did not recognize any revenues from product sales in 1995 or 1996, as the Company did not commence selling its products until June 1997. The Company recognized product revenues of $1.6 million in 1997, primarily due to sales of headend controllers and cable modems. A majority of the products shipped during 1997 were for customer trial purposes. During 1997, the Company also recognized $480,000 of technology development revenues pursuant to a technology development agreement (the "Development Agreement") to provide telephony modules to a telecommunications systems manufacturer. The Company does not expect significant revenues to be recognized pursuant to the Development Agreement in the future.

Cost of Goods Sold. In 1995, the Company incurred $676,000 in cost of goods sold as a result of technology development costs incurred pursuant to the Development Agreement. The Company did not incur any cost of goods sold in 1996. The Company incurred $6.5 million in cost of goods sold in 1997, reflecting the costs of the Company's manufacturing operations group for the full year and direct product costs related to sales that occurred primarily in the last six months of 1997.

Gross Profit (Loss). The Company incurred a gross loss of $676,000 in 1995 due to technology development costs incurred pursuant to the Development Agreement. The Company did not realize any gross profit or loss in 1996. The Company incurred a gross loss of $4.3 million in 1997, primarily due to manufacturing costs for the full year spread against revenues recognized primarily in the last six months of 1997. The manufacturing costs incurred in the first six months of 1997 consisted of pre-production activities related to preparation for commercialization of the Company's products.

Research and Development. Research and development expenses increased from $2.0 million in 1995 to $8.0 million in 1996, primarily due to increased number of personnel and related labor costs and approximately $1.5 million of prototype and non-recurring engineering costs related to the development of the Company's initial products. Research and development expenses increased from $8.0 million in 1996 to $11.3 million in 1997 due to increased staffing and associated engineering costs related to new and existing product development.

Sales and Marketing. Sales and marketing expenses increased from $205,000 in 1995 to $1.1 million in 1996, primarily as a result of increased number of personnel and related labor costs and costs related to promotional activities and early trials of the Company's products. Sales and marketing expenses increased from $1.1 million in 1996 to $4.5 million in 1997, primarily due to increased payroll costs related to additional sales and support personnel for commercial and market trials and the commercial launch of the Company's products.

General and Administrative. General and administrative expenses increased from $825,000 in 1995 to $1.8 million in 1996, primarily due to increased hiring and higher legal and travel expenses related to preparations for the commercial release of the Company's products. General and administrative expenses increased from $1.8 million in 1996 to $2.5 million in 1997, due to increased number of personnel and related payroll costs and higher legal and executive travel expenses.

Net Interest Income (Expense). Net interest income increased from $68,000 in 1995 to $253,000 in 1996, as a result of increased cash balances during 1996 resulting from the Company's financing activities during those periods. Net interest income decreased from $253,000 in 1996 to $128,000 in 1997, primarily as a result of higher interest expense due to larger loan balances.

Quarterly Results of Operations

The following table sets forth selected unaudited consolidated statement of operations data for each of the three month periods in the five quarters ended March 31, 1998. The data set forth below have been derived from unaudited consolidated financial statements of the Company and have been prepared on the same basis as the audited consolidated financial statements contained in this Prospectus, and in the opinion of management, include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such information for the periods presented. Such consolidated statement of operations data should be read in conjunction with the Consolidated Financial Statements and Notes thereto appearing elsewhere in this Prospectus. Results of operations in any period should not be considered indicative of the results to be expected in any future period.

THREE MONTHS ENDED MARCH 31, JUNE 30, SEPT. 30, DEC. 31, MARCH 31, 1997 1997 1997 1997 1998 (IN THOUSANDS)

Revenues	$ --	$ 93	$ 662	$ 1,363	$ 2,444
Cost of goods sold	178	304	1,761	4,219	4,134
Gross profit (loss)	(178)	(211)	(1,099)	(2,856)	(1,690)
Operating expenses:					
Research and development	2,580	3,306	2,695	2,738	2,305
Sales and marketing	529	994	1,192	1,753	1,140

General and administrative....	461	644	610	831	505
Total operating expenses....	3,570	4,944	4,497	5,322	3,950
Loss from operations.....	(3,748)	(5,155)	(5,596)	(8,178)	(5,640)
Net interest income (expense)...	91	32	7	(2)	(64)
Net loss.....	$(3,657)	$(5,123)	$(5,589)	$(8,180)	$(5,704)

Revenues increased in each of the consecutive three month periods due to commencement of commercial shipment of the Company's products in June 1997. The Company incurred increasing gross losses and declining gross margin in the second half of 1997 as the Company commenced sales of cable modems which, due to low volume production quantities and resulting high manufacturing costs and per-unit overhead allocations, were sold at negative margins. Revenues for the fourth quarter of 1997 include $480,000 of product development revenues related to the Company's development of a telephony module for a telecommunications system manufacturer. Gross margin improved in the first quarter of 1998 as unit volume sales increased and unit manufacturing costs declined. Gross margin also improved in the period due to a change in product mix, with a higher ratio of higher margin headend products sold relative to lower margin cable modems. Operating expenses varied in the last three quarters ended March 31, 1998 due to the timing of research and development projects and due to a significant trade show in the fourth quarter of 1997.

The Company has experienced, and expects to continue to experience, fluctuations in its operating results on a quarterly and an annual basis. Historically, the Company's quarterly revenues have been unpredictable due to a number of factors. Factors that have influenced and will continue to influence the Company's operating results include: a long sales cycle for the Company's products; competitive pricing pressures; the effects of extended payment terms, promotional pricing, service, marketing or other terms offered to customers; accuracy of customer forecasts of end user demand; personnel changes; quality control of products sold; and regulatory changes or delays in obtaining required regulatory approvals. For example, the Company's product shipments to date to a customer in Brazil have been significantly lower than anticipated, due to delays in certain regulatory approvals in Brazil. There can be no assurance that similar delays will not occur in other countries in which the Company is marketing or plans to market its products. Any such delays would have an adverse effect on the Company's operating results for a particular period. Factors that may influence the Company's operating results in the future include: the size and timing of customer orders and subsequent shipments; customer order deferrals in anticipation of new products or technologies; timing of product introductions or enhancements by the Company or its competitors; market acceptance of new products; technological changes in the cable, wireless and telecommunications industries; changes in the Company's operating expenses; customers' capital spending; delays of orders by customers; customers' delay in or failure to pay accounts receivable; and general economic conditions. See "Risk Factors--Fluctuations in Operating Results."

Income Taxes

The Company has not generated any net income to date and therefore has not accrued any income taxes since its inception. The Company accounts for income taxes under Statement of Financial Accounting Standards No. 109. Realization of deferred tax assets is dependent on future earnings, if

any, the timing and amount of which are uncertain. Accordingly, valuation allowances in amounts equal to the net deferred tax assets as of December 31, 1997 and 1996 have been established to reflect these uncertainties.

At December 31, 1997, the Company had federal and state net operating loss carryforwards of $31.0 million and $15.0 million, respectively, and federal and state tax credit carryforwards of $1.7 million and $1.2 million, respectively, that will expire at various dates beginning in 1999 through 2012, if not utilized. Utilization of net operating loss and tax credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating loss and tax credit carryforwards before full utilization.

Stock-based Compensation

With respect to certain stock option grants in 1997 and the first quarter of 1998, the Company had recorded deferred compensation of $389,000 as of March 31, 1998. The Company amortized approximately $12,000 of the deferred compensation in 1997 and $15,000 in the first quarter of 1998, and will amortize the remainder over the related vesting period of the stock options. The future compensation charges are subject to reduction for any employee who terminates employment prior to the expiration of such employee's vesting period. See Note 8 of Notes to Consolidated Financial Statements.

Liquidity and Capital Resources

Since its inception through March 31, 1998 the Company met its liquidity needs primarily through private sales of preferred stock for aggregate proceeds of $38.5 million, before deduction of issuance costs.

Since its inception, the Company has used cash in operating activities of $33.3 million through March 31, 1998. Cash used in operating activities in 1995, 1996, 1997 and the first three months of 1998 was $2.3 million, $9.4 million, $18.8 million and $2.8 million, respectively. Cash used in investing activities was $1.3 million in 1995 and $6.5 million in 1996. Investment activities in 1995 consisted primarily of the purchase of hardware, software and test equipment and in 1996 consisted primarily of the purchase of short- term investments. Cash provided by investing activities, primarily from the sales of short-term investments, was $1.5 million in 1997 and $158,000 in the first three months of 1998.

At March 31, 1998 the Company had approximately $109,000 in cash and cash equivalents and a $10.0 million revolving line of credit. At March 31, 1998, the Company was in violation of certain covenants under its line of credit.

The Company believes that its cash balances and funds available under an existing bank line of credit, together with the proceeds of this offering, will be sufficient to satisfy its cash requirements for at least the next 12 months. There can be no assurance, however, that the Company will not require additional

financing prior to such time to fund its operations and it may seek to raise such additional funds through the sale of public or private equity or debt financing or from other sources. The sale of additional equity or debt securities may result in additional dilution to the Company's stockholders. There can be no assurance that any additional financing will be available to the Company on acceptable terms, or at all, when required by the Company. See "Risk Factors--Significant Future Capital Requirements."

Year 2000

Many existing computer systems and applications and other control devices use only two digits to identify a year in the date field, without considering the impact of the upcoming change in the century. As a result, in less than two years, computer systems and applications used by many companies may need to be upgraded to comply with Year 2000 requirements. Significant uncertainty exists in the computer industry concerning the potential effects associated with such compliance. The Company relies on computer systems in operating and monitoring many significant aspects of its business, including financial systems (such as general ledger, accounts payable, accounts receivable, inventory and order management), customer services, infrastructure and network and telecommunications equipment. The Company also relies directly and indirectly on the systems of external enterprises such as customers, suppliers, creditors, financial organizations and domestic and international governments. The Company currently estimates that its costs associated with Year 2000 compliance, including any costs associated with the consequences of incomplete or untimely resolution of Year 2000 compliance issues, will not have a material adverse effect on the Company's business, financial condition or results of operations in any given year. However, the Company has not extensively investigated and does not believe that it has fully identified the impact of Year 2000 compliance and has not concluded that it can resolve any issues that may arise in connection with Year 2000 compliance without disruption of its business or without incurring significant expense. In addition, even if the Company's internal systems are not materially affected by Year 2000 compliance issues, the Company could be affected through disruption in the operation of the enterprises with which the Company interacts. There can be no assurance that the Company's products will be Year 2000 compliant, that third-party products with which the Company's products interface will be Year 2000 compliant or that any changes to third-party products made in response to Year 2000 compliance issues will not render the Company's products incompatible with such third-party products.

Recent Financial Accounting Pronouncements

In June 1997, the Financial Accounting Standards Board ("FASB") issued Statement No. 130, Reporting Comprehensive Income. This statement requires that all items that are to be required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. This statement is effective for fiscal years beginning after December 15, 1997, and will be adopted by the Company for the year ended December 31, 1998.

In June 1997, FASB issued Statement No. 131, Disclosures About Segments of an Enterprise and Related Information. This statement replaces Statement No. 14, Financial Reporting for Segments of a Business Enterprise, and changes the way public companies report segment information. This statement is effective for fiscal years beginning after December 15, 1997 and will be adopted by the Company for the year ended December 31, 1998.

Business

Overview

Terayon develops, markets and sells cable modem systems that enable cable operators to cost-effectively deploy reliable two-way broadband access services. The Company's TeraComm system is designed to allow cable operators to minimize time-consuming and costly network infrastructure upgrades, achieve reduced time to market and provide a wide range of service levels to residential and commercial end users. Cable operators using the TeraComm system are able to provide additional revenue-generating services to end users, enabling cable operators to compete effectively in the emerging market for broadband access services.

The Company's TeraComm system, comprised of the TeraPro cable modem, the TeraLink 1000 Master Controller, the TeraLink Gateway and the TeraView Element Management and Provisioning Software, is based on Terayon's S-CDMA technology. S-CDMA enables reliable two-way broadband communications over both pure coaxial and HFC cable infrastructure by maximizing resistance to noise that interferes with data transmissions over previously unusable frequency spectrum.

Industry Background

Demand for Broadband Access

In recent years, the volume of bandwidth intensive data, voice and video traffic across the Internet, corporate intranets and other public networks has increased dramatically. This demand has been driven by the proliferation of residential and commercial computer users that are accessing networks in a variety of applications, including communications via the Internet, electronic commerce and telecommuting. These applications often require the transmission of large, multimedia-intensive files. IDC estimates that the number of Internet users will increase from approximately 69 million at the end of 1997 to approximately 320 million by the end of 2002. IDC also estimates that the number of home office households will increase from approximately 35 million at the end of 1997 to approximately 40 million by the end of 1999.

Despite significant advances in the performance of computer processors and data backbone networks, high speed data transmission has been limited by the existing local access network infrastructure (the local loop), which is not optimized for distribution of data-intensive multimedia content. Users of dial-up analog modems with maximum data rates of only 28.8 Kbps to 56 Kbps often experience frustration, as they encounter frequent and lengthy delays or complete failures in transmission. In response to the growing demand for increased bandwidth, the communications industry has begun to deploy new broadband access technologies that can deliver megabit per second ("Mbps") or better performance to end users.

Advantages of Cable Modems Over Alternative Broadband Access Technologies

As residential and commercial demand for faster Internet access continues to grow, particularly for applications such as streaming audio and video, IP telephony and interactive two-way video, service providers are investing in enabling infrastructure and technologies. Various technologies have emerged to address the need for broadband access. The leading technologies include ISDN, ADSL and xDSL technologies being marketed by telecommunications companies, and cable infrastructure technologies such as cable modems being marketed by cable operators. These digital technologies offer substantial performance increases over traditional analog 56 Kbps dial-up modem technologies.

The following chart depicts the maximum available throughput of various broadband access technologies:

Comparison of Alternative Broadband Technologies

MAXIMUM AVAILABLE THROUGHPUT TECHNOLOGY DESCRIPTION DOWNSTREAM UPSTREAM

Cable Modems	High speed digital technology over HFC and pure coaxial systems	27.0 to 36.0 Mbps	2.0 to 14.0 Mbps
ADSL	High speed digital technology over existing copper wire	1.5 to 6.1 Mbps	640 Kbps
ISDN	High speed digital technology over existing copper wire	128 Kbps	128 Kbps
Dial-up Analog Access	Digital-to-analog conversion utilizing existing copper wire	56 Kbps	33 Kbps

Of the digital technologies, cable modems currently provide the highest available two-way transmission speeds and their "always on" availability eliminates the tedious and unreliable dial-up process of other technologies. The existing cable infrastructure offers other important advantages over alternative broadband architectures. Currently, the cable infrastructure passes over 95% of homes in the United States and a large number of small businesses. In addition, the cable infrastructure has the capacity to offer a wide range of broadband services, such as digital TV, Internet access and IP telephony. Many cable operators have recognized the need to expand beyond broadcast and video TV services to diversify their business and remain competitive. A growing number of cable operators have

already expanded their business to include data- over-cable services through affiliations with service providers such as @Home and Road Runner, and several cable operators are exploring voice-over-cable services as well. Kinetic Strategies Inc. estimates that over 200,000 North American homes currently have data-over-cable services.

Limitations of Existing Cable Infrastructure

Most cable networks were designed to provide one-way video broadcast from the cable headend to subscribers. Data-over-cable and other two-way services require cable operators to provide an upstream return path from subscribers to the headend. Noise interferes with upstream signal transmissions, potentially resulting in corrupted information or service outages. Common noise problems are (i) "ingress noise," a relatively constant level of interference resulting from home appliances and consumer electronics leaking noise into the cable system through imperfections in the cable plant, such as faulty connections or cracked cable shielding and (ii) "impulse noise," which is transient, unpredictable interference that results from home appliances switching on and off. Noise is a particular problem in the upstream return path because each home's noise is aggregated into the headend. In addition, the 5 to 42 MHz frequency spectrum reserved for subscriber-to-headend transmissions is highly susceptible to ingress and impulse noise.

Cable Operator Objectives in Deploying Broadband Access Services

In order to successfully exploit the opportunities offered by the increasing demand for broadband access, cable operators face a number of challenges.

Cost-effectively manage system noise. Cable modems based on current- generation TDMA technologies typically require a Signal-to-Noise Ratio ("SNR") of 20dB or better for reliable operation. To respond to ingress noise, cable operators using cable modems based on TDMA often must upgrade their networks to an HFC architecture. An upgrade to an HFC system includes replacing a substantial portion of the existing coaxial network with optical fiber, replacing the headend transmission equipment with optical transmission systems and providing additional interface layers between the optical fiber and the coaxial connection into the home.

To further address ingress noise and attempt to prevent impulse noise interference, cable operators must often completely rebuild their HFC network. This entails dividing the network into smaller segments, to isolate noise and therefore limit the aggregate noise arriving at the headend, as well as replacing coaxial drops in the homes of subscribers for data services and placing filters on non-subscriber homes. In addition, many TDMA-based systems employ a frequency-agile scheme where the transmission system will shift transmission to a pre-reserved backup channel if the primary channel is affected by a noise event. Despite these expenditures, cable operators using TDMA may still be required to increase routine maintenance procedures in order to provide reliable service and to restrict

two-way services to a limited portion of the 5 to 42 MHz frequency spectrum where noise events are less likely to occur. To reduce these costs and improve the quality of their service, cable operators require new upstream transmission technologies that address both ingress and impulse noise.

Minimize network capital equipment costs. Noise levels are directly related to the number of homes passed by a network, regardless of the number of subscribers on such network. As a result, the number of homes that can be supported by a single TDMA-based cable modem headend is limited, even in the early phase of deployment, when the number of subscribers may be very small. Cable operators using TDMA technology are often required to deploy a large number of headends to create a large service area "footprint." Minimizing initial investments and attaining "pay-as-you-go" capability that allows revenues to support incremental investment are vital to the ability of cable operators to enter the broadband access market.

Time to market. As telecommunications operators move quickly to offer broadband services, the Company believes that a cable operator's success in a particular geographic market will be determined by being first to market with broadband access services. Therefore, the Company believes that cable operators will need the ability to accelerate cable modem deployments in order to enhance their competitive position.

Ability to offer tiered services. The Company believes that cable operators can benefit from having a network capable of offering tiered services that allow them to maximize revenue from bandwidth allocated to those services. For example, a residential customer who only utilizes e-mail or Internet access may only be willing to pay a small premium over the cost of a dial-up connection, while commercial users may be willing to pay a substantial premium for guaranteed bandwidth. In order to offer multiple tiers of service with varied access speeds and priority connections, cable operators need the ability to assign a portion of shared bandwidth to individual customers.

To meet these challenges, cable operators require a highly reliable broadband access solution that can be deployed rapidly at low initial costs, that enables cable operators to maximize revenues from available bandwidth capacity, and that scales as the number of broadband access subscribers increases.

The Terayon Solution

The Company's TeraComm system is designed to enable cable operators to minimize time-consuming and costly network infrastructure upgrades, achieve reduced time to market and provide a wide range of service levels to residential and commercial end users. Cable operators using the TeraComm system are able to provide additional revenue-generating services to end users, enabling cable operators to compete effectively in the emerging market for broadband access services. The Company's system is based on its spread- spectrum technology, S-CDMA, which offers cable operators the following advantages:

Minimize cable infrastructure upgrades. Terayon's S-CDMA technology operates at extremely low SNRs, which enables Terayon's cable modems to be deployed on pure coaxial or HFC-upgraded systems, with minimal system upgrades. TDMA-based systems, which demand higher SNRs for

operation, often require costly system upgrades or complete rebuilds to high quality HFC in order to support comparable broadband access services.

Reduce time to market. Activating two-way transmission by installing the TeraComm system does not require the time-consuming network upgrades or rebuilds usually required to support TDMA-based transmission equipment. As a result, cable operators can accelerate cable modem deployment and reduce their time to market with broadband access services, thereby enhancing their competitive position.

Minimize initial headend capital equipment costs. By deploying the TeraComm system, cable operators can minimize the initial capital expense for headend equipment. The noise-resistant properties of S-CDMA allow more cable segments to be aggregated to form a single shared upstream channel. These properties provide cable operators with a cost-effective solution during initial stages of deployment even with a limited number of users. As the number of users increases, additional Terayon equipment can be installed for a smooth transition to a larger-scale network. For large deployments, the routed architecture of Terayon's system will support a large number of headends, enabling cable operators to effectively manage thousands of subscribers as a single IP network with multiple logical sub-networks. In contrast, TDMA-based systems only support a smaller number of homes passed per headend due to susceptibility to noise-related service problems.

Increase signal transmission reliability. Cable operators who plan to offer broadband access services must demonstrate the ability to provide reliable and continuous service. S-CDMA enables cable operators to maintain signal transmission even in high noise environments. Further, S-CDMA's rate-adaptive response to sudden changes in plant conditions prevents even short service outages, unlike alternative systems that utilize a frequency-agile scheme, which can result in a loss of service.

Maximize spectrum usage. The TeraComm system is designed to operate effectively in the lowest frequency ranges of the upstream spectrum, where noise is too severe to allow the operation of TDMA-based systems. As a result, cable operators who employ the TeraComm system can utilize more of the existing upstream bandwidth than alternative broadband access technologies.

Generate additional revenue through tiered services. The high capacity and dynamic bandwidth management capabilities of the TeraComm system are designed to enable cable operators to offer a wide range of services at tiered prices. Cable operators can emulate high margin commercial-service offerings such as T-1, frame-relay and leased lines in the same network as lower margin, residential, Internet access.

Reduce ongoing cable infrastructure maintenance costs. Cable operators utilizing the TeraComm system can capitalize on S-CDMA's noise-resistant properties, which enable cable operators to operate plants in a wide range of conditions, thus reducing on-going maintenance costs and minimizing service problems. For example, while all cable operators monitor their networks on a regular basis, cable operators using TDMA-based systems are generally required to take more frequent corrective action than cable operators using S-CDMA- based systems to prevent normal "wear and tear" on the cable system from impacting service.

Strategy

The Company's objective is to be the leading provider of cable modem systems to cable operators seeking to provide broadband access services to residential and commercial end users. Key elements of the Company's strategy are as follows:

Supply leading cable operators worldwide. The Company's initial target market is the ten largest cable companies in each major geographic area. In most markets, a small number of large cable operators often provide services to a majority of subscribers in a specific region and thus influence the purchase decisions of smaller cable operators. In the United States, ten cable operators together own and operate facilities passing approximately 74% of total homes passed. To date, two of the largest North American cable operators are deploying the TeraComm system commercially.

Establish relationships with industry leaders. The Company seeks to provide cable operators with a complete broadband access solution by establishing relationships with networking companies, systems integrators and other industry leaders. For example, the Company has a co-development agreement with Cisco to create an integrated headend solution. Additionally, the Company and @Home have integrated the Company's products with @Home's service. The Company will continue to pursue strategic relationships to expand the capabilities of its system.

Expand worldwide distribution channels. The Company intends to continue to increase its direct sales efforts and to establish strategic relationships with leading distributors worldwide. The Company's distribution strategy is to customize its sales and distribution efforts to address the specific needs of each market. For example, the Company has an agreement with Sumitomo, through its subsidiary Crossbeam Networks Corporation ("Crossbeam"), to distribute the Company's products in Japan. In Latin America and Europe, the Company has appointed local distributors with expertise in their specific geographic regions. In the United States, the Company has begun to establish distribution relationships to provide broadband access solutions to smaller cable operators.

Provide superior customer service and support. The Company believes that its ability to provide consistent high quality service and support will be a key factor in attracting and retaining customers. In addition to assigning a field applications engineer to each customer account, the Company provides its customers with technical support and training through customer support representatives and representatives of distributors. The Company provides service and support to its customers 24 hours a day, 7 days a week.

Adopt and advocate industry standards. The rapidly evolving market in which the Company participates has recently adopted DOCSIS for cable modem standards, and the industry has commenced discussion of a next-generation cable modem standard, DOCSIS 2.0. The Company is developing a next-generation product, known as the UCM, which is intended to offer a mode of operation compliant with DOCSIS. The Company is actively participating in industry standard-setting efforts and intends to work with the MCNS consortium to incorporate S-CDMA into the DOCSIS 2.0 standard.

Leverage S-CDMA technology. The Company believes that S-CDMA technology provides significant advantages over alternative broadband access technologies. The Company's team of engineers has extensive experience in many areas of broadband access system design, including communication systems, ASICs, data networking, RF, software and hardware. The Company intends to leverage these engineering capabilities to expand the features and functionality of its S-CDMA technology, and to apply S-CDMA to additional applications such as IP telephony, wireless communications and LMDS.

Technology

Terayon's products are based on the Company's S-CDMA technology. S-CDMA is integrated into a single ASIC chip, which implements the physical ("PHY") layer and media access control ("MAC") layer communication protocols in the TeraComm system. S-CDMA is the primary differentiator between Terayon's cable modems and those of competitors who use TDMA-based technology for the PHY and MAC layer protocols. S-CDMA is designed to maximize resistance to noise, optimize use of network capacity and provide cable operators with multiple revenue streams through the ability to offer multiple Quality of Service levels.

Maximum noise resistance through spread spectrum and rate adaptive technologies. S-CDMA, like asynchronous Code Division Multiple Access ("CDMA") commonly used in mobile communications, is a form of spread spectrum technology. Spread spectrum technology was originally designed for use by the military to provide reliable and secure communications in harsh RF environments. The RF environment is subject to a variety of noise sources that can interfere with the transmission of data. In spread spectrum systems, data is transmitted by spreading the information across a range of frequencies and across a period of time, allowing sufficient information reception for the data to be reconstructed by the receiver. Data is encoded by transmitters in unique spreading codes that allow multiple data streams to be received and decoded by the receiver simultaneously. Therefore, noise events that are typically specific to a particular frequency or a period of time do not significantly interfere with transmission In addition to spread spectrum, S-CDMA incorporates other techniques, including forward error correction and interleaving, that further enhance the ability of S-CDMA to resist impulse and ingress noise. In extremely harsh noise environments, S-CDMA incorporates a rate adaptive mode of operation that changes modulation schemes, reducing capacity, but allowing continued reliable transmission. This combination of techniques enables S-CDMA-based systems to operate in SNR environments as low as 13dB at full capacity, and as low as - 13dB in rate adaptive mode.

Optimal capacity utilization through synchronization. In asynchronous CDMA systems, codes arriving at the receiver are unaligned. This causes mutual interference between the codes, which forces the use of lower order modulation schemes resulting in significantly reduced data capacity. S-CDMA minimizes mutual interference by ensuring that codes are synchronized with each other through ranging, power management and adaptive equalization. The process of ranging guarantees time alignment by ensuring all codes arrive at the receiver at the same time. Power management and adaptive equalization compensate for variables such as temperature and changes in network topology.

These techniques allow S-CDMA to utilize higher order modulation schemes providing a capacity of 14 Mbps in a 5 MHz channel in both the upstream and downstream paths. This 14 Mbps capacity is divided into 144 data streams each represented by a unique S-CDMA spreading code.

Efficient bandwidth management for multiple levels of Quality of Service. The TeraComm system segments each 14 Mbps upstream and downstream channel into 128 user data streams and 16 management and control data streams. Separating user data from management and control ensures high channel efficiency under heavy channel loading. Each of the 128 user data streams has a continuous data payload capacity of 64 Kbps. The bandwidth manager software residing in the system headend allocates data streams to cable modems individually or in groups. Data streams can also be assigned on a permanent basis, or can be multiplexed among multiple modems based on a fairness algorithm in the bandwidth manager. This capability allows the TeraComm system to provide a variety of Quality of Service levels. Constant Bit Rate ("CBR") services can be provisioned in increments of 64 Kbps by continuous assignment of data streams to a TeraPro cable modem. As a result, services such as leased lines and T-1 circuits can be emulated. Unspecified Bit Rate ("UBR") services can be supported by allowing modems to contend for data streams on an "as requested" basis. Because all access requests and grants are communicated through management streams, the impact on channel efficiency is minimized as more modems contend for bandwidth. Both CBR and UBR services can co-exist on a single channel enabling a cable operator to create multiple service levels and maximize revenue from the available bandwidth capacity.

Products

Current Products

The Company's TeraComm system enables cable operators to cost-effectively deploy reliable two-way broadband access services. The TeraComm system is comprised of the TeraPro cable modem, the TeraLink 1000 Master Controller, the TeraLink Gateway and the TeraView Element Management and Provisioning Software.

The following diagram illustrates the TeraComm system:

[Diagram of the components of the TeraComm system]

The Teracomm System

TeraPro Cable Modem. The TeraPro cable modem is a data communications device installed in a subscriber's home or business. The TeraPro cable modem connects to the subscriber's PC via a standard 10BaseT Ethernet connector and to the cable network via a standard coaxial cable connector. The TeraPro cable modem automatically configures itself without user intervention, thus minimizing

modem installation time. In addition, the configuration software for the TeraPro cable modem is downloaded remotely, allowing centralized software upgrades directly from the headend management system.

The TeraPro cable modem delivers full two-way communication over the cable network, with data rates of up to 14 Mbps per 5 MHz channel in both the upstream and the downstream direction. The TeraPro cable modem operates at full capacity at an SNR as low as 13 dB, and gradually adjusts throughput to provide transmission at an SNR as low as -13 dB. This feature will permit the TeraPro cable modem to operate across any portion of the 5 to 42 MHz upstream RF spectrum.

TeraLink 1000 Master Controller. The TeraLink 1000 Master Controller is a data channel controller and multiplexer located at the cable headend system or distribution hub. The TeraLink 1000 Master Controller provides control, management and data transport functions for TeraPro cable modems connected to the cable network. It offers dynamic bandwidth management, high-speed traffic concentration, access control to data networking resources, and data service quality and integrity.

The TeraLink 1000 Master Controller is a single channel, rack-mountable controller that supports up to 2,000 cable modems per channel. Additional TeraLink 1000 Master Controllers can be added to scale service as performance and subscriber needs grow. The TeraLink 1000 Master Controller, with the TeraLink Gateway, provides a 100 BaseT interface for direct connectivity to a private backbone or any vendor's router or switch. Alternatively, the TeraLink 1000 Master Controller, with its built-in ATM OC-3 interface, can be connected via an ATM switch, or directly to Cisco's 7500 series routers.

TeraLink Gateway. The TeraLink Gateway is a rack-mountable edge concentrator providing end-user clients with broadband access to a remote IP backbone (e.g., Internet) as well as efficient communication between modems. The TeraLink Gateway includes an ATM OC-3 interface for connectivity to up to two TeraLink 1000 Master Controllers or an ATM switch. It also provides a 10/100 BaseT Ethernet/Fast Ethernet auto-sense interface to a headend backbone or any IP router including the Cisco Universal Broadband Router. The TeraLink Gateway also includes a separate 10 BaseT interface, which may be connected to a separate management network or the headend network. The TeraLink Gateway supports up to 2,000 cable modems per RF channel when connected to a TeraLink 1000 Master Controller. When used with the TeraLink Gateway, the TeraPro cable modems behave as an extension of the TeraLink Gateway, providing maximum bandwidth and privacy.

TeraView Element Management and Provisioning Software. The TeraView Element Management and Provisioning Software is a Windows 95 and Windows NT standards- based software application installed at the headend system or the network operations center. The TeraView software allows cable operators to configure, control, monitor and maintain multiple channels of the TeraComm system.

Products Under Development

Universal Cable Modem and TeraLink 2000 Master Controller. The Company currently is designing and developing a next-generation system, which includes the UCM and an accompanying headend controller, the TeraLink 2000 Master Controller. The UCM and the TeraLink 2000 Master Controller

will be designed to be fully compliant with DOCSIS standards, while also offering additional features and performance enabled by the use of the S-CDMA technology. The UCM and the TeraLink 2000 Master Controller are in the early stages of development and the Company does not anticipate commercial deployment of these products until 1999.

The UCM will be designed to operate in any of three modes: (i) as an existing TeraPro cable modem to ensure backward compatibility for existing TeraComm system users; (ii) as a DOCSIS-compliant modem that will be compatible with multiple vendors' DOCSIS-compliant systems; and (iii) as an advanced system. In the advanced mode the UCM will be designed to offer DOCSIS-compliant 64/256 QAM modulation downstream channels, coupled with an advanced S-CDMA upstream channel, offering up to 40 Mbps downstream channel capacity and 30 Mbps upstream channel capacity.

Customers

The Company markets its products to cable operators that seek to provide broadband access services to both residential and commercial end users. The Company's initial target market consists of the ten largest cable companies in each major geographic area. In most markets, a small number of large cable operators often provide services to a majority of subscribers in a specific region and thus influence the purchasing decisions of smaller cable operators. In the United States, ten cable operators together own and operate facilities passing approximately 74% of total homes passed. The Company commenced volume shipments of its products in the first quarter of 1998. To date, two of the largest North American cable operators are deploying the TeraComm system commercially.

Selected examples of the range of customers and applications for which the TeraComm system is being commercially deployed are as follows:

Shaw Cable. Shaw is the third largest cable operator in Canada, with cable infrastructure passing approximately 2.0 million homes. Shaw currently has the largest cable modem deployment in Canada, with over 25,000 cable modem users. Shaw has selected Terayon to supply cable modem systems for Shaw's @Home service deployments in Victoria, British Columbia, Edmonton, Alberta and parts of metropolitan Toronto, Ontario.

Sumitomo. The Company has a distribution agreement with Sumitomo under which Crossbeam is distributing the TeraComm system to three of Japan's leading cable operators. The TeraComm system's noise resistant properties are designed to enable two-way broadband access over pure coaxial networks, which comprise the majority of Japan's cable infrastructure.

TCA Cable Systems. TCA is the 15th largest cable operator in the United States, with cable infrastructure passing approximately 940,000 homes in Texas, Arkansas, and Louisiana. TCA has deployed the TeraComm system in Bryan/College Station, Texas and Amarillo, Texas. TCA provides a tiered service offering, with prices ranging from $40 per month for residential Internet access to $175 per month for commercial Internet access. TCA has announced that it intends to leverage the noise resistant properties of Terayon's products to deploy broadband access services on a pure coaxial network in Tyler, Texas.

Three customers accounted for approximately 73% of the Company's revenues in 1997 and for approximately 62% of the Company's revenues in the first quarter of 1998. In 1997, sales to Telegate, Sumitomo and NET Brasil represented approximately 30%, 29% and 14%, respectively, of the Company's revenues. In the first quarter of 1998, sales to Shaw, Sumitomo and Telegate represented approximately 37%, 13% and 12%, respectively, of the Company's revenues. The Company believes that a substantial majority of its revenues will continue to be derived from sales to a relatively small number of customers for the foreseeable future. In addition, the Company believes that sales to these customers will be focused on a small number of projects. See "Risk Factors-- Dependence on Small Number of Customers."

Research and Development

The Company believes that its future success will depend upon its ability to enhance its existing products and to develop and introduce new products that meet a wide range of evolving cable operator and end user needs. In addition, to address competitive and pricing pressures, the Company expects that it will have to reduce the unit cost of manufacturing its cable modems through design and engineering changes. For example, the Company has developed and intends to introduce a single-board modem by the end of 1998, which the Company anticipates will provide cost savings over its current dual-board modem. There can be no assurance that the Company will be successful in redesigning its products, that any such redesign will be made on a timely basis and without introducing significant errors and product defects, or that any such redesign, including the single board modem, would result in sufficient cost reductions to allow the Company to significantly reduce the list price of its products or improve its gross margin.

The Company also currently is designing and developing a next-generation system, which includes the UCM and an accompanying headend controller, the TeraLink 2000 Master Controller. The UCM and the TeraLink 2000 Master Controller will be designed to be fully compliant with emerging DOCSIS standards, while also offering additional features and performance enabled by the use of the S-CDMA technology. The UCM and the TeraLink 2000 Master Controller are in the early stages of development and the Company does not anticipate commercial deployment of these products until 1999. See "Risk Factors--Evolving Market; Rapid Technological Change; Market Acceptance of S- CDMA," "--Ability to Achieve Cost Reductions," "--Evolving Industry Standards" and "--Dependence on Products Under Development."

As of May 31, 1998, the Company had 50 employees engaged in research and development. The Company's total research and development expenses for 1995, 1996 and 1997 and the first quarter of 1998 were $2.0 million, $8.0 million, $11.3 million and $2.3 million, respectively.

Sales and Marketing

Terayon has direct sales forces in North America, Latin America and Europe. The Company also distributes its products via distributors and systems integrators. Terayon has signed a distribution agreement with Sumitomo under which Crossbeam is distributing the TeraComm system to three of Japan's leading cable operators.

The Company markets its products directly to cable operators through its sales force, key distribution and technology partners, as well as other marketing vehicles such as industry press, trade shows and the World Wide Web. Through its marketing efforts, the Company strives to educate cable operators on the technological and business benefits of its system solution, as well as the Company's ability to provide quality support and service to the customer. Terayon participates in the major trade shows and industry events for the cable industry in the United States and is expanding its presence in other markets through joint participation at local events with its international sales and marketing partners. Industry referrals and reference accounts are significant marketing tools developed and utilized by the Company.

Customer Service and Technical Support

The Company believes that its ability to consistently provide high quality service and support will be a key factor in attracting and retaining customers. The Technical Services and Support ("TSS") organization provides support 24 hours a day, seven days per week. Prior to deployment of the Company's systems, each cable operator's needs are assessed and proactive solutions are implemented, including various levels of training, periodic management and coordination meetings, and problem escalation procedures. Terayon places a strong emphasis on technical training, both for cable operators and systems integrators. Initial training is offered to cable operators and systems integrators at no cost, both in Terayon's headquarters in Santa Clara and on a cable operator's or system integrator's premises. At May 31, 1998, the TSS organization consisted of 13 employees located in North America, Europe, Latin America and Asia.

In addition, Terayon has developed sophisticated tools for remote diagnosis and monitoring of the TeraComm systems deployed by cable operators. Such tools enable the Company to monitor cable operators' installations of the TeraLink 1000 Master Controller and to proactively suggest solutions before problems become noticeable to end users. The Company is developing a Web-based knowledge system to provide cable operators with access to the latest technical support information.

Manufacturing

The Company outsources the materials procurement, printed circuit board assembly, and product assembly and testing to turnkey contract manufacturers. Currently, the Company contracts with Solectron, located in Milpitas, California, for the manufacture of the majority of its products. CMC, located in Santa Clara, California, also manufactures certain of the Company's products. The Company

has a limited in-house manufacturing capability at its headquarters in Santa Clara. This facility is currently used for the assembly and final testing of TeraLink 1000 Master Controller and TeraLink Gateways, pilot production of new modem designs, sample testing of products received from volume modem manufacturers, developing the manufacturing process and documentation for new products in preparation for outsourcing. The Company also repairs products returned from customers with its in-house manufacturing resources.

The Company's future success will depend in significant part on its ability to obtain high volume manufacturing at low costs. As volume increases, the Company plans to engage additional contract manufacturers, to procure additional manufacturing facilities and equipment, to modify existing inventory procedures, to substantially increase its personnel and to revise its quality assurance and testing practices. There can be no assurance that any of these efforts will be successful. The Company anticipates that the need to reduce the manufacturing costs of its cable modem and will continue to evaluate the use of low cost third-party suppliers and manufacturers. See "Risk Factors--Ability to Achieve Cost Reductions" and "--Limited Manufacturing Experience and Dependence on Contract Manufacturer."

Subcontractors supply the Company's contract manufacturers with both standard components and subassemblies manufactured to the Company's specifications. The Company is dependent upon certain key suppliers for a number of the components for its products. For example, the Company currently relies on VLSI for the Company's S-CDMA ASIC, which is used in the Company's headend and cable modem products. In addition, all of the Company's products contain one or more components that are currently only available from a single source.

Competition

The market for broadband access systems is extremely competitive and is characterized by rapid technological change. The Company's direct competitors in the cable modem arena include Bay Networks, Com21, Hayes, Hybrid, Matsushita, Motorola, Phasecom, RCA, Samsung, Scientific-Atlanta, Sony, 3Com, Toshiba and Zenith and there are many other potential market entrants. In addition, Bay Networks, Com21, Hybrid and Motorola introduced cable modems prior to the Company, and have established relationships and have worked with customers for a longer period of time than the Company. The principal competitive factors in this market include: product performance, features and reliability; price; size and stability of operations; breadth of product line; sales and distribution capability; technical support and service; relationships with cable operators; standards compliance; and general industry and economic conditions. Certain of these factors are outside of the Company's control. The existing conditions in the broadband access market could change rapidly and significantly as a result of technological changes, and the development and market acceptance of alternative technologies could decrease the demand for the Company's products or render them obsolete. There can be no assurance that these companies and other competitors will not introduce broadband access products that will be less costly or provide superior performance or achieve greater market acceptance than the Company's products.

The Company sells products that also compete with existing data access and transmission systems utilizing the telecommunications networks, such as those of 3Com. Additionally, the Company's controller and headend system products face intense competition from well-established companies such as Bay Networks, Cisco and 3Com. Many of the Company's current and potential competitors have significantly greater financial, technical, marketing, distribution, customer support and other resources, as well as greater name recognition and access to customers than the Company. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not have a material adverse effect on its business, operating results and financial condition.

The market for cable modems may be impacted by the development of other technologies that enable the provisioning of broadband access services. Examples of such technologies include technologies that increase the efficiency of digital transmission over telephone companies' existing copper infrastructure, such as various xDSL, as well as ISDN. Similarly, broadband access services may be deployed over a number of other media, including fiber optic cable, DBS and other wireless technologies. Broadband access services based on some of these competing technologies are already available and could materially limit acceptance of cable modem-based services. The failure of broadband access services based on cable modem technology to gain widespread commercial acceptance by cable operators and end users of broadband access services would have a material adverse effect on the Company's business, operating results and financial condition. See "Risk Factors -- Highly Competitive Industry; Established Competitors."

Regulation

The Company and its customers are subject to varying degrees of federal, state and local regulation. The jurisdiction of the FCC extends to the communications industry, including broadband access products such as those of the Company. The FCC has promulgated regulations that, among other things, set installation and equipment standards for communications systems. Although FCC regulations and other governmental regulations have not materially restricted the Company's operations, there can be no assurance that future regulations adopted by the FCC or other regulatory bodies will not have a material adverse effect on the Company. Further, regulation of the Company's customers may adversely impact the Company's business, operating results and financial condition. For example, FCC regulatory policies affecting the availability of cable services and other terms on which cable companies conduct their business, may impede the Company's penetration of certain markets. In addition, regulation of cable television rates may affect the speed at which cable operators upgrade their cable infrastructures to two-way HFC. Changes in, or the failure by the Company to comply with, applicable domestic and international regulations could have a material adverse effect on the Company's business, operating results and financial condition. In addition, the increasing demand for communications systems has exerted pressure on regulatory bodies worldwide to adopt new standards for such products and services, generally following extensive investigation of and deliberation over competing technologies. The delays inherent in this governmental approval process have in the past,

and may in the future, cause the cancellation, postponement or rescheduling of the installation of communications systems by the Company's customers, which in turn may have a material adverse effect on the sale of products by the Company to such customers. For example, the Company experienced delays in product shipments to a customer in Brazil due to delays in certain regulatory approvals in Brazil, and there can be no assurance that similar delays will not occur in other countries in which the Company markets or plans to market its products. In addition, the Company's customers in certain parts of Asia, such as Japan, are required to obtain licenses prior to selling the Company's products, and delays in obtaining such licenses could have an adverse impact on the Company's operating results. See "Risk Factors -- Regulation of the Communications Industry."

In the United States, in addition to complying with FCC regulations, the Company's products will be required to meet certain safety requirements. For example, the Company will be required to have its products certified by UL in order to meet federal requirements relating to electrical appliances to be used inside the home. Outside of the United States, the Company's products will be subject the regulatory requirements of each country in which the products are manufactured or sold. These requirements are likely to vary widely, and there can be no assurance that the Company will be able to obtain on a timely basis or at all such regulatory approvals as may be required for the manufacture, marketing or sale of its products. Any delay in or failure to obtain such approvals or meet such requirements could have a material adverse effect on the Company's business, operating results and financial condition. See "Risk Factors -- Other Regulatory Approvals or Certifications."

Intellectual Property

The Company relies on a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in its products. The Company has two issued patents and five patent applications pending in the United States. The Company has seven patent applications pending internationally. There can be no assurance that the Company's patent applications will be granted or, if granted, that the claims covered by the patents will not be reduced from those included in the Company's applications. Any patent might be subject to challenge in court and, whether or not challenged, might not be sufficiently broad to prevent third parties from developing equivalent technologies or products. The Company has entered into confidentiality and invention assignment agreements with its employees, and enters into non-disclosure agreements with certain of its suppliers, distributors and appropriate customers so as to limit access to and disclosure of its proprietary information. There can be no assurance that these statutory and contractual arrangements will prove sufficient to prevent misappropriation of the Company's technology or to deter independent third-party development of similar technologies.

The Company pursues the registration of its trademarks in the United States and has applications pending to register several of its trademarks. However, since the laws of certain foreign countries might not protect the Company's products or intellectual property rights to the same extent as do the laws of the United States, effective trademark, copyright, trade secret and patent protection might not be available in every country in which the Company's products might be manufactured, marketed or sold.

The Company expects that developers of cable modems will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows. The Company has received a letter from an individual claiming that the Company's technology infringes a patent held by such individual. The Company has reviewed the allegations made by such individual and, after consulting with its patent counsel, does not believe that the Company's technology infringes any valid claim of such individual's patent. There can be no assurance that, if the issue were to be submitted to a court, such a court would not find that the Company's products infringe the patent, nor that the individual will not continue to assert infringement. If the Company is found to have infringed such individual's patent, the Company could be subject to substantial damages and/or an injunction preventing it from conducting its proposed business, and the Company's business could be materially and adversely affected. In addition, there can be no assurance that other third parties will not assert infringement claims against the Company in the future. Any such claim, whether meritorious or not, could be time- consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition. Litigation also may be necessary to enforce the Company's intellectual property rights. Any infringement claim or other litigation against or by the Company could have a material adverse effect on the Company's business, operating results and financial condition.

Employees

As of May 31, 1998, Terayon had 104 employees, of which 50 were in the engineering group, 27 were in marketing, sales and customer support, 14 were in operations and 13 were in general and administrative functions. None of the Company's employees is represented by a union. The Company believes that its relations with its employees are good.

Properties

The Company leases an approximately 30,000 square foot facility located in Santa Clara, California and has an option to lease approximately 10,000 additional square feet in August 1998. The current lease for the Santa Clara facility expires in March 2002. The Company has sales offices in Denver, Colorado; Atlanta, Georgia; Sao Paulo, Brazil; and Brussels, Belgium. The Company believes that its existing facilities are adequate to meet its needs for the immediate future and that future growth can be accommodated by leasing additional or alternative space near its current facilities.

Legal Proceedings

The Company is not currently a party to any material legal proceedings.

Management

Directors, Executive Officers and Key Employees

Certain information regarding the Company's directors, executive officers and key employees as of June 15, 1998 is set forth below.

Name Age Position

EXECUTIVE OFFICERS AND DIRECTORS Dr. Zaki Rakib(1)..... 39 Chief Executive Officer, Chief Financial Officer and Director Shlomo Rakib..... 41 Chairman of the Board, President and Chief Technical Officer Dennis J. Picker..... 50 Chief Operating Officer Linda R. Palmor..... 43 Vice President, Finance Michael D'Avella..... 39 Director Christopher J. Schaepe(1)(2).... 34 Director Lewis Solomon(2)..... 64 Director Mark A. Stevens(1)..... 38 Director KEY EMPLOYEES Brian Bentley..... 36 Vice President, Worldwide Sales Vice President, Marketing and Business Gary W. Law..... 42 Development Gershon Schatzberg..... 43 Vice President, Customer Satisfaction W. Lee Stalcup..... 57 Vice President, Manufacturing Operations (1) Member of the Compensation Committee. (2) Member of the Audit Committee.

Zaki Rakib co-founded Terayon in 1993 and has served as Chief Executive Officer and Chief Financial Officer since January 1993 and as a director since February 1995. Prior to co-founding the Company, Dr. Rakib served as Director of Engineering for Cadence Design Systems, an electronic design automation software company, from 1990 to 1994. Prior to joining Cadence, Dr. Rakib was Vice President of Engineering at Helios Software, which was acquired by Cadence in 1990. Dr. Rakib holds B.S., M.S. and Ph.D. degrees in engineering from Ben-Gurion University in Israel. Dr. Rakib is the brother of Shlomo Rakib, the Company's Chairman of the Board, President and Chief Technical Officer.

Shlomo Rakib co-founded Terayon in 1993 and has served as Chairman of the Board and President since January 1993 and as Chief Technical Officer since February 1995. Prior to co-founding the Company, Mr. Rakib served as Chief Engineer at PhaseCom, Inc., a communications products company, from 1981 to 1993, where he pioneered the development of data and telephony applications over cable. Mr. Rakib is the inventor of several patented technologies in the area of data and telephony applications over cable. Mr. Rakib holds a B.S.E.E. degree from Technion University in Israel. Mr. Rakib is the brother of Zaki Rakib, the Chief Executive Officer, Chief Financial Officer and a director of the Company.

Dennis Picker has served as Chief Operating Officer since February 1998 and served as Vice President, Standards from October 1997 to February 1998 and Vice President, Engineering from May 1996 to October 1997. From 1994 to April 1996, Mr. Picker was Director of the Cable Data Products Business

Unit of Motorola, Inc., an electronics company, and from 1992 to 1994, he was Senior Director of Data Networking Products at Motorola. Mr. Picker holds a B.S. degree in electrical engineering from the University of Pennsylvania and an M.S. degree in electrical engineering from Northwestern University.

Linda Palmor has served as Vice President, Finance since May 1997 and served as Corporate Controller from February 1996 to May 1997. Prior to joining the Company, Ms. Palmor served as the Corporate Controller of Electronic Arts Inc., a multimedia software company, from 1995 to 1996 and held financial positions with The Walt Disney Company, a media conglomerate, from 1991 to 1995. Ms. Palmor is a certified public accountant and holds a B.Sc. degree in biochemistry from Manchester University in the United Kingdom.

Michael D'Avella has served as a director of the Company since April 1998. Mr. D'Avella is the Senior Vice President, Planning for Shaw Communications Inc. ("Shaw"), a diversified communications company and a leading cable operator in Canada. Mr. D'Avella has held a variety of senior management positions at Shaw since 1991. Prior to that, he held positions with the Canadian Cable Television Association and Telesat Canada. He is a director of several privately held companies. Mr. D'Avella holds a B.A. degree in economics and planning from the University of Toronto in Canada.

Christopher J. Schaepe has served as a director of the Company since March 1995. Mr. Schaepe is a General Partner of Weiss, Peck & Greer Venture Partners, L.P., a technology-focused venture capital firm, which he joined in 1991. Previously, Mr. Schaepe served in corporate finance and capital markets roles for three years at Goldman, Sachs & Company after his employment as a software engineer at IBM Corporation. He is a director of Galileo Technology Ltd., a communications semiconductor company, as well as several privately held companies. Mr. Schaepe holds B.S. and M.S. degrees in computer science from the Massachusetts Institute of Technology and an M.B.A. degree from Stanford Business School.

Lewis Solomon has served as a director of the Company since March 1995. Mr. Solomon has been a principal of G&L Investments, a consulting firm, since 1989 and currently serves as the Chairman of the Board of ICTV, Inc. From 1983 to 1988, he served as Executive Vice President at Alan Patricof Associates, a venture capital firm focused on high technology, biotechnology and communications industries. Prior to that, Mr. Solomon served in various capacities with General Instrument Corp., most recently as Senior Vice President. He serves on the boards of Anadigics, Inc., a manufacturer of integrated circuits; Anacomp, Inc., a manufacturer of data storage systems; Artesyn Technologies, Inc., a power supply and power converter supply company; and Microelectronic Packaging, Inc., an integrated circuit packaging manufacturer. Mr. Solomon also serves on the boards of several privately held companies.

Mark Stevens has served as a director of the Company since March 1995. Mr. Stevens has been a General Partner of Sequoia Capital, a venture capital investment fund, since March 1993. Mr. Stevens currently serves on the Board of Directors of Aspect Development, Inc., a client/server applications software company, and several privately held companies. Prior to joining Sequoia in 1989, he held

technical sales and marketing positions at Intel Corporation. Mr. Stevens holds a B.S.E.E. degree, a B.A. degree in economics and an M.S. degree in computer engineering from the University of Southern California and an M.B.A. degree from Harvard Business School.

Brian Bentley has served as Vice President, Worldwide Sales since February 1997. From 1995 to February 1997, he served as Director of TCI Sales for Scientific-Atlanta, Inc., a satellite manufacturer. Prior to that, Mr. Bentley served as Vice President of MSO Sales for the Multimedia Group of Motorola from January 1995 to November 1995, and as Vice President and General Manager for the Optical Media Group of Antec Corporation, a fiber-optic equipment manufacturer company, from 1992 to 1995. He holds a B.S. degree in economics from Arizona State University.

Gary Law has served as Vice President, Marketing and Business Development since March 1997. From August 1995 to March 1997, he was Vice President of Marketing for the Networking Products Group of Adaptec, Inc., a hardware and software manufacturer company. Prior to that, Mr. Law served as Director of Market Development for Bay Networks, Inc. from 1989 to 1995 and held sales and marketing management positions with Hewlett-Packard Company, an electronics company and Ungermann-Bass Inc. between 1978 and 1988. He holds a B.S. degree in engineering from the University of Texas.

Gershon Schatzberg has served as the Company's Vice President, Customer Satisfaction since April 1998 and served as Group Director of Technical Support Services from August 1997 to April 1998. Prior to joining the Company, he served as Director of Network Consulting for 3Com Corporation, a networking hardware manufacturer company, running North American sales support operations from 1996 to 1997. From 1989 to 1996, Mr. Schatzberg served as the President and Vice President of Engineering for RAD Network Devices, Inc., a networking and router manufacturer company. Prior to that, he held engineering positions with various companies. Mr. Schatzberg holds a B.S.E.E. degree from Technion University in Israel.

W. Lee Stalcup has served as the Company's Vice President, Manufacturing Operations since May 1998. Prior to joining the Company, Mr. Stalcup was Vice President of Operations for Magellan Systems Corporation, a global positioning systems manufacturer, from October 1996 to May 1998. From May 1994 to October 1994, he served as Director of Operations at AST Research, Inc., a computer and network server manufacturer, and from October 1994 to October 1996 he served as its Vice President of Worldwide Materials. From 1990 to 1993, Mr. Stalcup was Executive Vice President and Chief Operating Officer of Vitalrel Microelectronics, a multi-chip module company.

The Company's Board of Directors (the "Board") currently is comprised of six directors. Directors are elected by the stockholders at each annual meeting of stockholders to serve until the next annual meeting of stockholders or until their successors are duly elected and qualified. Pursuant to a voting agreement, Messrs. Rakib, who together own 4,000,000 shares of the Company's stock, have agreed to vote to elect a nominee of Shaw to the Company's Board ("Shaw Nominee"), currently Mr. D'Avella, until such time as Shaw own less than 384,615 shares of the Company's stock. The Company has also agreed to use its best efforts to nominate a Shaw Nominee to the Board. The Company's agreement with Shaw expires on the earlier of December 31, 2000 or the date upon which Shaw no longer holds at

least 384,615 shares of the Company's stock. The Company's Certificate of Incorporation, which will become effective upon the completion of this offering, provides that the Board will be divided into three classes, Class I, Class II and Class III, with each class serving staggered three-year terms. The Class I directors, initially Messrs. Solomon and Stevens, will stand for reelection or election at the 1999 annual meeting of stockholders. The Class II directors, initially Mr. D'Avella and Shlomo Rakib, will stand for reelection or election at the 2000 annual meeting of stockholders. The Class III directors, initially Mr. Schaepe and Zaki Rakib, will stand for reelection or election at the 2001 annual meeting of stockholders.

Advisory Board

In early 1997, the Company established an Advisory Board, which consists of representatives from the United States and international cable industries. The Advisory Board currently consists of nine members: Steven Craddock, the Vice President of New Media for Comcast Corporation; Michael D'Avella, the Senior Vice President of Planning for Shaw and a member of the Company's Board of Directors; David Fellows, the former Vice President of Technology for MediaOne; George Harte, the Director of Telecom Technology for Rogers Communications Inc.; Wilt Hildebrand, the Vice President of Technology for Cablevision Systems Corporation; Isao Momota, the President of Crossbeam Networks; Richard Rexroat, the Vice President, Engineering of TCI International; J.C. Sparkman, a former Executive Vice President of TCI; and Arthur Steiner, the Director of Business Development for NET Brasil.

Compensation Committee Interlocks and Insider Participation

Prior to February 1998, the Company did not have a Compensation Committee of the Board of Directors, and the entire Board participated in all compensation decisions, except that Messrs. Rakib did not participate in decisions relating to their respective compensation. In February 1998, the Board formed the Company's Compensation Committee to review and recommend to the Board compensation and benefits for the Company's executive officers and administer the Company's stock purchase and stock option plans. Each of the Company's directors, or an affiliated entity, holds securities of the Company. See "Certain Transactions" and "Principal Stockholders."

Board Committees

The Audit Committee of the Board of Directors, currently consisting of Messrs. Schaepe and Solomon, reviews the internal accounting procedures of the Company and consults with and reviews the services provided by the Company's independent auditors. The Compensation Committee of the Board of Directors currently consists of Dr. Rakib and Messrs. Schaepe and Stevens. The Compensation Committee reviews and recommends to the Board the compensation and benefits for the Company's executive officers, except that Dr. Rakib does not participate in decisions relating to his compensation.

The Compensation Committee also administers the issuance of stock options and other awards under the Company's 1995 Stock Option Plan, 1997 Equity Incentive Plan, 1998 Employee Stock Purchase Plan and 1998 Non-Employee Directors' Stock Option Plan. See "-- Employee Benefit Plans."

Director Compensation

Lewis Solomon receives $2,000 per month for his service as a member of the Board. No other director of the Company receives cash for services provided as a director. From time to time, certain directors who are not employees of the Company have received grants of options to purchase shares of the Company's Common Stock. In July 1997, Mr. Stevens was granted an option to purchase 30,000 shares of Common Stock at an exercise price of $1.25 per share and entities affiliated with Weiss, Peck & Greer L.L.C. ("WPG") were granted options to purchase an aggregate of 30,000 shares of Common Stock at an exercise price of $1.25 per share. Mr. Schaepe is a partner of WPG. In May 1998, Mr. D'Avella was granted an option to purchase 30,000 shares of Common Stock at an exercise price of $6.50 per share.

In June 1998, the Board adopted the 1998 Non-Employee Directors' Stock Option Plan (the "Directors' Plan") to provide for the automatic grant of options to purchase shares of Common Stock to non-employee directors of the Company who are not employees of or consultants to the Company or of any affiliate of the Company (a "Non-Employee Director"). The Directors' Plan is administered by the Board, unless the Board delegates administration to a Committee comprised of members of the Board. See "--Employee Benefit Plans--1998 Non-Employee Directors' Stock Option Plan."

Limitation on Directors' and Officers' Liability

As permitted by Section 145 of the Delaware General Corporation Law, the Bylaws of the Company provide that (i) the Company is required to indemnify its directors and executive officers to the fullest extent permitted by the Delaware General Corporation Law, (ii) the Company may, in its discretion, indemnify other officers, employees and agents as set forth in the Delaware General Corporation Law, (iii) to the fullest extent permitted by the Delaware General Corporation Law, the Company is required to advance all expenses incurred by its directors and executive officers in connection with a legal proceeding (subject to certain exceptions), (iv) the rights conferred in the Bylaws are not exclusive, (v) the Company is authorized to enter into indemnification agreements with its directors, officers, employees and agents and (vi) the Company may not retroactively amend the Bylaws provisions relating to indemnity. The Company intends to enter into agreements to indemnify its officers and directors. A copy of the form of such indemnification has been filed as an exhibit to the Registration Statement.

Executive Compensation

The following table sets forth the annualized compensation awarded or paid by the Company during the fiscal year ended December 31, 1997 to the Company's Chief Executive Officer and four other most highly compensated officers whose annual salary and bonus exceeded $100,000 in fiscal 1997 (hereinafter, the "Named Executive Officers").

Summary Compensation Table

		ANNUAL COMPENSATION			LONG-TERM COMPENSATION AWARDS	
NAME AND PRINCIPAL POSITION	YEAR	SALARY($)	BONUS($)	OTHER ANNUAL COMPENSATION($)	SECURITIES UNDERLYING OPTIONS (#)	

Dr. Zaki Rakib..... 1997 150,000 12,500 -- -- Chief Executive Officer and Chief Financial Officer Shlomo Rakib..... 1997 150,000 12,500 -- -- President and Chief Technical Officer Gary Law..... 1997 108,333 -- -- 115,000 Vice President, Marketing and Business Development Linda Palmor..... 1997 108,306 10,000 -- 35,000 Vice President, Finance Dennis Picker..... 1997 129,000 31,800 75,166(2) -- Vice President, Standards(1) (1) Mr. Picker has served as Chief Operating Officer since February 1998. (2) Consists of reimbursement to Mr. Picker for travel costs.

Option Grants in Last Fiscal Year

The following table sets forth each grant of stock options made during the fiscal year ended December 31, 1997 to each of the Named Executive Officers:

	INDIVIDUAL GRANTS				POTENTIAL REALIZABLE	
	NUMBER OF SECURITIES UNDERLYING OPTIONS	PERCENTAGE OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN FISCAL YEAR	EXERCISE PRICE	EXPIRATION	VALUE AT ASSUMED ANNUAL RATES OF STOCK PRICE APPRECIATION FOR OPTION TERM (4)	
NAME	GRANTED (#) (1)	(%) (2)	($/SH) (3)	DATE	5% ($)	10% ($)
Dr. Zaki Rakib.....	--	--	--	--	--	--
Shlomo Rakib.....	--	--	--	--	--	--
Gary Law.....	115,000	8.82%	$1.25	03/25/07	$234,154	372,850
Linda Palmor.....	35,000	2.68%	$1.25	05/05/07	$ 71,264	113,476
Dennis Picker.....	--	--	--	--	--	--

(1) Options generally vest at a rate 20% on the first anniversary of the vesting commencement date and 1/48th each month thereafter. The term of each option granted is generally the earlier of (i) ten years or (ii) 90 days after termination of the optionee's services to the Company. Options are immediately exercisable; however, the unvested shares purchasable under such options are subject to repurchase by the Company at the original exercise price paid per share upon the optionee's cessation of service prior to the vesting of such shares. (2) Based on an aggregate of 1,304,050 options granted to employees, consultants and directors, including the Named Executive Officers, of the Company during the fiscal year ended December 31, 1997. (3) The exercise price per share of each option was equal to the fair market value of the Common Stock on the date of grant as determined by the Board of Directors. (4) The potential realizable value is calculated based on the term of the option at its time of grant (ten years). It is calculated assuming that the fair market value of the Company's Common Stock on the date of grant appreciates at the indicated annual rate compounded annually for the entire term of the option and that the option is exercised and sold on the last day of its term for the appreciated stock price.

Aggregate Option Exercises in Fiscal 1997 and December 31, 1997 Option Values

There were no exercises of options by any Named Executive Officer in the fiscal year ended December 31, 1997.

Employee Benefit Plans

1997 Equity Incentive Plan. The Company's 1997 Equity Incentive Plan (the "1997 Plan") was adopted in March 1997 and amended in December 1997 and June 1998. An aggregate of 3,300,000 shares of Common Stock currently are authorized for issuance under the 1997 Plan. However, each year on January 1, starting with January 1, 1999, the aggregate number of shares of Common Stock that are available for issuance under the 1997 Plan will automatically be increased to that number of shares of Common Stock that is equal to 5% of the Company's outstanding shares of Common Stock on such date.

The 1997 Plan provides for the grant of incentive stock options, as defined under the Internal Revenue Code of 1986, as amended (the "Code"), to employees (including officers and employee directors) and non-statutory stock options, restricted stock purchase awards and stock bonuses to employees (including officers and employee directors), directors and consultants of the Company and its affiliates. The 1997 Plan is administered by the Compensation Committee, which determines the recipients and types of awards to be granted, including the exercise price, number of shares subject to the award and the exercisability thereof.

The terms of options granted under the 1997 Plan may not exceed 10 years. The Compensation Committee determines the exercise price of options granted under the 1997 Plan. However, the exercise price for an incentive stock option cannot be less than 100% of the fair market value of the Common Stock on the date of the option grant, and the exercise price for a non-statutory stock option cannot be less than 85% of the fair market value of the Common Stock on the date of the option grant. Options granted under the 1997 Plan vest at the rate specified in the option agreement. Generally, the right to exercise 20% of the total number of shares granted vest 12 months after the date of option grant, with the reminder vesting monthly over four years thereafter, such that an option is fully vested on the fifth anniversary of the date of the option grant. Generally, the optionee may not transfer a stock option other than by will or the laws of descent or distribution. However, an optionee may designate a beneficiary who may exercise the option in the event of the optionee's death or disability. Unless the terms of an optionee's option agreement provide for an earlier termination, in the event of the optionee's cessation of his or her relationship with the Company due to death or disability, the optionee's beneficiary may exercise any vested options up to 18 months and 12 months, respectively, after the date of such cessation. If such optionee's relationship with the Company ceases for any reason other than the optionee's death or disability, the optionee may exercise any vested options during the 30 days following such cessation.

No incentive stock option (and, prior to the Company's stock being publicly traded, no non-statutory stock option) may be granted to any person who, at the time of the grant, owns (or is deemed to own) stock possessing more than 10% of the total combined voting power of the Company or any affiliate of the Company, unless the option exercise price is at lease 110% of the fair market value of the stock subject to the option on the date of grant and the term of the option does not exceed five years from the date of the grant. In addition, the aggregate fair market value, determined at the time of grant, of the shares of Common Stock with respect to which incentive stock options are exercisable for the first time by an optionee during any calender year (under the 1997 Plan and all other stock plans of the Company and its affiliates) may not exceed $100,000.

When the Company becomes subject to Section 162(m) of the Code (which denies a deduction to publicly held corporations for certain compensation paid to specified employees in a taxable year to the extent that the compensation exceeds $1,000,000), no person may be granted options under the Incentive Plan covering more than 500,000 shares of Common Stock in any calendar year.

Shares subject to stock awards that have expired or otherwise terminated without having been exercised in full again become available for the grant of awards under the 1997 Plan. The Compensation Committee has the authority to reprice outstanding options or to offer optionees the opportunity to replace outstanding options with new options for the same or a different number of shares. Both the original and new options will count toward the Code Section 162(m) limitations set forth above.

Restricted stock purchase awards granted under the 1997 Plan may be granted pursuant to a repurchase option in favor of the Company in accordance with a vesting schedule and at a price determined by the Compensation Committee. Stock bonuses may be awarded in consideration of past

services without a purchase payment. Rights under a stock bonus or restricted stock bonus agreement generally may not be transferred other than by will or the laws of descent and distribution during such period as the stock awarded pursuant to such an agreement remains subject to the agreement.

If there is any sale of all or substantially all of the Company's assets, any merger or any consolidation in which the Company is not the surviving corporation or a like transaction involving the Company, all outstanding awards under the 1997 Plan either will be assumed or substituted for by any surviving entity. If the surviving entity determines not to assume or substitute for such awards, the vesting of stock awards held by persons still serving the Company or its affiliate will be accelerated and such awards will terminate if not exercised prior to the sale of assets, merger or consolidation.

As of May 31, 1998, 39,250 shares of Common Stock had been issued upon the exercise of options granted under the 1997 Plan, options to purchase 1,000,760 shares of Common Stock were outstanding and 9,990 shares remained available for future grant. The 1997 Plan will terminate in March 2007 unless terminated by the Board before then. As of May 31, 1998, no stock awards or restricted stock had been granted under the 1997 Plan.

1995 Stock Option Plan. The Company also has a 1995 Stock Option Plan (the "1995 Plan"). The 1995 Plan is administered by the Board, unless the Board delegates administration to a committee comprised of members of the Board. Under the 1995 Plan, stock options and awards may be granted to employees, directors and consultants. Only employees may receive incentive stock options; employees, directors and consultants may receive non-statutory stock options and stock awards other than incentive stock options. The exercise price of incentive stock options granted under the 1995 Plan must be at least equal to the fair market value of the Common Stock on the date of grant, while the exercise price of nonstatutory options must equal at least 85% of such market value. Generally, the right to exercise 20% of the total number of shares granted vest 12 months after the date of option grant, with the reminder vesting monthly over four years thereafter, such that an option is fully vested on the fifth anniversary of the date of the option grant. Options and awards granted under the Plan must be exercised within ten years of the date of grant. The other terms of the 1995 Plan are substantially similar to the terms of the 1997 Plan.

As of May 31, 1998, 724,185 shares had been issued upon the exercise of options under the 1995 Plan, 1,341,015 shares of Common Stock were subject to outstanding options and 49,547 shares remained available for future grant. The 1995 Plan will terminate in March 2005 unless terminated by the Board of Directors before then.

1998 Non-Employee Directors' Stock Option Plan. In June 1998, the Board adopted the Directors' Plan to provide for the automatic grant of options to purchase shares of Common Stock to non-employee directors of the Company who are not employees of or consultants to the Company or of any affiliate of the Company (a "Non-Employee Director"). The Directors' Plan is administered by the Board, unless the Board delegates administration to a Committee comprised of members of the Board.

The aggregate number of shares of Common Stock that may be issued pursuant to options granted under the Directors' Plan is 200,000 shares. Pursuant to the terms of the Directors' Plan, after the effective date of the initial public offering of the Company's Common Stock, each person who is

elected or appointed for the first time to be a Non-Employee Director automatically shall, upon the date of his or her initial election or appointment to be a Non-Employee Director by the Board or stockholders of the Company, be granted an option to purchase 30,000 shares of Common Stock. In addition, on the day following each Annual Meeting of Stockholders of the Company ("Annual Meeting"), commencing with the Annual Meeting in 1999, each person who is then serving as a Non-Employee Director automatically shall be granted an option to purchase 12,500 shares of Common Stock, which amount shall be prorated for any Non-Employee Director who has not continuously served as a Non-Employee Director for the 12- month period prior to the date of such Annual Meeting. In addition, on the day following each Annual Meeting, commencing with the Annual Meeting in 1999, each Non-Employee Director who is then serving as a member of a committee of the Board of Directors automatically shall be granted, for each such committee, an option to purchase 3,000 shares of Common Stock of the Company, which amount shall be prorated for any Non-Employee Director who has not continuously served as a member of such committee for the 12-month period prior to the date of such Annual Meeting.

The exercise price of the options granted under the Directors' Plan will be equal to the fair market value of the Common Stock on the date of grant. No option granted under the Directors' Plan may be exercised after the expiration of 10 years from the date it was granted. Options granted under the Directors' Plan vest and become exercisable as to 33% of the shares on the first anniversary of the date of grant and 1/36th of the shares monthly thereafter. Options granted under the Directors' Plan generally are non-transferable. However, an optionee may designate a beneficiary who may exercise the option following the optionee's death. An optionee whose service relationship with the Company or any affiliate (whether as a Non-Employee Director of the Company or subsequently as an employee, director or consultant of either the Company or an affiliate) ceases for any reason may exercise vested options for the term provided in the option agreement (3 months generally, 12 months in the event of disability, and 18 months in the event of death).

In the event of certain changes in control of the Company, all outstanding awards under the Directors' Plan either will be assumed or substituted for by any surviving entity. If the surviving entity determines not to assume or substitute for such awards, the vesting and time during which such options may be exercised shall be accelerated prior to such event and the options will terminate if not exercised after such acceleration and at or prior to such event. Unless terminated sooner by the Board of Directors, the Directors' Plan will terminate in June 2008.

1998 Employee Stock Purchase Plan. In June 1998, the Company's Board of Directors approved the 1998 Employee Stock Purchase Plan (the "Purchase Plan"), covering an aggregate of 700,000 shares of Common Stock. The Purchase Plan is intended to qualify as an employee stock purchase plan within the meaning of Section 423 of the Code. Under the Purchase Plan, the Board of Directors may authorize participation by eligible employees, including officers, in periodic offerings following the adoption of the Purchase Plan. The offering period for any offering will be no more than 27 months.

Under the Purchase Plan, employees are eligible to participate if they are employed by the Company or an affiliate of the Company designated by the Board of Directors and are employed at least 20 hours per week and five months per year. Employees who participate in an offering will have the right to purchase up to the number of shares of Common Stock purchasable with a percentage designated by the Board of Directors, up to 15%, of an employee's earnings withheld pursuant to the Purchase Plan and applied, on specified dates determined by the Board of Directors, to the purchase of shares of Common Stock. The price of Common Stock purchased under the Purchase Plan will be equal to 85% of the lower of the fair market value of the Common Stock on the commencement date of each offering period or the relevant purchase date. Employees may end their participation in the offering at any time during the offering period, and participation ends automatically on termination of employment with the Company.

In the event of certain changes in control of the Company, the Company and the Board of Directors have discretion to provide that each right to purchase Common Stock will be assumed or an equivalent right will be substituted by the successor corporation, or the Board may shorten the offering period and provide for all sums collected by payroll deductions to be applied to purchase stock immediately prior to the change in control. The Purchase Plan will terminate at the Board's discretion or when all of the shares reserved for issuance under the Purchase Plan have been issued.

401(k) Plan. The Company maintains the Terayon Corporation 401(k) Retirement Plan (the "401(k) Plan") for eligible employees ("Participants"). A Participant may contribute up to 15% of his or her total annual compensation to the 401(k) Plan, or up to a statutorily prescribed annual limit, if less. The annual limit for 1998 is $10,000. Each Participant is fully vested in his or her deferred salary contributions. Participant contributions are held and invested by the 401(k) Plan's trustee. The Company may make discretionary contributions as a percentage of Participant contributions, subject to established limits. To date, the Company has made [no] contributions to the 401(k) Plan on behalf of the Participants. The 401(k) Plan is intended to qualify under Section 401 of the Code, so that contributions by employees or by the Company to the 401(k) Plan, and income earned on the 401(k) Plan contributions, are not taxable to employees until withdrawn from the 401(k) Plan, and so that contributions by the Company, if any, will be deductible by the Company when made.

Employment Agreements

In February 1993, the Company entered into an employment agreement with Shlomo Rakib to serve as President and Chairman of the Board of Directors. The employment agreement is for a period of seven years, terminable at will or without cause at any time upon written notice. In February 1993, the Company also entered into an employment agreement with Zaki Rakib to serve as Chief Executive Officer and Chief Financial Officer. The employment agreement is not for a specified term and is terminable at will or without cause at any time upon written notice.

Certain Transactions

In February 1993, the Company entered into an employment agreement with Zaki Rakib, the Company's Chief Executive Officer and a director of the Company. Dr. Rakib is the brother of Shlomo Rakib, the Company's Chairman of the Board, President and Chief Technical Officer. See "Management--Employment Agreements."

In February 1993, the Company also entered into an employment agreement with Shlomo Rakib, the Company's Chairman of the Board, President and Chief Technical Officer. Mr. Rakib is the brother of Zaki Rakib, the Company's Chief Executive Officer, Chief Financial Officer and director of the Company. See "Management--Employment Agreements."

In December 1995, in connection with the purchase by Cisco of Series B Preferred Stock of the Company, the Company granted Cisco a right of first offer to acquire the Company in the event the Company commences a sale of fifty percent (50%) or more of its outstanding capital stock or all of its assets. The Company also granted Cisco the right to make an offer to purchase the Company in the event the Company commences an initial public offering of its securities. Cisco holds more than 5% of the outstanding equity of the Company. Cisco also has the right to elect one director to the Company's Board of Directors. Cisco's rights terminate upon the completion of the Company's initial public offering.

In March 1996, the Company loaned Shlomo Rakib, the Company's Chairman of the Board, President and Chief Technical Officer, $100,000 pursuant to an interest- free promissory note, with the principal amount due in March 2001. The note (i) may be extended for a longer term at the option of the Company, (ii) is secured by 20,000 shares of Common Stock held by Mr. Rakib and (iii) will accelerate upon termination of his employment with the Company, the initial public offering of the Company's securities or the sale of the Company. Mr. Rakib is the brother of Zaki Rakib, the Company's Chief Executive Officer, Chief Financial Officer and a director of the company.

In December 1997, the Company entered into a strategic partnership and distributorship agreement with Sumitomo, a greater than five percent stockholder of the Company, whereby Sumitomo and the Company formed a strategic partner relationship for the purpose of promoting Terayon's products in Japan. Pursuant to this agreement, the Company appointed Sumitomo as its exclusive distributor for Terayon's products in Japan and as a non-exclusive distributor for Terayon's products in the rest of the world. Sales to Sumitomo in the first quarter of 1998 were approximately $325,000, which represented approximately 13% of the Company's revenues for that quarter.

In the quarter ended March 31, 1998, the Company sold products to Shaw for an aggregate of approximately $900,000. In addition, in April 1998, the Company issued Shaw a warrant to purchase 3,000,000 shares of Common Stock at an exercise price of $6.50 per share. Michael D'Avella, a director of the Company, is the Senior Vice President of Planning for Shaw.

The Company has granted options to certain of its directors and executive officers.

The Company believes that the terms of the transactions described above were no less favorable to the Company than would have been obtained from an unaffiliated third party. Any future transactions between the Company and any of its officers, directors or principal stockholders will be on terms no less favorable to the Company than could be obtained from unaffiliated third parties and will be approved by a majority of the independent and disinterested members of the Board of Directors.

The Company intends to enter into indemnification agreements with its directors and executive officers for the indemnification of and advancement of expenses to such persons to the full extent permitted by law. The Company also intends to execute such agreements with its future directors and executive officers. See "Management -- Limitation on Directors' and Officers' Liability."

Holders of Preferred Stock are entitled to certain registration rights with respect to the Common Stock issued or issuable upon conversion thereof. See "Description of Capital Stock -- Registration Rights."

Principal Stockholders

The following table sets forth certain information with respect to the beneficial ownership of the Company's Common Stock as of May 31, 1998, and as adjusted to reflect the sale of the shares of Common Stock offered hereby by (i) each of the Company's Named Executive Officers, (ii) each of the Company's directors, (iii) each holder of more than 5% of the Company's Common Stock, (iv) certain other stockholders and (v) all current directors and executive officers as a group.

		PERCENTAGE OF SHARES BENEFICIALLY OWNED (1)	
BENEFICIAL OWNERS	SHARES BENEFICIALLY OWNED (1)	PRIOR TO OFFERING	AFTER OFFERING
Dr. Zaki Rakib (2).....	2,000,000	15.9%	
Shlomo Rakib (2).....	2,000,000	15.9%	
Entities associated with Weiss, Peck & Greer (3)..... 555 California Street, Suite 3130 San Francisco, California 94104	1,713,882	13.6%	
Entities associated with Sequoia Capital (4)..... 3000 Sand Hill Road Suite 280, Building 4 Menlo Park, California 94025	1,683,882	13.4%	
Cisco Systems, Inc..... 170 West Tasman Drive San Jose, California 95134	896,834	7.1%	
Entities associated with Walden Ventures (5)..... 750 Battery Street, 7th Floor San Francisco, California 94111	840,620	6.7%	
Sumitomo Corporation..... 2-2 Hitotsubashi 1-Chome, Chiyoda-Ku C.P.O. Box 1524 Tokyo, 100-91 JAPAN	784,615	6.2%	
Shaw Communications Inc. (6).....	576,923	4.6%	
Christopher J. Schaepe (3).....	1,713,882	13.6%	
Mark Stevens (4)(7).....	1,713,882	13.6%	

Lewis Solomon (8).....	100,000	*	*
Michael D'Avella (6)(9).....	611,923	4.9%	
Gary Law (10).....	120,000	*	*
Linda Palmor (11).....	90,000	*	*
Dennis Picker (12).....	240,000	1.9%	
All directors and executive officers as a group (8 persons) (13).....	8,589,687	40.6%	

* Less than 1%. (1) Percentage of beneficial ownership is based on 12,575,637 shares of Common Stock outstanding on an as-converted basis as of May 31, 1998. (2) The address for Messrs. Rakib is c/o Terayon Communication Systems, 2952 Bunker Hill Lane, Santa Clara, CA 95054. (3) Includes 919,400 shares held by WPG Enterprise Fund II, L.P. and 764,482 shares held by Weiss, Peck & Greer Venture Associates III, L.P. Also includes 16,380 shares issuable to WPG Enterprise Fund II, L.P. and 13,620 shares issuable to Weiss, Peck & Greer Venture Associates III, L.P. upon the early exercise of options vesting through July 2000. Christopher Schaepe, a director of the Company, is a General Partner of WPG Venture Partners III, L.P., a general partner of the entities associated with Weiss, Peck & Greer. Mr. Schaepe may be deemed to have a voting and investment power over the shares held by the entities associated with Weiss, Peck & Greer. He disclaims beneficial ownership of such shares except to the extent of his pecuniary interest therein. (4) Includes (i) 1,532,333 shares held by Sequoia Capital VI; (ii) 84,195 shares held by Sequoia Technology Partners VI; (iii) 62,860 shares held by Sequoia XXIV; (iv) 2,296 shares held by Sequoia 1995; (v) 791 shares held by Sequoia 1997; and (vi) 1,407 shares held by SQP 1997. Mark Stevens, a director of the Company, is a General Partner of the entities associated with Sequoia Capital. Mr. Stevens may be deemed to have a voting and investment power over the shares held by the entities associated with Sequoia Capital. He disclaims beneficial ownership of such shares except to the extent of his pecuniary interest therein. (5) Includes (i) 392,270 shares held by Walden-Israel Ventures, L.P.; (ii) 392,270 shares held by Walden-SBIC, L.P.; and (iii) 56,080 shares held by Walden Technology Ventures II, L.P. (6) Includes 192,308 shares issued to Shaw subsequent to May 31, 1998. Does not include 3,000,000 shares issuable pursuant to a warrant. (7) Includes 20,000 shares subject to repurchase by the Company within 60 days of May 31, 1998. (8) Includes 30,000 shares issued to Mr. Solomon upon the exercise of options subsequent to May 31, 1998 and 20,000 shares issuable upon the early exercise of options vesting through May 2000, 2,500 of which will be fully vested and no longer subject to repurchase within 60 days of May 31, 1998. (9) Includes 384,615 shares held by Shaw Communications Inc. Mr. D'Avella, a director of the Company, is the Senior Vice President, Planning for Shaw. Also includes 35,000 shares issuable upon the early exercise of options vesting through April 2001. Mr. D'Avella may be deemed to have a voting and investment power over the shares held by Shaw. He disclaims beneficial ownership as to all shares held by Shaw. (10) Includes 120,000 shares issuable upon the early exercise of options vesting through May 2003, 30,667, of which will be fully vested and no longer subject to repurchase within 60 days of May 31, 1998. (11) Includes 90,000 shares issuable upon the early exercise of options vesting through May 2003, 25,083 of which will be fully vested and no longer subject to repurchase within 60 days of May 31, 1998. (12) Includes 240,000 shares issuable upon the early exercise of options vesting through May 2003, 80,667 of which will be fully vested and no longer subject to repurchase within 60 days of May

31, 1998. (13) Includes 535,000 shares issuable upon the early exercise of options vesting through May 2003, 138,917 of which will be fully vested and no longer subject to repurchase within 60 days of May 31, 1998.

Description of Capital Stock

Upon the completion of this Offering, the authorized capital stock of the Company will consist of 30,000,000 shares of Common Stock, par value $0.001 per share, and 5,000,000 shares of Preferred Stock, par value $0.001 per share ("Preferred Stock").

Common Stock

As of March 31, 1998, there were 11,973,351 shares of Common Stock (including shares of Preferred Stock that will be converted into Common Stock upon completion of this Offering) outstanding held of record by 93 stockholders.

The holders of Common Stock are entitled to one vote for each share held of record on all matters submitted to a vote of the stockholders. Subject to preferences that may be applicable to any outstanding shares of the Preferred Stock, the holders of Common Stock are entitled to receive ratably such dividends as may be declared by the Board of Directors out of funds legally available therefor. See "Dividend Policy." In the event of a liquidation, dissolution or winding up of the Company, holders of the Common Stock are entitled to share ratably in all assets remaining after payment of liabilities and the liquidation preferences of any outstanding shares of Preferred Stock. Holders of Common Stock have no preemptive rights and no right to convert their Common Stock into any other securities. There are no redemption or sinking fund provisions applicable to the Common Stock. All outstanding shares of Common Stock are, and all shares of Common Stock to be outstanding upon the completion of this Offering will be, fully paid and non-assessable.

Preferred Stock

Pursuant to the Restated Certificate, the Board of Directors has the authority, without further action by the stockholders, to issue up to 5,000,000 shares of Preferred Stock in one or more series and to fix the designations, powers, preferences, privileges and relative participating, optional or special rights and the qualifications, limitations or restrictions thereof, including dividend rights, conversion rights, voting rights, terms of redemption and liquidation preferences, any or all of which may be greater than the rights of the Common Stock. The Board of Directors, without stockholder approval, can issue Preferred Stock with voting, conversion or other rights that could adversely affect the voting power and other rights of the holders of Common Stock. Preferred Stock could thus be issued quickly with terms calculated to delay, defer or prevent a change in control of the Company or make removal of management more difficult. Additionally, the issuance of Preferred Stock may have the effect of decreasing the market price of the Common Stock and may adversely affect the voting and other rights

of the holders of Common Stock. Upon the completion of this Offering, there will be no shares of Preferred Stock outstanding and the Company has no current plans to issue any shares of the Preferred Stock.

Warrants

In April 1998, the Company issued to Shaw a warrant ("Product Purchase Warrant") to purchase 3,000,000 shares of Common Stock at an exercise price of $6.50 per share. The Product Purchase Warrant is exercisable between April 6, 2003 and December 31, 2003, or earlier depending on the volume of cable modem purchases by Shaw in 1998, 1999 and 2000. In addition, the Company issued to Shaw a warrant ("Anti-Dilution Warrant") to purchase an indeterminate number of shares of Common Stock for an aggregate price of $1.00. The Anti-Dilution Warrant is exercisable from time to time when the Company issues certain new equity securities until the date upon which Shaw ceases to own at least 384,615 shares of Common Stock.

Registration Rights

Pursuant to an agreement between the Company and the holders (or their permitted transferees) of approximately 8,360,635 shares of Common Stock and Preferred Stock (which Preferred Stock will automatically be converted into Common Stock upon the completion of this offering) and of warrants to purchase 3,038,462 shares of Common Stock ("Holders"), the Holders will be entitled to certain rights with respect to registration of such shares for sale in the public market. The Holders are entitled to certain rights with respect to the registration of such shares under the Securities Act. If the Company proposes to register its Common Stock, subject to certain exceptions, under the Securities Act, the Holders are entitled to notice of the registration and are entitled at the Company's expense to include such shares therein, provided that the managing underwriters have the right to limit the number of such shares included in the registration or exclude such shares entirely. In addition, certain of the Holders may require the Company, at the Company's expense, on no more than six occasions, to file a registration statement under the Securities Act with respect to their shares of Common Stock. Such rights may not be exercised until six months after the completion of this offering. Further, certain Holders may require the Company at the Company's expense on no more than four occasions, to register all or portion of their shares on Form S-3 when such form becomes available to the Company, subject to certain conditions and limitations. Such rights expire on the seventh anniversary of completion of this Offering.

Anti-takeover Effects of Provisions of Charter Documents and Delaware Law

Charter Documents

The Restated Certificate and Restated Bylaws include a number of provisions that may have the effect of deterring hostile takeovers or delaying or preventing changes in control or management of the Company. First, the Restated Certificate provides that all stockholder action upon completion of this offering must be effected at a duly called meeting of holders and not by a consent in writing. Second, the Restated Bylaws provide that special meetings of the holders may be called only by (i) the Chairman of the Board of Directors, (ii) the Chief Executive Officer or (iii) Board of Directors pursuant to a resolution adopted by a majority of the total number of authorized directors. Third, the Certificate and the Bylaws provide for a classified Board of Directors. The Certificate includes a provision requiring cumulative voting for directors only if required by applicable California law. Under cumulative voting, a minority stockholder holding a sufficient percentage of a class of shares may be able to ensure the election of one or more directors. As a result of the provisions of the Certificate and applicable California and Delaware law, at any annual meeting whereby the Company had at least 800 stockholders as of the end of the fiscal year prior to the record date for such annual meeting, stockholders will not be able to cumulate votes for directors. Finally, the Restated Bylaws establish procedures, including advance notice procedures with regard to the nomination of candidates for election as directors and stockholder proposals. These provisions of the Restated Certificate and Restated Bylaws could discourage potential acquisition proposals and could delay or prevent a change in control or management of the Company. Such provisions also may have the effect of preventing changes in the management of the Company. See "Risk Factors--Anti-Takeover Provisions."

Delaware Takeover Statute The Company is subject to the provisions of Section 203 of the Delaware General Corporation Law ("Section 203"). In general, Section 203 prohibits a publicly held Delaware corporation, such as the Company shall become upon completion of this Offering, from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date of the transaction pursuant to which the person became an interested stockholder, unless the business combination is approved in a manner prescribed by Delaware law. For purposes of Section 203, a "business combination" includes a merger, asset sale or other transaction resulting in a financial benefit to the interested stockholder, and an "interested stockholder" is a person who, together with affiliates and associates, owns (or within three years prior, did own) 15% or more of the corporation's voting stock.

Transfer Agent and Registrar

has been appointed as the transfer agent and registrar for the Company's Common Stock.

Shares Eligible for Future Sale

Prior to this offering, there has been no market for the Common Stock of the Company, and there can be no assurance that a significant public market for the Common Stock will develop or be sustained after this offering. Future sales of substantial amounts of Common Stock (including shares issued upon exercise of outstanding options and warrants) in the public market following this offering could

adversely affect market prices prevailing from time to time and could impair the Company's ability to raise capital through sale of its equity securities. As described below, no shares currently outstanding will be available for sale immediately after this offering because of certain contractual restrictions on resale. Sales of substantial amounts of Common Stock of the Company in the public market after the restrictions lapse could adversely affect the prevailing market price and the ability of the Company to raise equity capital in the future.

Upon completion of this offering, the Company will have outstanding shares of Common Stock (based upon shares outstanding as of May 31, 1998), assuming no exercise of the Underwriters' over-allotment option and no exercise of outstanding options or warrants that do not expire prior to completion of this offering. Of these shares, the shares sold in this offering will be freely tradable without restriction under the Securities Act except for any shares purchased by "affiliates" of the Company as that term is defined in Rule 144 under the Securities Act. The remaining 12,575,637 shares of Common Stock held by existing stockholders are "Restricted Shares" as that term is defined in Rule 144. All such Restricted Shares are subject to lock-up agreements providing that, with certain limited exceptions, the stockholder will not offer, sell, contract to sell or otherwise dispose of any Common Stock of the Company, including any securities that are convertible into or exchangeable for, Common Stock for a period 180 days after the date of this Prospectus without the prior written consent of BT Alex. Brown Incorporated or the Company. As a result of these lock-up agreements, notwithstanding possible earlier eligibility for sale under the provisions of Rules 144, 144(k) and 701, none of these shares will be salable until 181 days after the date of this Prospectus. Beginning 181 days after the date of this Prospectus, 12,091,022 Restricted Shares will be eligible for sale in the public market, subject to volume and other limitations under Rule 144. In addition, as of June 11, 1998, there were outstanding options to purchase 2,489,232 shares and warrants to purchase 3,038,462 shares. All such options and warrants are subject to lock-up agreements. The Company has agreed with BT Alex. Brown Incorporated not to release any stockholder from any lock-up agreement between the Company and the stockholder without the prior written consent of BT Alex. Brown Incorporated. BT Alex. Brown Incorporated may, in its sole discretion and at any time without notice, release all or any portion of the securities subject to lock-up agreements.

In general, under Rule 144 as currently in effect, beginning 90 days after the date of this Prospectus, a person (or persons whose shares are aggregated) who has beneficially owned Restricted Shares for at least one year (including the holding period of any prior owner except an affiliate) would be entitled to sell within any three-month period a number of shares that does not exceed the greater of: (i) 1% of the number of shares of Common Stock then outstanding (which will equal approximately shares immediately after this offering); or (ii) the average weekly trading volume of the Common Stock during the four calendar weeks preceding the filing of a Form 144 with respect to such sale. Sales under Rule 144 are also subject to certain manner of sale provisions and notice requirements and to the availability of current public information about the Company. Under Rule 144(k), a person who is not deemed to have been an affiliate of the Company at any time during the three months preceding a sale,

and who has beneficially owned the shares proposed to be sold for at least two years (including the holding period of any prior owner except and affiliate), is entitled to sell such shares without complying with the manner of sale, public information, volume limitation or notice provisions of Rule 144.

Rule 701, as currently in effect, permits resales of shares in reliance upon Rule 144 but without compliance with certain restrictions, including the holding period requirement, of Rule 144. Any employee, officer or director of or consultant to the Company who purchased shares pursuant to a written compensatory plan or contract may be entitled to rely on the resale provisions of Rule 701. Rule 701 permits affiliates to sell their Rule 701 shares under Rule 144 without complying with the holding period requirements of Rule 144. Rule 701 further provides that non-affiliates may sell such shares in reliance on Rule 144 without having to comply with the holding period, public information, volume limitation or notice provisions of Rule 144. All holders of Rule 701 shares are required to wait until 90 days after the date of this Prospectus before selling such shares. However, all Rule 701 shares are subject to lock-up agreements and will only become eligible for sale at the expiration of the 180-day lock-up agreements or no sooner than 90 days after the offering upon obtaining the prior written consent of BT Alex. Brown Incorporated.

Immediately after this offering, the Company intends to file a registration statement under the Securities Act covering shares of Common Stock subject to outstanding options under the 1995 Stock Option Plan, the 1997 Equity Incentive Plan, the 1998 Employee Stock Purchase Plan and the 1998 Non-employee Director's Stock Option Plan (collectively the "Incentive Stock Plans"). See "Management--Equity Incentive Plans". Based on the number of shares subject to outstanding options as of June 11, 1998 and currently reserved for issuance under the Incentive Stock Plans, such registration statement would cover approximately 5,600,000 shares. Such registration statement will automatically become effective upon filing. Accordingly, shares registered under such registration statement will, subject to Rule 144 volume limitations applicable to affiliates of the Company, be available for sale in the open market immediately after the 180-day lock-up agreements expire.

Also beginning 180 days after the date of this offering, holders of approximately 8,360,635 Restricted Shares and holders of warrants to purchase 3,038,462 shares of Common Stock will be entitled to certain rights with respect to registration of such shares for sale in the public market. See "Description of Capital Stock--Registration Rights". Registration of such shares under the Securities Act would result in such shares becoming freely tradable without restriction under the Securities Act (except for shares purchased by affiliates) immediately upon the effectiveness of such registration.

Underwriting

Subject to the terms and conditions of the underwriting agreement (the "Underwriting Agreement"), the underwriters named below (the "Underwriters"), through their Representatives, BT Alex. Brown Incorporated, Hambrecht & Quist LLC and Smith Barney Inc., have severally agreed to purchase from the Company the following respective number of shares of Common Stock at the initial public offering price less the underwriting discounts and commissions set forth on the cover page of this Prospectus:

Number of Underwriter Shares

BT Alex. Brown Incorporated..... Hambrecht & Quist LLC.....
Smith Barney Inc. ..... Total.....

The Underwriting Agreement provides that the obligations of the Underwriters are subject to certain conditions precedent and that the Underwriters will purchase all shares of the Common Stock offered hereby if any such shares are purchased.

The Company has been advised by Representatives of the Underwriters that the Underwriters propose to offer the shares of Common Stock directly to the public at the initial offering price set forth on the cover page of this Prospectus and to certain dealers at such price less a concession not in excess of $ per share. The Underwriters may allow, and such dealers may reallow, a concession not in excess of $ per share to certain other dealers. After the initial public offering of the shares, the offering price and other selling terms may be changed by the Representatives of the Underwriters.

The Company has granted to the Underwriters an option, exercisable no later than 30 days after the date of this Prospectus, to purchase up to additional shares of Common Stock at the initial public offering price less the underwriting discounts and commissions set forth on the cover page of this Prospectus. To the extent that the Underwriters exercise such option, each of the Underwriters will have a firm commitment to purchase approximately the same percentage of such additional shares as the number set forth next to such Underwriter's name in the above table bears to the total number of shares of Common Stock offered hereby, and the Company will be obligated, pursuant to the option, to sell such shares to the Underwriters to the extent the option is exercised. The Underwriters may exercise such option only to cover over- allotments made in connection with the sale of Common Stock offered hereby. If purchased, the Underwriters will offer such additional shares on the same terms as those on which the shares are being offered.

The Company has agreed to indemnify the Underwriters against certain liabilities, including liabilities under the Securities Act, and to contribute to payments the Underwriters may be required to make in respect thereof.

The Company and its officers, directors and stockholders have agreed not to offer, sell or otherwise dispose of any shares of Common Stock for a period of 180 days after the date of this Prospectus without the prior written consent of BT Alex. Brown Incorporated. Such consent may be given without any public notice.

Prior to this offering, there has been no public market for the Common Stock of the Company. Consequently, the initial public offering price for the Common Stock will be determined by negotiation between the Company and the Representatives of the Underwriters. Among the factors to be considered in such negotiations will be prevailing market conditions, the results of operations of the Company in recent periods, the market capitalizations and stages of development of other companies that the Company and the Representatives of the Underwriters believe to be comparable to the Company, estimates of the business potential of the Company and its industry in general and the present state of the Company's development and other factors deemed relevant.

The Company has been advised by the Representatives that during and after this offering, the Underwriters may purchase and sell Common Stock in the open market. These transactions may include over-allotment and stabilizing transactions and purchases to cover syndicate short positions created in connection with this offering. Stabilizing transactions consist of certain bids or purchases for the purpose of preventing or retarding a decline in the market price of the Common Stock; and syndicate short positions involve the sale by the Underwriters of a greater number of shares of Common Stock than they are required to purchase from the Company in this offering. The Underwriters also may impose penalty bids, whereby selling concessions allowed to the syndicate members or other broker-dealers in respect of the Common Stock sold in this offering for their account may be reclaimed by the syndicate if such securities are repurchased by the syndicate in stabilizing or short-covering transactions. These activities may stabilize, maintain or otherwise affect the market price of the Common Stock, which may be higher than the price that might otherwise prevail in the open market. These transactions may be effected on the Nasdaq National Market or otherwise and these activities, if commenced, may be discontinued at any time.

The Representatives of the Underwriters have advised the Company that the Underwriters do not intend to confirm orders to any account over which they exercise discretionary authority.

Legal Matters

The validity of the Common Stock offered hereby will be passed upon for the Company by Cooley Godward llp ("Cooley Godward"), San Francisco, California. Certain legal matters related to the offering will be passed upon for the Underwriters by Wilson Sonsini Goodrich & Rosati, Professional Corporation, Palo Alto, California. As of the date of this Prospectus, certain partners and associates of Cooley Godward own through an investment partnership an aggregate of 36,668 shares of Common Stock of the Company.

Experts

The consolidated financial statements of Terayon Communication Systems at December 31, 1997 and 1996, and for each of the three years in the period ended December 31, 1997, appearing in this Prospectus and Registration Statement have been audited by Ernst & Young LLP, independent auditors, as set forth in their report thereon appearing elsewhere herein, and are included in reliance upon such report given upon the authority of such firm as experts in accounting and auditing.

Additional Information

The Company has filed with the Securities and Exchange Commission (the "Commission"), Washington, D.C. 20549, a Registration Statement on Form S-1 under the Securities Act with respect to the shares of Common Stock offered hereby. This Prospectus does not contain all the information set forth in the Registration Statement and the exhibits and schedules thereto. For further information

with respect to the Company and such Common Stock, reference is made to the Registration Statement and to the exhibits and schedules filed therewith. Statements contained in this Prospectus as to the contents of any contract or other document referred to are not necessarily complete, and in each instance reference is made to the copy of such contract or other document filed as an exhibit to the Registration Statement, each such statement being qualified in all respects by such reference. A copy of the Registration Statement may be inspected by anyone without charge at the Commission's principal office in Washington, D.C., and copies of all or any part of the Registration Statement may be obtained from the Public Reference Section of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, upon payment of certain fees prescribed by the Commission. The Commission also maintains a World Wide Web site that contains reports, proxy and information statements and other information regarding registrants, such as the Company, that file electronically with the Commission. The address of the site is http://www.sec.gov.

The Company intends to furnish to its stockholders annual reports containing audited financial statements certified by an independent public accounting firm and quarterly reports containing unaudited interim financial information for each of the first three fiscal quarters of each fiscal year of the Company.

Glossary of Technical Terms

10BASET..... Ethernet standard which applies to the physical layer of the OSI Reference Model for 10 Mbps Ethernet over two pairs of category 3, 4 or 5 Unshielded Twisted Pair (UTP) wire. 100BASET..... An extension to the 10BaseT Ethernet network access method which operates at 100 Mbps. 56 KBPS..... Equivalent to a single high speed telephone service line, capable of transmitting one voice call or 56 Kbps of data. ADSL..... Asymmetric Digital Subscriber Line. A high speed technology that enables the transfer of data over existing copper line. ANALOG..... A form of transmission employing a continuous electrical signal (rather than a pulsed or digital system) that varies in frequency and amplitude. ASIC..... Application specific integrated circuit. ASYNCHRONOUS..... A form of concurrent input and output communication transmission with no timing relationship between the two signals. Slower- speed asynchronous transmission requires start and stop bits to avoid a dependency on timing clocks (10 bits to send an 8-bit byte). ATM..... Asynchronous Transfer Mode. A fixed length 53- byte packet-based transmission technology that may be used to transmit data, voice and video traffic; ATM utilizes cell switching. BANDWIDTH..... A range of signal frequencies, measured in cycles per second or Hertz (Hz). Also refers to the speed at which data is transmitted, measured in bits per second (bps). BROADBAND ACCESS..... A transmission that has a bandwidth greater than a voice-grade line of 3KHz, usually at transmission speeds of greater than 1.5 Mbps (T-1). CBR..... Constant bit rate. A Quality of Service class specified when service is initiated. CDMA..... Code Division Multiple Access. An information transmission technology that transmits information from multiple sources across a fixed frequency band by encoding each in a unique transmission code. COAXIAL CABLE..... A large capacity data transmission medium consisting of insulated wires grouped

together inside an insulated cable. Used for broadband communications networks and cable TV. DAVLC..... Digital Audio Video Interactive Council. A European standards setting committee. DBS..... Direct Broadcast Satellite. A broadband communications technology that broadcasts digital television programming from satellites directly to user dish antennas.

DOWNSTREAM..... The data path from service provider to end user. DSL..... Digital Subscriber Line. Point-to-point public network access technologies that allow multiple forms of data, voice and video to be carried over twisted-pair copper wire on the local loop between a network service provider's central office and the customer site at limited distances. FCC..... Federal Communications Commission. FDMA..... Frequency Division Multiple Access. A transmission technology that multiplexes information from multiple sources onto discrete carrier frequencies over fixed time intervals. FREQUENCY..... The number of identical cycles per second, measured in hertz, of a periodic oscillation or wave in radio propagation. HDSL..... High Bit Rate Digital Subscriber Line. A technology that enables high speed transmission of data over copper wires. HEADEND..... The central distribution point in a cable system. Typically serves tens to hundreds of thousands of homes. HERTZ..... Cycles per second. HFC..... Hybrid Fiber/Coax. Upgraded cable plant, which uses a combination of fiber optic cable in the backbone and coaxial cable in the subscriber feeder plant. HOMES PASSED..... Homes physically passed by a cable network. IEEE..... Institute of Electrical and Electronics Engineers, Inc. ISDN..... Integrated Services Digital Network. An internationally accepted standard for voice, data and signaling that makes all transmission circuits end-to-end digital and defines a standard out-of-band signaling system. KBPS..... Kilobits per second. Thousand bits per second. LMDS..... Local Multipoint Distribution Service. A broadband wireless communications network that uses millimeter wave frequencies around 28 to 38 GHz to transmit video and data to residences over a cellular-like network at distances under a few miles. MBPS..... Megabits per second. Millions of bits per second. MCNS..... Multimedia Cable Network System. Industry consortium that defines the technical requirement for interoperability of high speed cable modem and headend equipment. MHZ..... Megahertz. Millions of cycles per second. MMDS..... Multichannel Multipoint Distribution Service. A broadband wireless communications network that uses microwave frequencies around 2.5 GHz to transmit video to residences at distances up to tens of miles.

OC-3..... A specification of transmission of data over optical cable at 155 megabits per second. QAM..... Quadrature Amplitude Modulation. A digital modulation technique commonly used in broadband networks. RF..... Radio Frequency. The range of electro-magnetic frequencies above the audio range and below visible light. RF MODULATION..... The transmission of a signal through a carrier frequency. SNR..... Signal-to-noise ratio. SYNCHRONOUS..... A form of communication transmission with a direct timing relationship between input and output signals. The transmitter and receiver are in sync and signals are sent at a fixed rate. Information is sent in multibyte packets. TDMA..... Time Division Multiple Access. An information transmission technology that multiplexes information from multiple sources onto a single frequency carrier signal over discrete time intervals. UBR..... Unspecified Bit

Rate. A Quality of Service class that provides no guarantee of a fixed data rate, or bandwidth to the user. Bandwidth is provided on a best effort basis. UL..... Underwriter's Laboratory. A United States regulatory body responsible for certification of safety standards. UPSTREAM..... The data path from the end user to the service provider. XDSL..... Other Digital Subscriber Line. Generic representation of entire family of Digital Subscriber Line technology spanning data rates from 128 Kbps to 52 Mbps depending on the distance between the central office and the subscriber.

Terayon Communication Systems

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Report of Ernst & Young Llp, Independent Auditors

The Board of Directors and Shareholders Terayon Communication Systems We have audited the accompanying consolidated balance sheets of Terayon Communication Systems as of December 31, 1996 and 1997, and the related consolidated statements of operations, shareholders' equity (net capital deficiency), and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Terayon Communication Systems at December 31, 1996 and 1997, and the consolidated results of its operations and its cash flows for each of the three

years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

Ernst & Young LLP San Jose, California February 6, 1998, except for Note 13, as to which the date is June 11, 1998

Terayon Communication Systems

Consolidated Balance Sheets

(In Thousands, Except Share Data)

DECEMBER 31,			UNAUDITED PRO FORMA
1996	1997	MARCH 31, 1998 (UNAUDITED)	SHAREHOLDERS' EQUITY MARCH 31, 1998

ASSETS Current assets: Cash and cash equivalents. $ 8,356 $ 1,569 $ 109 Short-term investments.... 4,508 418 -- Accounts receivable, less allowance for doubtful accounts of $20 in 1997 and $70 in 1998..... -- 574 1,601 Accounts receivable from related party..... -- 362 552 Other receivable..... -- -- 1,264 Inventory..... -- 1,322 380 Other current assets..... 299 690 714 Total current assets..... 13,163 4,935 4,620 Property and equipment, net. 2,572 3,615 3,373 Officer note receivable..... 100 100 100 Other assets..... 143 128 133 Total assets..... $15,978 $ 8,778 $ 8,226 LIABILITIES AND SHAREHOLDERS' EQUITY (NET CAPITAL DEFICIENCY) Current liabilities: Accounts payable..... $ 682 $ 2,232 $ 4,942 Accrued payroll and related expenses..... 570 1,052 1,099 Other accrued liabilities. 450 1,526 2,735 Advance from related party..... -- 2,000 2,000 Deferred revenue..... 425 95 95 Current portion of long- term debt..... 917 2,812 2,466 Current portion of capital lease obligations..... 148 65 52 Total current liabilities..... 3,192 9,782 13,389 Long-term debt..... 1,150 -- -- Long-term portion of capital lease obligations..... 105 44 34 Deferred rent..... 102 126 130 Other noncurrent liabilities..... 24 -- -- Commitments and contingencies Redeemable convertible preferred stock, no par value: Authorized shares-- included in convertible preferred stock authorized Issued and outstanding shares--100,000 in 1998, and none pro forma, aggregate redemption value of $1,500; aggregate liquidation preference of $1,500 in 1998..... -- -- 1,494 $ -- Shareholders' equity (net capital deficiency): Preferred stock, $.001 par value: Authorized shares-- 5,000,000 pro forma Issued and outstanding shares--none pro forma... -- -- -- -- Convertible preferred stock, no par value: Authorized shares-- 10,000,000 actual; none pro forma Issued and outstanding shares--6,322,174 in 1996, 7,131,161 in 1997 and 1998, and none pro forma; aggregate liquidation preference-- $26,158 in 1996, $36,675 in 1997 and 1998..... 25,989 35,807 35,807 -- Common stock, no par value: Authorized shares-- 20,000,000 actual; 30,000,000 pro forma Issued and outstanding shares--4,138,799 in 1996, 4,630,447 in 1997, 4,742,190 in 1998 and 11,973,351 pro forma (includes 10,000 shares subject to redemption in 1997 and 1998)..... 90 471

661 37,962 Accumulated deficit..... (14,614) (37,163) (42,867) (42,867) Deferred compensation..... -- (216) (362) (362) Shareholders' notes receivable..... (60) (73) (60) (60) Total shareholders' equity (net capital deficiency)..... 11,405 (1,174) (6,821) $(5,327) Total liabilities and shareholders' equity (net capital deficiency)..... $15,978 $ 8,778 $ 8,226 See accompanying notes.

Terayon Communication Systems

Consolidated Statements of Operations (In Thousands, Except Per Share Data)

	YEARS ENDED DECEMBER 31,			THREE MONTHS ENDED MARCH 31,	
	1995	1996	1997	1997	1998
				(UNAUDITED)	
REVENUES:					
Product revenues	$ --	$ --	$ 1,021	$ --	$ 2,077
Related party revenues	--	--	617	--	367
Contract consulting and technology development revenues	--	--	480	--	--
Total revenues	--	--	2,118	--	2,444
COST OF GOODS SOLD:					
Cost of product revenues	--	--	3,904	178	3,564
Cost of related party revenues	--	--	2,558	--	570
Cost of contract consulting and technology development revenues	676	--	--	--	--
Total cost of goods sold	676	--	6,462	178	4,134
GROSS PROFIT (LOSS)	(676)	--	(4,344)	(178)	(1,690)
OPERATING EXPENSES:					
Research and development	2,028	8,020	11,319	2,580	2,305
Sales and marketing	205	1,141	4,468	529	1,140
General and administrative	825	1,789	2,546	461	505
Total operating expenses	3,058	10,950	18,333	3,570	3,950
Loss from operations	(3,734)	(10,950)	(22,677)	(3,748)	(5,640)
Interest income	110	393	396	140	14
Interest expense	(42)	(140)	(268)	(49)	(78)
Net loss	$(3,666)	$(10,697)	$(22,549)	$(3,657)	$(5,704)
Pro forma basic and diluted net loss per share			$ (2.07)		$ (0.48)
Shares used in pro forma basic and diluted net loss per share			10,873		11,773

See accompanying notes.

Terayon Communication Systems

Consolidated Statements of Shareholders' Equity (Net Capital Deficiency)

(In Thousands, Except Share Amounts)

	CONVERTIBLE PREFERRED STOCK		COMMON STOCK					TOTAL SHAREHOLDERS' EQUITY (NET CAPITAL DEFICIENCY)
	SHARES	AMOUNT	SHARES	AMOUNT	ACCUMULATED DEFICIT	DEFERRED COMPENSATION	NOTES RECEIVABLE	
BALANCE AT DECEMBER 31, 1994	--	$ --	2,000,000	$ 62	$ (251)	$ --	$(13)	$ (202)
Exercise of option to purchase common stock	--	--	2,000,000	--	--	--	--	--
Net cash proceeds from issuance of Series A preferred stock	4,077,093	3,853	--	--	--	--	--	3,853
Issuance of Series A preferred stock for notes receivable	85,000	81	--	--	--	--	--	(81)
Net cash proceeds from issuance of Series B preferred stock	896,834	7,970	--	--	--	--	--	7,970
Net loss	--	--	--	--	--	(3,666)	--	--
(3,666)								
BALANCE AT DECEMBER 31, 1995	5,058,927	11,904	4,000,000	62	(3,917)	--	(94)	7,955
Net cash proceeds from issuance of Series B-1 preferred stock	448,417	3,957	--	--	--	--	--	--
3,957								
Cash proceeds from payment on a shareholder note receivable	--	--	--	--	--	--	--	34
34								
Exercise of options for cash to purchase common stock	--	--	106,219	11	--	--	--	11
Issuance of common stock for consulting services	--	--	32,580	17	--	--	--	17
Net cash proceeds from issuance of Series C preferred stock	814,830	10,128	--	--	--	--	--	10,128
Net loss	--	--	--	--	--	(10,697)	--	--
(10,697)								
BALANCE AT DECEMBER 31, 1996	6,322,174	25,989	4,138,799	90	(14,614)	--	(60)	11,405
Exercise of options for cash to purchase common stock	--	--	481,648	140	--	--	--	140
Net cash proceeds from issuance of Series D preferred stock	808,987	9,818	--	--	--	--	--	9,818
Issuance of common stock for note receivable	--	--	10,000	13	--	--	(13)	--
Unearned compensation related to stock options	--	--	--	228	--	(228)	--	--
Amortization of unearned compensation	--	--	--	--	--	12	--	12
Net loss	--	--	--	--	--	(22,549)	--	--
(22,549)								
BALANCE AT DECEMBER 31, 1997	7,131,161	35,807	4,630,447	471	(37,163)	(216)	(73)	(1,174)
Exercise of options for cash to purchase common stock (unaudited)	--	--	111,743	29	--	--	--	29
Cash proceeds from payment on a shareholder note receivable (unaudited).	--	--	--	--	--	--	13	13
Unearned compensation related to stock options (unaudited)	--	--	--	161	--	(161)	--	--
Amortization of unearned compensation (unaudited)	--	--	--	--	--	15	--	15
Net loss (unaudited)	--	--	--	--	--	(5,704)	--	--
(5,704)								
BALANCE AT MARCH 31, 1998 (UNAUDITED)	7,131,161	$35,807	4,742,190	$661	$(42,867)	$(362)	$(60)	$(6,821)

See accompanying notes.

Terayon Communication Systems

Consolidated Statements of Cash Flows

(In Thousands)

	YEARS ENDED DECEMBER 31,			THREE MONTHS ENDED MARCH 31,	
	1995	1996	1997	1997	1998
				(UNAUDITED)	
OPERATING ACTIVITIES:					
Net loss	$(3,666)	$(10,697)	$(22,549)	$ (3,657)	$ (5,704)
Adjustments to reconcile net loss to net cash used in operating activities:					
Depreciation and amortization	203	830	1,563	304	502
Amortization of unearned compensation related to stock options	--	--	12	--	15
Loss on disposal of fixed assets	--	20	--	--	--
Issuance of common stock for consulting services	--	17	--	--	--
Changes in operating assets and liabilities:					
Accounts receivable	--	--	(574)	--	(1,027)
Accounts receivable from related party	--	--	(362)	--	(190)
Other receivable	--	--	--	--	(1,264)
Inventory	--	--	(1,322)	--	942
Other current assets	(97)	(177)	(391)	(6)	(24)
Other assets	(7)	(118)	15	10	(5)
Accounts payable	518	8	1,550	45	2,710
Accrued payroll and related expenses	212	346	482	44	47
Other accrued liabilities	168	263	1,076	118	1,209
Advance from related party	--	--	2,000	--	--
Deferred revenue	325	--	(330)	55	--
Deferred rent	--	102	24	9	4
Other noncurrent liabilities	--	24	(24)	--	--
Net cash used in operating activities	(2,344)	(9,382)	(18,830)	(3,078)	(2,785)
INVESTING ACTIVITIES:					
Purchases of short-term investments	--	(6,863)	(10,995)	(4,764)	--
Proceeds from sales and maturities of short-term investments	--	2,355	15,085	1,064	418
Purchases of property and equipment	(1,301)	(1,892)	(2,606)	(385)	(260)
Proceeds from sale of assets	--	42	--	--	--
Officer note receivable	--	(100)	--	--	--

Net cash provided by (used in) investing activities...	(1,301)	(6,458)	1,484	(4,085)	158

See accompanying notes.

Terayon Communication Systems

Consolidated Statements of Cash Flows--(continued)

(In Thousands)

	YEARS ENDED DECEMBER 31,			THREE MONTHS ENDED MARCH 31,	
	1995	1996	1997	1997	1998
				(UNAUDITED)	
FINANCING ACTIVITIES: Principal payments on capital leases....	$ (82)	$ (124)	$ (144)	$ (15)	$ (23)
Principal payments on long-term debt....	(16)	(273)	(909)	(249)	(346)
Proceeds from long-term debt.....	513	1,843	1,654	--	--
Exercise of option to purchase common stock.....	--	11	140	7	29
Proceeds from issuance of preferred stock.....	11,823	14,085	9,818	--	--
Proceeds from issuance of redeemable preferred stock.....	--	--	--	--	1,494
Principal payments on shareholder note receivable.....	--	34	--	--	13
Net cash provided by (used in) financing activities.....	12,238	15,576	10,559	(257)	1,167
Net increase (decrease) in cash and cash equivalents.....	8,593	(264)	(6,787)	(7,420)	(1,460)
Cash and cash equivalents at beginning of period.....	27	8,620	8,356	8,356	1,569
Cash and cash equivalents at end of period.....	$8,620	$8,356	$1,569	$ 936	$ 109
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: Cash paid for interest.....	$ 42	$ 140	$ 268	$ 49	$ 78
SUPPLEMENTAL NONCASH INVESTING AND FINANCING ACTIVITIES: Property and equipment acquired under capital leases.....	$ 176	$ 137	$ --	$ --	$ --
Maintenance agreement acquired under capital lease.....	$ 6	$ --	$ --	$ --	$ --
Issuance of convertible preferred stock for shareholder note receivable.....	$ 81	$ --	$ --	$ --	$ --
Sale of asset for decrease in accounts payable.....	$ 210	$ --	$ --	$ --	$ --
Issuance of common stock for consulting services.....	$ --	$ 17	$ --	$ --	$ --
Issuance of common stock for shareholder note receivable.....	$ --	$ --	$ 13	$ --	$ --

See accompanying notes.

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Notes to Consolidated Financial Statements

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED)

1. Organization and Summary of Significant Accounting Policies

Description of Business Terayon Communication Systems (the Company) was incorporated under the laws of the state of California on January 20, 1993 for the purpose of developing, producing, and marketing broadband access system products. In October 1997, the Company changed its legal name from Terayon Corporation. Through December 31, 1996, the Company was active in product development, the acquisition of equipment and facilities, and raising capital; accordingly, the Company was in the development stage. The Company emerged from the development stage during 1997.

Unaudited Interim Financial Information The accompanying consolidated financial statements at March 31, 1998 and for the three months ended March 31, 1998 and 1997 are unaudited but include all adjustments (consisting of normal recurring accruals) which, in the opinion of management, are necessary for a fair statement of the financial position and the operating results and cash flows for the interim date and periods presented. Results for the interim period ended March 31, 1998 are not necessarily indicative of results for the entire fiscal year or future periods.

Basis of Consolidation The consolidated financial statements include the accounts of the Company and its majority owned subsidiaries, Terayon Communication Systems Europe and Terayon do Brasil. The minority interests in net losses of Terayon Communication Systems Europe and Terayon do Brasil were not significant for all periods presented. All material intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain prior year balances have been restated to conform with current year presentation.

Advertising Expenses

The Company accounts for advertising costs as expense in the period in which they are incurred. Advertising expense for the years ended December 31, 1995, 1996 and 1997 and for the three months ended March 31, 1997 and 1998 were not significant.

Cash Equivalents and Short-Term Investments The Company invests its excess cash in money market accounts and debt instruments and considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Investments with an original maturity at the time of purchase of over three months but less than a year are classified as short-term

investments. At December 31, 1996 and 1997, approximately 90% and 45%, respectively, of the Company's total cash and short-term investment balance was placed on deposit with an affiliate of a convertible preferred shareholder (none at March 31, 1998). Management

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) determines the appropriate classification of debt and equity securities at the time of purchase and reevaluates such designation at the end of each period.

At December 31, 1996 and 1997, all of the Company's investments in debt securities were classified as available-for-sale and were obligations issued by U.S. government agencies, maturing within one year. The amortized cost, which approximated fair value, of debt instruments classified as cash equivalents and short-term investments was approximately $6,436,000 and $4,508,000, respectively, at December 31, 1996 and approximately $99,000 and $418,000, respectively, at December 31, 1997 (none at March 31, 1998). The amount of unrealized gains or losses was not significant at December 31, 1996 or 1997. The estimated fair values of cash equivalents and short-term investments are based on quoted market prices. The amount of realized gains or losses for the years ended December 31, 1995, 1996, and 1997, and for the three months ended March 31, 1997 and 1998 were not significant.

Concentrations of Credit Risk, Customer, Supplier, and Product The Company operates in one business segment, the development and sale of cable modem access products, which it sells primarily to customers within the cable and communications industries, including related parties (see Note 12). The Company performs ongoing credit evaluations of its customers and generally requires no collateral. A relatively small number of customers and resellers account for a significant percentage of the Company's revenues. The Company expects that the sale of its products to a limited number of customers and resellers may continue to account for a high percentage of revenues for the foreseeable future.

Currently, the Company relies on single source suppliers of materials and labor for the significant majority of its product inventory but is actively pursuing additional supplier alternatives. As a result, should the Company's current suppliers not produce and deliver inventory for the Company to sell on a timely basis, operating results may be adversely impacted.

Substantially all of the Company's revenues have been attributable to sales of the TeraLink and the TeraPro. These products are expected to account for a significant part of the Company's revenues for the foreseeable future. As a result, a decline in demand for or failure to achieve broad market acceptance of the TeraLink or the TeraPro would adversely affect operating results.

In addition, market acceptance of the Company's products may be affected by the emergence and evolution of industry standards. While the Company expects its products to become compliant with industry standards, its inability to do so may adversely affect operating results.

The Company invests its excess cash in debt instruments of the U.S. Treasury, governmental agencies, and corporations with strong credit ratings. The Company has established guidelines relative to diversification and maturities that attempt to maintain safety and liquidity. The Company has not experienced any significant losses on its cash equivalents or short-term investments.

Other Receivable

As of March 31, 1998, the Company recorded a receivable of $1,264,000 relating to inventory components the Company was required to purchase from its previous contract manufacturer and then subsequently sold to its current contract manufacturer. Some of the components purchased from the previous subcontract manufacturer were obsolete or sold to the new subcontract manufacturer at a loss. The Company took a charge of $1,300,000 for the obsolete and sold inventory in the three months ended March 31, 1998.

Terayon Communication Systems

Notes to Consolidated Financial Statements--(continued)

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) Inventory Inventory is stated at the lower of cost (first-in, first-out) or market. The components of inventory are as follows (in thousands):

December 31, March 31, 1997 1998

Inventory:		
Finished goods	$ 163	$143
Work-in-process	366	91
Raw materials	793	146
	$1,322	$380

Property and Equipment Property and equipment are carried at cost less accumulated depreciation and amortization. Property and equipment are depreciated for financial reporting purposes using the straight-line method over the estimated useful lives of three to five years. Leasehold improvements are amortized using the straight- line method over the shorter of the useful lives of the assets or the terms of the leases.

Property and equipment are as follows (in thousands):

	DECEMBER 31, 1996	1997	MARCH 31, 1998
Software and computers	$ 2,516	$ 3,695	$ 3,812
Furniture and equipment	1,064	2,421	2,564

```
Leasehold improvements.......................      19       89        89
                                               $ 3,599  $ 6,205   $ 6,465
Accumulated depreciation and amortization.....  (1,027)  (2,590)   (3,092)
Property and equipment, net..................  $ 2,572  $ 3,615   $ 3,373
```

Revenue Recognition

Revenues related to product sales are generally recognized when the products are shipped to the customer. The Company has also performed some research and product development work under best efforts technology development agreements. Due to technological risk factors, the costs of these agreements have been expensed as incurred and are included in cost of goods sold for the year ended December 31, 1995. Revenues are recognized when applicable customer milestones have been met, including deliverables and, in any case, not in excess of the amount that would be recognized using the percentage-of-completion method. The Company met deliverables under an agreement in the fourth quarter of the year ended December 31, 1997 and recognized the related revenue (see Note 3).

Manufacturing Start-Up Expenses For the three months ended March 31, 1997, the Company incurred $178,000 of manufacturing start-up expenses related to the company's manufacturing operations group as it prepared for

Terayon Communication Systems

Notes to Consolidated Financial Statements--(continued)

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) commercialization of the Company's products. The Company's manufacturing operations group consists of assembly, test and quality assurance for the products, and associated costs of personnel and equipment.

Warranty Reserves

Due to the recent introduction of the Company's products, the Company has limited experience with warranty commitments that may arise with the current generation of its products. The Company's products generally carry a one-year warranty that includes factory and on-site repair services as needed for replacement of parts. Estimated expenses for warranty obligations are accrued as revenue is recognized. Reserve estimates are adjusted periodically to reflect actual experience.

Stock-Based Compensation As described in Note 8, the Company has elected to account for its employee stock plans in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB Opinion No.25), and to adopt the disclosure-only provisions as required under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123).

Net Loss Per Share and Unaudited Pro Forma Shareholders' Equity (Net Capital Deficiency) Historical basic and diluted net loss per share are computed using the weighted average number of common shares outstanding. Options, warrants, restricted stock and preferred stock were not included in the computation of diluted net loss per share because the effect would be antidilutive.

Pro forma net loss per share has been computed as described above and also gives effect, even if antidilutive, to common equivalent shares from preferred stock that will automatically convert upon the closing of the Company's initial public offering (using the as-if-converted method). If the offering contemplated by this Prospectus is consummated, all of the convertible preferred stock and redeemable convertible preferred stock outstanding as of the closing date will automatically be converted into an aggregate of approximately 7,231,161 shares of common stock based on the shares of convertible preferred stock outstanding at March 31, 1998. Unaudited pro forma shareholders' equity (net capital deficiency) at March 31, 1998, as adjusted for the conversion of preferred stock and redeemable preferred stock, is disclosed on the balance sheet.

Terayon Communication Systems

Notes to Consolidated Financial Statements--(continued)

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) A reconciliation of shares used in the calculation of historical and pro forma basic and diluted net loss per share follows (in thousands, except per share data):

	YEAR ENDED DECEMBER 31,			THREE MONTHS ENDED MARCH 31,	
	1995	1996	1997	1997	1998
Net loss	$(3,666)	$(10,697)	$(22,549)	$(3,657)	$(5,704)
Shares used in computing basic and diluted net loss per share	3,589	4,054	4,289	4,158	4,594
Historical basic and diluted net loss per share	$ (1.02)	$ (2.64)	$ (5.26)	$ (0.88)	$ (1.24)
Shares used in computing basic and diluted net loss per share			4,289		4,594
Adjustment to reflect the effect of the assumed conversion of weighted average shares of convertible preferred stock outstanding			6,584		7,179
Shares used in computing pro forma basic and diluted net loss per share			10,873		11,773
Pro forma basic and diluted net loss per share			$ (2.07)		$ (0.48)

Impact of Recently Issued Accounting Standards In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (FAS 130). FAS 130 requires that all items that are to be required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. FAS 130 is effective for fiscal years beginning after December 15, 1997 and will be adopted by the Company for the year ended December 31, 1998. The Company's total comprehensive loss was the same as its net loss for the three months ended March 31, 1997 and 1998.

In addition, during June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" (FAS 131). FAS 131 replaces FAS 14, "Financial Reporting for Segments of a Business Enterprise" and changes the way public companies report segment information. FAS 131 is effective for fiscal years beginning after December 15, 1997 and will be adopted by the Company for the year ended December 31, 1998.

2. Officer Note Receivable

In March 1996, the Company loaned an officer $100,000 pursuant to a promissory note. The note does not bear interest, matures in March 2001, and is full recourse, including being collateralized by 20,000 shares of the Company's common stock.

3. Deferred Revenue

On January 4, 1995, the Company entered into a Development and Production Agreement with a telecommunications systems manufacturer (the Manufacturer), whereby the Company agreed to develop an enabling technology for use with certain manufacturer technology (the Product). Pursuant to the agreement, the Manufacturer is obligated to purchase certain minimum quantities of the Product, and the Company has agreed to provide the Product to the Manufacturer on favorable pricing terms for a period of four years following completion of the Product. In addition, the Company has agreed that for the first three months following the completion of the Product, the Company will not sell the Product to any third party for use in the carrying of voice-over coaxial cables.

In accordance with the agreement, the Company will receive funding from the Manufacturer totaling $1,000,000. These payments were originally received upon the completion of certain milestones set forth in the agreement. In March 1998, the agreement was amended, and the Company is to receive the remaining payments (in addition to normal Product billings) over a certain number of future unit shipments to the Manufacturer. As of December 31, 1997, approximately $480,000 of cash advances had been received under the agreement. In the fourth quarter of the year ended December 31, 1997, the Company delivered the Product under the agreement and recognized the $480,000 as revenue. An additional $95,000 related to the agreement has been recorded as a receivable and deferred revenue at December 31, 1997 and March 31, 1998.

4. Commitments

The Company leases its facility and certain equipment under operating leases. The operating lease for the Company's facility expires in 2002. Rental expense was approximately $114,000, $542,000, and $850,000 for the years ended December 31, 1995, 1996, and 1997, respectively, and approximately $179,000 and $227,000 for the three months ended March 31, 1997 and March 31, 1998, respectively. The Company signed a promissory note of approximately $59,000 in connection with the initial security deposit for the facility. The note did not bear interest and matured in April 1997.

In March 1996, the Company subleased its former facilities to a third party through December 1997. Sublease rental income was approximately $106,000 and $122,000 for the years ended December 31, 1996 and 1997, respectively and approximately $32,000 for the three months ended March 31, 1997. In October 1997, the master lease and underlying sublease for these facilities were terminated concurrently.

The Company leases certain equipment under noncancelable lease agreements that are accounted for as capital leases. Equipment under capital lease arrangements and included in property and equipment aggregated approximately $452,000 at December 31, 1996 and 1997 and March 31, 1998. Related accumulated amortization was approximately $211,000, $337,000 and $365,000 at December 31, 1996 and 1997, and March 31, 1998, respectively. Amortization expense related to assets under capital leases is included in depreciation expense. In addition, the capital leases are secured by the related equipment, and the Company is required to maintain liability and property damage insurance.

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) Future minimum lease payments under noncancelable operating leases and capital leases are as follows (in thousands):

DECEMBER 31, 1997 MARCH 31, 1998 OPERATING CAPITAL OPERATING CAPITAL LEASES LEASES LEASES LEASES

1998	$ 610	$ 80	$ 461	$ 55
1999	666	34	666	34
2000	688	11	688	11
2001	708	4	708	4
2002	178	--	178	--
Total minimum payments	$2,850	129	$2,701	104
Less amount representing interest		20		18
		109		86
Less current portion		65		52
		$ 44		$ 34

Unconditional Purchase Obligations The Company has unconditional purchase obligations to a few of its suppliers that support the Company's ability to manufacture its products. The obligations require the Company to purchase minimum quantities of the suppliers' products at a specified price. At March 31, 1998, the Company had approximately $12,702,000 of unconditional purchase obligations ($784,000 at December 31, 1997 and none at December 31, 1996).

5. Debt Obligations

In April 1997, the Company amended an existing credit agreement with a bank to provide for a revolving line of credit up to $10,000,000 and four term loans totaling $4,250,000. Borrowings under the revolving line of credit are limited to the lesser of a) 80% of accounts receivable less than ninety days from the invoice date or b) $10,000,000. Borrowings under the revolving line of credit bear interest at the bank's prime rate plus 0.50% per annum (8.75% at December 31, 1996 and 9.0% at December 31, 1997 and March 31, 1998). There were no borrowings under the revolving line of credit at December 31, 1996 and 1997 and March 31, 1998.

Each term loan is subject to an interest rate calculated at the bank's prime rate plus 1.50% per annum (9.75% at December 31, 1996 and 10% at December 31, 1997 and March 31, 1998). The first term loan is payable in thirty monthly payments consisting of six interest payments and twenty-four equal principal and interest payments through May 1998. Borrowings under the first term loan of approximately $303,000, $85,000 and $34,000 were outstanding at December 31, 1996 and 1997 and March 31, 1998, respectively.

The second term loan is payable in forty monthly payments of four interest payments and thirty-six equal principal and interest payments through October 1999. Borrowings under the second term loan of approximately $944,000, $611,000, and $528,000 were outstanding at December 31, 1996 and 1997 and March 31, 1998, respectively.

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) The third term loan is payable according to two separate payment schedules. The first payment schedule includes thirty-six equal principal and interest payments through November 1999. At December 31, 1996 and 1997 and March 31, 1998, borrowings under the first payment schedule were approximately $820,000, $539,000 and $469,000, respectively. The second payment schedule consists of thirty-one payments of one interest payment and thirty equal principal and interest payments through December 1999. At December 31, 1997 and March 31, 1998, borrowings under the second payment schedule were approximately $119,000 and $103,000, respectively (none at December 31, 1996).

The fourth term loan is payable in forty-one monthly payments of five interest payments and thirty-six equal principal and interest payments through November 2000. Borrowings under the fourth term loan of approximately $1,458,000 and $1,332,000 were outstanding at December 31, 1997 and March 31, 1998, respectively (none at December 31, 1996).

Outstanding borrowings under the credit agreement are secured by all of the Company's assets. The credit agreement contains affirmative and negative covenants and will, among other things, require the Company to maintain minimum levels of investable funds and liquid assets. The credit agreement also limits the Company's ability to incur additional debt, to pay cash dividends, or to purchase or sell certain assets. Finally, the agreement restricts the Company to a maximum liability to tangible net worth ratio and prohibits certain acquisitions, mergers, consolidations, or similar transactions. At December 31, 1997 and March 31, 1998, the Company was out of compliance with certain covenants contained within the credit agreement and therefore has classified all outstanding borrowings as short-term at those dates.

The Company incurred interest expense related to the term loans of approximately $18,000, $88,000, and $205,000 for the years ended December 31, 1995, 1996, and 1997, respectively and $43,000 and $68,000 for the three months ended March 31, 1997 and 1998, respectively.

6. Contingencies

During 1997, the Company placed a noncancelable purchase order (subject to specific delivery date requirements) with a subcontract manufacturer. As delivery of the initial shipments was delayed by the manufacturer, the Company subsequently canceled the purchase order without the consent of the subcontract manufacturer. The Company has received notification from the subcontract manufacturer that the Company is obligated to make payment for materials and services rendered under the terms of the purchase order. While management believes that amounts recorded on its financial statements are adequate to cover all related risks, the subcontract manufacturer has not agreed to a settlement with the Company. Although the ultimate outcome of this matter cannot be determined at this time, management does not believe that the outcome will have a material adverse effect on the Company's financial position, results of operations, and cash flows. However, based on future developments, the Company's estimate of the outcome of these matters could change in the near term.

The Company has also received a letter from an individual claiming that the Company's technology infringes a patent held by such individual. The Company has reviewed the allegations made by such individual, and management does not believe that the outcome will have a material adverse effect on the Company's financial position, results of operations, or cash flows.

In the normal course of business, the Company from time to time receives inquiries with regard to various legal proceedings. In the opinion of management, any liability resulting from these inquiries has

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) been accrued and will not have a material adverse effect on the Company's financial position or results of operations.

7. Redeemable Convertible Preferred Stock

In December 1997, the Company entered into a Series E redeemable convertible preferred stock agreement ("the Agreement"). The Agreement calls for the establishment of a $5,000,000 escrow account to fund the issuance of up to 333,334 shares of Series E redeemable convertible preferred stock ("the Stock") for cash at $15.00 per share. The escrow account will release cash to the Company as the Company reaches certain technological and customer base milestones as defined under the Agreement. Upon the first closing, the Company is also to issue a warrant to purchase up to an additional 33,334 shares of the Stock at $15.00 per share. In the event the final closing of the Agreement does not occur prior to the earlier of the (a) completion of the Company's initial public offering of shares of its Common Stock and (b) December 31, 1998, then any amount remaining in the escrow account will be returned to the Series E shareholder.

The Series E shareholder also has the option to sell to the Company some or all of the Stock held by the Series E shareholder ("the Put Right") any time after July 1, 1998. The price paid by the Company to the Series E shareholder for any shares of the Stock purchased pursuant to the Put Right is $15.00 per share. In the event of the Series E shareholder's exercise of the Put Right, the Company will apply the total amount of the Put Right toward the purchase of the Company's products. Any of the Stock not sold back to the Company by the Series E shareholder will retain its Put Right until the Put Termination Date which is defined under the Agreement as the earlier of (a) February 10, 1999 and (b) the completion of the Company's initial public offering of shares of its Common Stock.

Finally, in the event that prior to the Put Termination Date either (a) the completion of the Company's initial public offering of shares of its Common Stock has not occurred or (b) an acquisition of at least ninety percent of all of the Company's capital stock has not occurred, then the Series E shareholder has the right to receive a cash payment from the Company in an amount equal to ten percent of the aggregate purchase price of the number of shares of the Stock purchased by the Series E shareholder pursuant to the Agreement as of the Put Termination Date.

In February 1998, the Company reached a milestone under the Series E redeemable convertible preferred stock agreement and issued 100,000 shares of Series E redeemable convertible preferred stock, resulting in cash proceeds of approximately $1,500,000 to the Company. In conjunction with this issuance, the Company issued a warrant to the Series E shareholder to purchase 33,334 shares of the Company's redeemable convertible preferred stock at $15.00 per share.

In June 1998, the Company and the Series E shareholder amended the Agreement and all of the Stock outstanding was canceled. The proceeds from the Stock were applied toward the purchase of Series D redeemable convertible preferred stock (see Note 13).

8. Shareholders' Equity (Net Capital Deficiency)

Convertible Preferred Stock The following is a summary of convertible preferred stock authorized, issued, and outstanding, including redeemable convertible preferred stock:

Terayon Communication Systems

Notes to Consolidated Financial Statements--(continued)

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED)

SERIES	SHARES AUTHORIZED	SHARES ISSUED AND OUTSTANDING DECEMBER 31, 1997	MARCH 31, 1998
A	4,162,093	4,162,093	4,162,093
B	896,834	896,834	896,834
B-1	448,417	448,417	448,417
C	814,830	814,830	814,830
D	1,500,000	808,987	808,987
E	2,000,000	--	100,000
Undesignated	177,826	--	--
	10,000,000	7,131,161	7,231,161

Convertible preferred shareholders and redeemable convertible preferred shareholders have the same voting rights as common shareholders. In addition, the Series A, B, B-1, C, D and E shareholders will vote as a single class. In the event of any voluntary or involuntary liquidation of the Company, Series A, B, B-1, C, D and E shareholders are entitled to a per share liquidation preference of $0.9545, $8.92, up to $17.84, $12.50, up to $19.50, and up to $22.50, respectively, plus accrued dividends, if any. The holders of Series A, B, B-1, C, D and E stock are entitled to per share noncumulative dividends of $0.0764, $0.7136, $0.7136, $1.00, $1.04 and $1.20 per annum, respectively, when and if declared by the Board of Directors.

Each share of preferred stock and redeemable preferred stock is convertible at the option of the holder into one share of common stock, subject to adjustments for future dilution. Each share of Series A, B, and B-1 preferred stock automatically converts into common stock at the then applicable conversion rate upon the earlier of (a) the public offering of the Company's common stock with aggregate proceeds in excess of $10,000,000 or (b) the date on which the Company obtains the consent of at least two-thirds of the shares of Series A, B, and B-1 shareholders separately by class. Each share of Series C preferred stock automatically converts at the earlier of (a) the public offering of the Company's

common stock at a per share price of $12.50 (b) the end of any twenty-day period after a public offering of the Company's common stock during which the closing sales price per share was at least $12.50, or (c) the date on which the Company obtains the consent of at least two-thirds of the shares of Series C shareholders, as applicable. Each share of Series D preferred stock and Series E redeemable preferred stock automatically converts at the earlier of (a) the public offering of the Company's common stock at a per share price of $13.00 per share or (b) the date on which the Company obtains the consent of at least two-thirds of the shares of Series D and Series E shareholders, as applicable. The Company has fully reserved shares of common stock for issuance upon the conversion of the convertible preferred stock and redeemable convertible preferred stock.

Prior to undertaking an initial public offering of its securities or initiating a sale of 50% or more of the Company's outstanding capital stock or substantially all of the Company's assets to a third party, the Company must provide written notice to one of the convertible preferred shareholders. The investor then has the right to make the first offer to purchase the Company for a period of up to thirty days from receipt of the Company's notice.

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Notes to Consolidated Financial Statements--(continued)

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) Common Stock Reserved Common stock reserved for issuance is as follows:

December 31, March 31, 1997 1998

Convertible preferred stock	7,131,161	7,131,161
Redeemable convertible preferred stock	--	100,000
Common stock options	2,646,880	2,535,137
Convertible preferred stock option	153,846	153,846
Redeemable convertible preferred stock in escrow	333,334	233,334
Series E preferred stock warrant	--	33,334
	10,265,221	10,186,812

Stock-Based Compensation In March 1995 and February 1997, the Board of Directors approved a stock option plan and an equity incentive plan, respectively, that authorized the grant of options to purchase shares of the Company's common stock. At December 31, 1997, the total authorized number of shares under the 1995 and 1997 plans was 2,114,747 and 1,050,000, respectively. The plans are administered by the Board of Directors and provide for incentive stock options or nonqualified stock options to be issued to employees, directors, and consultants of the Company. Prices for incentive stock options may not be less than the fair value of the common stock at the date of grant. Prices for nonqualified stock options may not be less than 85% of the fair value of the common stock at the date of grant. Options are immediately exercisable and vest over a period not to exceed five years from the

date of grant. Any unvested stock issued is subject to repurchase by the Company at the original issuance price upon termination of the option holder's employment. Unexercised options expire ten years after the date of grant.

In March and July 1997, the Board of Directors authorized grants of common stock options outside the Company's stock option plans. The options are for 70,000 shares of common stock and generally vest over a three-year period in six equal installments occurring every six months.

During the year ended December 31, 1997 and the three months ended March 31, 1998, the Company recorded aggregate deferred compensation of approximately $228,000 and $161,000, respectively, representing the difference between the grant price and the deemed fair value of the Company's common stock options granted during these periods. The amortization of deferred compensation is being charged to operations and is being amortized over the vesting period of the options, which is typically five years. For the year ended December 31, 1997 and the three months ended March 31, 1998, the amortized expense was approximately $12,000 and $15,000, respectively.

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) The following is a summary of additional information with respect to the 1995 stock option plan, the 1997 equity incentive plan, and option grants made outside the plans:

		OPTIONS OUTSTANDING AND EXERCISABLE	
	OPTIONS AVAILABLE FOR GRANT	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Options authorized on March 8, 1995	1,414,747	--	$ --
Options granted	(1,630,500)	1,630,500	$0.10
Options canceled	396,000	(396,000)	$0.03
Balance at December 31, 1995	180,247	1,234,500	$0.10
Options authorized	700,000	--	$ --
Options granted	(988,500)	988,500	$0.51
Options exercised	--	(106,219)	$0.10
Options canceled	229,831	(229,831)	$0.15
Balance at December 31, 1996	121,578	1,886,950	$0.31
Options authorized	1,120,000	--	$ --
Options granted	(1,304,050)	1,304,050	$1.71
Options exercised	--	(481,648)	$0.30
Options canceled	372,168	(372,168)	$0.56
Balance at December 31, 1997	309,696	2,337,184	$1.05
Options granted (unaudited)	(79,500)	79,500	$5.00
Options exercised (unaudited)	--	(111,743)	$0.26
Options canceled (unaudited)	308,151	(308,151)	$2.14
Balance at March 31, 1998 (unaudited)	538,347	1,996,790	$1.08

The following table summarizes information about stock options that were outstanding and exercisable at December 31, 1997:

	OPTIONS OUTSTANDING AND EXERCISABLE		
RANGE OF EXERCISE PRICES	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (IN YEARS)
$0.10 - $0.50	1,167,134	$0.34	8.13
$1.25 - $1.30	974,800	$1.26	9.00
$3.00 - $5.00	195,250	$4.26	9.90
Total	2,337,184	$1.05	8.64

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) In addition, the following table summarizes information about stock options that were outstanding and exercisable at March 31, 1998:

	OPTIONS OUTSTANDING AND EXERCISABLE		
RANGE OF EXERCISE PRICES	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (IN YEARS)
$0.10 -- $0.50	977,540	$0.37	7.94
$1.25 -- $1.30	841,500	$1.25	8.67
$3.00 -- $5.00	177,750	$4.18	9.73
Total	1,996,790	$1.08	8.41

At December 31, 1997 and March 31, 1998, 103,050 and 99,774 shares, respectively, of common stock outstanding were subject to repurchase by the Company.

The Company has elected to follow APB Opinion No. 25 and related interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FAS 123 requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB Opinion No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Pro forma information regarding net loss is required under FAS 123 and is calculated as if the Company had accounted for its employee stock options granted during the years ended December 31, 1995, 1996 and 1997 under the fair value method of FAS 123. The fair value for these options was estimated at the date of grant using the minimum value method with the following weighted average assumptions: risk-free interest rates of 5.34%, 6.22%, and 5.75% for 1995, 1996, and 1997, respectively; no dividend yield or volatility factors of the expected market price of the Company's common stock; and a weighted average expected life of the option of five years.

As discussed above, the option valuation models used under FAS 123 were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected life of the option. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of FAS 123, the Company's net loss and loss per share would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

1995 1996 1997

Pro forma net loss..... $3,669 $10,718 $22,627 Pro forma basic and diluted net loss per share..... $(1.02) $ (2.64) $ (5.28) The pro forma impact of options on the net loss for the years ended December 31, 1995, 1996, and 1997 is not representative of the effects on net income (loss) for future years, as future years will include the effects of options vesting as well as the impact of multiple years of stock option grants. The full effect of FAS 123 will not be fully reflected until 1999.

The options' weighted average grant date fair value, which is the value assigned to the options under FAS 123, was $0.02, $0.11, and $0.41 for options granted during 1995, 1996, and 1997, respectively.

Shareholders' Notes Receivable In February 1993, the Company issued common stock to a founder in return for a full recourse note receivable for $12,500. The note bears an interest rate of 7.04% per annum and is due in February 1998.

During June and December 1995, certain officers of the Company were provided cash advances totaling $81,133 for the purpose of purchasing the Company's Series A preferred stock. One of the underlying full recourse notes matured and was paid in August 1996. The outstanding note is due in June 2000, bears interest at 10% per annum, and is secured by the purchased Series A preferred stock.

In September 1997, the Company issued common stock to an employee in return for a full recourse note receivable for $13,000. The note bears an interest rate of 5.81% per annum and is due in September 1998. Pursuant to the stock purchase agreement, the employee has the option to sell some or all of his shares to the Company on or after September 22, 1998 at a purchase price of $13.00 per

share (the "Put Price"). Such option expires upon the earlier of September 22, 2003 and b) the completion of the Corporation's initial public offering of shares of its Common Stock. The Company has accrued the difference between the note receivable's per share price and the Put Price over the option's vesting period and included the cumulative difference in other accrued liabilities as of March 31, 1998. The note receivable was paid in full in January 1998.

9. Income Taxes

Due to operating losses and the inability to recognize the benefits therefrom, there is no provision for income taxes for the fiscal years ended December 31, 1995, 1996, and 1997.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax

purposes. Significant components of the Company's deferred tax assets as of December 31, 1996 and 1997 are as follows (in thousands):

YEARS ENDED DECEMBER 31, 1996 1997

Deferred Tax Assets:		
Net operating loss carryforwards	$ 4,412	$ 11,323
Tax credit carryforwards	293	2,531
Capitalized research and development	912	1,373
Other, net	439	1,158
Total deferred tax assets	6,056	16,385
Valuation allowance	(6,056)	(16,385)
Net deferred tax assets	$ --	$ --

Realization of deferred tax assets is dependent on future earnings, if any, the timing and the amount of which are uncertain. Accordingly, a valuation allowance, in an amount equal to the net deferred tax asset as of December 31, 1996 and 1997, has been established to reflect these uncertainties. The change in the valuation allowance was a net increase of approximately $1,533,000, $4,444,000, and $10,329,000 for the years ended December 31, 1995, 1996, and 1997, respectively.

As of December 31, 1997, the Company had federal and California net operating loss carryforwards of approximately $31,000,000 and $15,000,000, respectively. The Company also had federal and California research and development tax credit carryforwards of approximately $1,700,000 and $1,200,000, respectively. The net operating loss and credit carryforwards will expire at various dates beginning in the years 1999 through 2012, if not utilized.

Utilization of net operating loss and tax credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating loss and tax credit carryforwards before full utilization.

The reconciliation of income tax expense (benefit) attributable to continuing operations computed at the U.S. federal statutory rates to income tax expense (benefit) for the fiscal years ended December 31, 1995, 1996, and 1997 is as follows (in thousands):

Years Ended December 31, 1995 1996 1997

Tax provision (benefit) at U.S. statutory rate	$ (1,258)	$ (3,638)	$ (7,667)
Loss for which no tax benefit is currently recognizable	1,258	3,638	7,667
	$ --	$ --	$ --

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED)

10. Significant Customer and Geographic Information

The Company's European subsidiary accounted for approximately $407,000 of the Company's revenues for the three months ended March 31, 1998 (none for the year ended December 31, 1997). The net loss of the Company's European subsidiary was approximately $107,000 after eliminations of approximately $407,000 for the three months ended March 31, 1998. Identifiable assets of the Company's European subsidiary were approximately $50,000 at March 31, 1998 after eliminations of approximately $407,000.

Three of the Company's customers, Telegate Ltd., Sumitomo Corporation, and Net Brasil S.A. accounted for 30%, 29%, and 14% of revenues, respectively, for the year ended December 31, 1997. In addition, Shaw Communications, Inc., Sumitomo Corporation, and Telegate Ltd. accounted for 37%, 13%, and 12% of revenues for the three months ended March 31, 1998. No other customer accounted for more than 10% of revenues during these periods.

Total net export revenues to regions outside of the United States were approximately $1,855,000 and $2,195,000 for the year ended December 31, 1997 and the three months ended March 31, 1998, respectively. Revenues by geographic region were as follows (in thousands):

	YEAR ENDED DECEMBER 31, 1997	THREE MONTHS ENDED MARCH 31, 1998
Revenues:		
United States	$ 263	$ 249
Canada	198	940
Asia	617	363
South America	326	205
Europe and Israel	714	687
Total	$2,118	$2,444

11. 401(K) Profit Sharing Plan and Trust

During 1995, the Company adopted a 401(k) Profit Sharing Plan and Trust that allows eligible employees to make contributions subject to certain limitations. The Company may make discretionary contributions based on profitability as determined by the Board of Directors. No amount was contributed by the Company to the plan during the years ended December 31, 1995, 1996, and 1997 or for the three months ended March 31, 1997 and 1998.

12. Related Party Transactions

During the year ended December 31, 1997, the Company recognized revenue of approximately $617,000 in connection with product shipments made to a Series D preferred shareholder. In addition, during the three months ended March 31, 1998, the Company recognized revenue of approximately $329,000 and $38,000 in connection with product shipments made to a Series D preferred shareholder and Series E redeemable convertible preferred shareholder, respectively. Accounts receivable from the related parties totaled approximately $362,000 and $552,000 at December 31, 1997 and March 31, 1998, respectively.

Terayon Communication Systems

Notes to Consolidated Financial Statements--(continued)

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) In September 1997, the Company received $2,000,000 from a Series D preferred shareholder in connection with a stock option agreement. As of December 31, 1997 and March 31, 1998, the Company has recorded the amount received as an advance from the related party. The stock option agreement allows for the purchase of 153,846 shares of Series D preferred stock for the $2,000,000, on or before April 30, 1998 (see Note 13). If the option to purchase the Series D preferred stock is not exercised, the $2,000,000 will be retained by the Company and be applied toward the purchase of the Company's product by the Series D preferred shareholder. Also, if the option to purchase Series D preferred stock is not exercised, the $2,000,000, or

any portion that has not been applied toward the purchase of product, shall earn interest at 6.0% per annum from the original date of deposit. No other amounts were payable to related parties at December 31, 1997 or March 31, 1998.

13. Subsequent Events

In April 1998, the Company issued 384,615 shares of Series F convertible preferred stock, resulting in cash proceeds of approximately $5,000,000 to the Company. Series F convertible preferred shareholders generally have the same voting rights and preferences as the Series D redeemable convertible preferred shares described below with the exception that these Series F convertible preferred shareholders do not have the right to sell stock back to the Company. In conjunction with the Series F convertible preferred stock sale, the Company issued a warrant to purchase 3,000,000 shares of the Company's common stock at an exercise price of $6.50 per share. The warrant is exercisable at any time on or after April 6, 2003 and prior to December 31, 2003. The exercisability of the warrant can be accelerated based upon purchases of the Company's cable modem product by the Series F convertible preferred stockholder during the years ended December 31, 1998, 1999, and 2000 as defined within the warrant agreement.

In April 1998, the Company's Board of Directors approved an increase in the authorized number of shares of convertible preferred stock to 15,000,000 shares.

In April 1998, a related party of the Company converted a $2,000,000 advance into 153,846 shares of Series D convertible preferred stock.

In June 1998, the Company's Board of Directors (i) authorized the reincorporation of the Company from California to Delaware, (ii) approved an increase in the total authorized number of shares of stock to 35,000,000 shares ,consisting of 30,000,000 shares of common stock, with a par value of $.001 per share and 5,000,000 shares of preferred stock, with a par value of $.001 per share as to which the Board of Directors has the authority to fix or alter the designation, powers, preferences and rights of the shares of each such series and qualifications, limitations or restrictions to any unissued series of preferred stock, (iii) authorized the adoption of the amended 1997 Equity Incentive Plan pursuant to which 2,250,000 additional shares (plus an additional 5% of the outstanding common stock at each year end) of the Company's common stock have been reserved for future issuance to selected employees, directors and consultants, (iv) authorized the adoption of the 1998 Non-Employee Directors' Stock Option Plan pursuant to which 200,000 additional shares of the Company's common stock have been reserved for future issuance to non-employee directors of the Company, and (v) authorized the adoption of the 1998 Employee Stock Purchase Plan pursuant to which 700,000 additional shares of the Company's common stock have been reserved for future issuance to eligible employees. These actions will be given effect prior to the effective date of the Company's initial public offering.

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) In June 1998, the Company and a Series E shareholder amended the Series E redeemable convertible preferred stock agreement (the "Amendment"). The Amendment calls for the cancellation of all outstanding Series E redeemable convertible preferred stock outstanding with the $1,500,000 of proceeds from the cancellation being applied toward the issuance of 115,385 shares of Series D redeemable convertible preferred stock. In addition, all future milestones under the Series E redeemable convertible preferred stock agreement were canceled under the Amendment and 269,231 additional shares of Series D redeemable convertible preferred stock were issued resulting in additional proceeds of approximately $3,500,000. The Amendment also cancels a warrant for the purchase of 33,334 Series E redeemable convertible preferred stock at $15.00 per share and issues a warrant for the purchase of 38,462 shares of Series D redeemable convertible preferred stock with an exercise price of $13.00 per share. The warrant is immediately exercisable and expires on the earlier of the effective date of the Company's initial public offering or June 11, 2003.

The Series D redeemable convertible preferred shareholder also has the option to sell to the Company some or all of the 384,616 redeemable shares held by the Series D redeemable convertible preferred shareholder (the "Put Right") any time after July 1, 1998. The price paid by the Company to the Series D redeemable convertible preferred shareholder for any shares purchased pursuant to the Put Right is $13.00 per share. In the event of the exercise of the Put Right, the Company will apply the total amount of the Put Right toward the purchase of the Company's products. Any of the redeemable shares not sold back to the Company by the Series D redeemable convertible preferred shareholder will retain their Put Right until the Put Termination Date which is defined under the Agreement as the earlier of (a) February 20, 1999 and (b) the completion of the Company's initial public offering of shares of its Common Stock. In addition, in the event that prior to the Put Termination Date either (a) the completion of the Company's initial public offering of shares of its Common Stock has not occurred or (b) an acquisition of at least ninety percent of all of the Company's capital stock has not occurred, then the Series D redeemable convertible preferred shareholder has the right to receive a cash payment from the Company in an amount equal to ten percent of the aggregate purchase price of the number of redeemable shares purchased by the Series D redeemable convertible preferred shareholder as of the Put Termination Date.

Series D redeemable convertible preferred shareholders generally have the same voting rights as common shareholders. In the event of any voluntary or involuntary liquidation of the Company, Series D redeemable convertible preferred shareholders are entitled to a liquidation preference of up to $19.50 per share. Each share of Series D redeemable convertible preferred stock automatically

converts at the earlier of (a) the public offering of the Company's Common Stock at a per share price of $13.00 or (b) the date on which the Company obtains the consent of at least two-thirds of the shares of Series D shareholders.

In June 1998, the Company also issued 114,089 shares of Series D convertible preferred stock resulting in additional proceeds of approximately $1,483,000 to the Company. The issue generally has the same rights and privileges as the Series D redeemable convertible preferred stock described above, with the exception of the Put Right.

In June 1998, the Company issued 192,308 shares of Series F redeemable convertible preferred stock resulting in proceeds of approximately $2,500,000 to the Company. Series F redeemable convertible preferred stock also contains an option that allows the Series F shareholder to sell some or all of the redeemable shares back to the Company at a price of $13.00 per share any time after June 1, 1999 to

(INFORMATION PERTAINING TO MARCH 31, 1998 AND THE THREE MONTH PERIODS ENDED MARCH 31, 1997 AND 1998 IS UNAUDITED) be used toward the purchase of the Company's products. Any of the redeemable shares not sold back to the Company by the Series F shareholder will retain the option until the completion of the Company's initial public offering of shares of its common stock. The Series F redeemable convertible preferred stock generally has the same rights and privileges as the Series D redeemable convertible preferred stock described above with the exception of the option's termination date.

NO PERSON HAS BEEN AUTHORIZED IN CONNECTION WITH THE OFFERING MADE HEREBY TO GIVE ANY INFORMATION OR TO MAKE ANY REPRESENTATION NOT CONTAINED IN THIS PRO- SPECTUS AND, IF GIVEN OR MADE, SUCH INFORMATION OR REPRESENTATION MUST NOT BE RELIED UPON AS HAVING BEEN AUTHORIZED BY THE COMPANY OR ANY UNDERWRITER. THIS PROSPECTUS DOES NOT CONSTITUTE AN OFFER TO SELL OR A SOLICITATION OF ANY OFFER TO BUY ANY OF THE SECURITIES OFFERED HEREBY TO ANY PERSON OR BY ANYONE IN ANY JURISDICTION IN WHICH IT IS UNLAWFUL TO MAKE SUCH OFFER OR SOLICITATION. NEI- THER THE DELIVERY OF THIS PROSPECTUS NOR ANY SALE MADE HEREUNDER SHALL, UNDER ANY CIRCUMSTANCES, CREATE ANY IMPLICATION THAT THE INFORMATION CONTAINED HEREIN IS CORRECT AS OF ANY DATE SUBSEQUENT TO THE DATE HEREOF.

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UNTIL , 1998 (25 DAYS AFTER THE DATE OF THIS PROSPECTUS), ALL DEALERS EFFECTING TRANSACTIONS IN THE COMMON STOCK OFFERED HEREBY, WHETHER OR NOT PARTICIPATING IN THIS DISTRIBUTION, MAY BE REQUIRED TO DELIVER A PROSPECTUS. THIS IS IN ADDITION TO THE OBLIGATION OF DEALERS TO DELIVER A PROSPECTUS WHEN ACTING AS UNDERWRITERS AND WITH RESPECT TO THEIR UNSOLD ALLOTMENTS OR SUBSCRIPTIONS.

Shares

[Logo of Terayon Appears Here]

Common Stock

Prospectus

Bt Alex. Brown

Hambrecht & Quist

Salomon Smith Barney

, 1998

Part Ii

Information Not Required in Prospectus

Item 13. Other Expenses of Issuance and Distribution.

The following table sets forth all expenses, other than the underwriting discounts and commissions, payable by the Registrant in connection with the sale of the shares of Common Stock being registered. All the amounts shown are estimates except for the registration fee, the NASD filing fee and the Nasdaq National Market listing fee.

Registration fee	$ 14,750
NASD filing fee	5,500
Nasdaq National Market listing fee	95,000
Blue sky qualification fee and expenses	5,000
Printing and engraving expenses	150,000
Legal fees and expenses	450,000
Accounting fees and expenses	150,000
Transfer agent and registrar fees	10,000
Miscellaneous	219,750
Total	$1,100,000

Item 14. Indemnification of Officers and Directors.

As permitted by Section 145 of the Delaware General Corporation Law, the Bylaws of the Company provide that (i) the Company is required to indemnify its directors and executive officers to the fullest extent permitted by the Delaware General Corporation Law, (ii) the Company may, in its discretion, indemnify other officers, employees and agents as set forth in the Delaware General Corporation Law, (iii) to the fullest extent permitted by the Delaware General Corporation Law, the Company is required to advance all expenses incurred by its directors and executive officers in connection with a legal proceeding (subject to certain exceptions), (iv) the rights conferred in the Bylaws are not exclusive, (v)

the Company is authorized to enter into indemnification agreements with its directors, officers, employees and agents and (vi) the Company may not retroactively amend the Bylaws provisions relating to indemnity.

The Company has entered into agreements with its directors and executive officers that require the Company to indemnify such persons against expenses, judgments, fines, settlements and other amounts that such person becomes legally obligated to pay (including expenses of a derivative action) in connection with any proceeding, whether actual or threatened, to which any such person may be made a party by reason of the fact that such person is or was a director or officer of the Company or any of its affiliated enterprises, provided such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the Company. The indemnification agreements also set forth certain procedures that will apply in the event of a claim for indemnification thereunder.

The Underwriting Agreement filed as Exhibit 1.1 to this Registration Statement provides for indemnification by the Underwriters of the Registrant and its officers and directors for certain liabilities arising under the Securities Act of 1933, as amended (the "Securities Act"), or otherwise.

Item 15. Recent Sales of Unregistered Securities.

Since June 1, 1995, Registrant has sold and issued the following unregistered securities:

(1) Between June 1995 and December 1995, Registrant issued and sold 160,000 shares of Series A Preferred Stock to three private investors for an aggregate purchase price of $152,720.00.

(2) In December 1995, Registrant issued and sold 896,834 shares of Series B Preferred Stock to Cisco Systems, Inc. for an aggregate purchase price of $7,999,759.

(3) In February 1996, Registrant issued and sold 448,417 shares of Series B-1 Preferred Stock to Sierra Ventures for an aggregate purchase price of $3,999,880.

(4) In April 1996, Registrant issued 32,580 shares of Common Stock to a consultant in consideration of consulting services rendered.

(5) In December 1996, Registrant issued and sold 814,830 shares of Series C Preferred Stock to 13 private investors for an aggregate purchase price of $10,185,375.

(6) In September 1997, Registrant issued and sold 10,000 shares of Common Stock to an employee for an aggregate offering price of $13,000.

(7) Between September 1997 and June 1998, Registrant issued and sold 1,461,538 shares of Series D Preferred Stock to 27 private investors for an aggregate purchase price of $18,999,994, and issued warrants to purchase an aggregate of 38,462 shares of Series D Preferred Stock at an exercise price of $13.00 per share to Sumitomo Corporation.

(8) In December 1997, Registrant issued 15,716 shares of Series D Preferred Stock to an investment bank for services rendered as the exclusive placement agent of the sale of Series D Preferred Stock.

(9) In April and June 1998, Registrant issued to Shaw Communications Inc. ("Shaw") an aggregate of 576,923 shares of Series F Preferred Stock for an aggregate purchase price of $7,499,999. In connection with such sales to Shaw, in April 1998 the Company issued to Shaw a warrant to purchase 3,000,000 shares of Common Stock at an exercise price of $6.50 per share and a warrant to purchase an indeterminate amount of Common Stock for $1.00 upon the occurrence of certain events.

(10) From June 1, 1995 to June 1, 1998, Registrant granted stock options to a total of 148 employees, directors and consultants covering an aggregate of 3,791,160 shares of Common Stock, at exercise prices varying from $.10 to $6.50. Of such shares, 771,769 shares have been issued and sold pursuant to the exercise of such options. Options to purchase 947,320 shares of Common Stock have been cancelled or have lapsed without being exercised or otherwise have been cancelled.

Registrant claimed exemptions under the Securities Act from registration under the Securities Act for the sale and issuance of securities in the transaction described in paragraphs (1) through (9) by virtue of Section 4(2), Regulation D promulgated thereunder as transactions not involving a public offering. The purchasers in each case represented their intention to acquire the securities for investment only and not with a view to the distribution thereof. Appropriate legends are affixed to the stock certificates issued in such transactions. All recipients either received adequate information about the Registrant or had access, through employment or other relationships, to such information.

The sales and issuances in the transactions described in paragraph (10) above were deemed to be exempt from registration under the Securities Act by virtue of Rule 701 promulgated thereunder, in that they were issued pursuant to a written compensatory benefit plan, as provided by Rule 701.

Item 16. Exhibits and Financial Statement Schedules.

(A) Exhibits.

Exhibit Number Description of Document

1.1*	Form of Underwriting Agreement.
3.1	Amended and Restated Articles of Incorporation of the Registrant.
3.2	Amended and Restated Bylaws of the Registrant.
3.3	Form of Certificate of Incorporation.
3.4	Form of Bylaws.
3.5	Form of Amended and Restated Certificate of Incorporation to be filed upon consummation of the offering.
4.1	Reference is made to Exhibits 3.1 through 3.5.
4.2*	Specimen Stock Certificate.
4.3	Amended and Restated Information and Registration Rights Agreement dated April 6, 1998.
5.1*	Opinion of Cooley Godward llp.
10.1	Form of Indemnity Agreement between Registration and each of its directors and officers.
10.2	1995 Stock Option Plan, as amended on March 26, 1996.
10.3	1997 Equity Incentive Plan, as amended on June 9, 1998.
10.4	1998 Employee Stock Purchase Plan.

10.5	1998 Non-Employee Directors Stock Option Plan.
10.6**	Supply Agreement between the Registrant and ECI Telecom Ltd. dated March 3, 1998.
10.7**	Strategic Partnership and Distributorship Agreement between the Registrant and Sumitomo Corporation dated December 4, 1996.
10.8**	Master Agreement between the Registrant and NET Brasil S.A. dated June 30, 1997.
10.9	Resale and License Agreement between the Registrant and Digital Equipment Corporation dated December 9, 1996.
10.10	Lease Agreement dated January 23, 1996 between the Registrant and Arrillaga Family Trust and Richard T. Peery Separate Property Trust.
10.11	Employment Agreement between the Registrant and Zaki Rakib dated February 1993.
10.12	Employment Agreement between the Registrant and Selim Rakib dated February 1993.
10.13	Credit Agreement between the Registrant and Imperial Bank dated April 24, 1997.
10.14	Product Development Agreement between the Registrant and Cisco Systems, Inc. dated July 22, 1996.
10.15	Promissory Note and Stock Pledge Agreement between the Registrant and Shlomo Rakib dated March 6, 1996.
10.16	Stock Repurchase Agreement between the Registrant and Zaki Rakib dated March 16, 1995.
10.17	Stock Repurchase Agreement between the Registrant and Shlomo Rakib dated March 16, 1995.
10.18	Series A Preferred Stock Purchase Agreement between the Registrant and Lewis Solomon dated June 16, 1995.
10.19	Promissory Note between the Registrant and Lewis Solomon dated June 16, 1997.
10.20	Stock Pledge Agreement between the Registrant and Lewis Solomon dated June 16, 1997.
10.21	Anti-Dilution Warrant to Purchase Shares of Common Stock dated April 6, 1998 issued to Shaw Communications Inc.
21.1	List of Subsidiaries.
23.1*	Consent of Cooley Godward llp (included in Exhibit 5.1).
23.2	Consent of Ernst & Young LLP, Independent Auditors. Reference is made to page F-2.
24.1	Power of Attorney. Reference is made to page II-5.
27.1	Financial Data Schedule.

* To be filed by amendment. ** Confidential treatment has been requested for portions of this document.

(b) FINANCIAL STATEMENT SCHEDULES.

Schedule II--Valuation and Qualifying Accounts Schedules not listed above are omitted because they are not required, they are not applicable or the information is already included in the consolidated financial statements or notes thereto.

Item 17. Undertakings.

The undersigned Registrant hereby undertakes to provide the Underwriters at the closing specified in the Underwriting Agreement certificates in such denominations and registered in such names as required by the Underwriters to permit prompt delivery to each purchaser.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 (the "Act") may be permitted to directors, officers, and controlling persons of the Registrant pursuant to the provisions described in Item 14 or otherwise, the Registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a director, officer, or controlling person of the Registrant in the successful defense of any action, suit, or proceeding) is asserted by such director, officer, or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

The undersigned Registrant hereby undertakes that: (1) for purposes of determining any liability under the Act, the information omitted from the form of prospectus as filed as part of the registration statement in reliance upon Rule 430A and contained in the form of prospectus filed by the Registrant pursuant to Rule 424(b)(1) or (4) or 497(h) under the Act shall be deemed to be part of the registration statement as of the time it was declared effective, (2) for the purpose of determining any liability under the Act, each post- effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and this offering of such securities at that time shall be deemed to be the initial bona fide offering thereof, and (3) to remove from registration by means of a post- effective amendment any of the securities being registered which remain unsold at the termination of the offering.

Signatures

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, REGISTRANT HAS CAUSED THIS REGISTRATION STATEMENT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE COUNTY OF SANTA CLARA, STATE OF CALIFORNIA, ON THE 15TH DAY OF JUNE, 1998.

Terayon Communication Systems

/s/ Zaki Rakib By_____ DR. ZAKI RAKIB CHIEF EXECUTIVE OFFICER, CHIEF FINANCIAL OFFICER AND DIRECTOR

Power of Attorney

Each person whose signature appears below constitutes and appoints Dr. Zaki Rakib and Shlomo Rakib as his true and lawful attorney-in-fact and agent, each acting alone, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments (including post-effective amendments) to this Registration Statement on Form S-1, and to

sign any registration statement filed under Rule 462 under the Securities Act of 1933 including post-effective amendments) thereto, and to file the same, with all exhibits thereto, and all documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, THIS REGISTRATION STATEMENT HAS BEEN SIGNED BELOW BY THE FOLLOWING PERSONS IN THE CAPACITIES AND ON THE DATES INDICATED.

Signatures Title Date

/s/ Zaki Rakib Chief Executive June 15, 1998 - ---------- Officer, Chief DR. ZAKI RAKIB Financial Officer and Director (Principal Executive Officer and Principal Financial Officer)

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          /s/ Linda Palmor              Vice President,         June 15, 1998
- ------------------------------------    Finance(Principal
            LINDA PALMOR                 Accounting Officer)

          /s/ Shlomo Rakib              Chairman of the         June 15, 1998
- ------------------------------------    Board of Directors
            SHLOMO RAKIB
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/s/ Michael D'Avella Director June 15, 1998 MICHAEL D'AVELLA /s/ Christopher J. Schaepe Director June 15, 1998 CHRISTOPHER J. SCHAEPE /s/ Lewis Solomon Director June 15, 1998 LEWIS SOLOMON /s/ Mark Stevens Director June 15, 1998 MARK STEVENS

Schedule Ii

Valuation and Qualifying Accounts

	ADDITIONS		
BALANCE AT BEGINNING OF PERIOD	CHARGED TO COSTS AND EXPENSES	WRITE-OFFS	BALANCE AT END OF PERIOD
	(IN THOUSANDS)		

Allowance for doubtful accounts: Year ended December 31, 1995..... $-- $-- $-- $-- Year ended December 31, 1996..... $-- $-- $-- $-- Year ended December 31, 1997..... $-- $ 20 $-- $ 20 Three months ended March 31, 1998 (unaudited)..... $ 20 $ 50 $-- $ 70

Exhibit Index

Exhibit Number Description of Document Page

1.1* Form of Underwriting Agreement. 3.1 Amended and Restated Articles of Incorporation of the Registrant. 3.2 Amended and Restated Bylaws of the Registrant. 3.3 Form of Certificate of Incorporation. 3.4 Form of Bylaws. 3.5 Form of Amended and Restated Certificate of Incorporation to be filed upon consummation of the offering. 4.1 Reference is made to Exhibits 3.1 through 3.5. 4.2* Specimen Stock Certificate. 4.3 Amended and Restated Information and Registration Rights Agreement dated April 6, 1998. 5.1* Opinion of Cooley Godward llp. 10.1 Form of Indemnity Agreement between Registration and each of its directors and officers. 10.2 1995 Stock Option Plan, as amended on March 26, 1996. 10.3 1997 Equity Incentive Plan, as amended on June 9, 1998. 10.4 1998 Employee Stock Purchase Plan. 10.5 1998 Non-Employee Directors Stock Option Plan. 10.6** Supply Agreement between the Registrant and ECI Telecom Ltd. dated March 3, 1998. 10.7** Strategic Partnership and Distributorship Agreement between the Registrant and Sumitomo Corporation dated December 4, 1996. 10.8** Master Agreement between the Registrant and NET Brasil S.A. dated June 30, 1997. 10.9 Resale and License Agreement between the Registrant and Digital Equipment Corporation dated December 9, 1996. 10.10 Lease Agreement dated January 23, 1996 between the Registrant and Arrillaga Family Trust and Richard T. Peery Separate Property Trust. 10.11 Employment Agreement between the Registrant and Zaki Rakib dated February 1993. 10.12 Employment Agreement between the Registrant and Selim Rakib dated February 1993. 10.13 Credit Agreement between the Registrant and Imperial Bank dated April 24, 1997. 10.14 Product Development Agreement between the Registrant and Cisco Systems, Inc. dated July 22, 1996. 10.15 Promissory Note and Stock Pledge Agreement between the Registrant and Shlomo Rakib dated March 6, 1996. 10.16 Stock Repurchase Agreement between the Registrant and Zaki Rakib dated March 16, 1995. 10.17 Stock Repurchase Agreement between the Registrant and Shlomo Rakib dated March 16, 1995. 10.18 Series A Preferred Stock Purchase Agreement between the Registrant and Lewis Solomon dated June 16, 1995. 10.19 Promissory Note between the Registrant and Lewis Solomon dated June 16, 1997. 10.20 Stock Pledge Agreement between the Registrant and Lewis Solomon dated June 16, 1997. 10.21 Anti-Dilution Warrant to Purchase Shares of Common Stock dated April 6, 1998 issued to Shaw Communications Inc. 21.1 List of Subsidiaries. 23.1* Consent of Cooley Godward llp (included in Exhibit 5.1). 23.2 Consent of Ernst & Young LLP, Independent Auditors. Reference is made to page F-2. 24.1 Power of Attorney. Reference is made to page II-5. 27.1 Financial Data Schedule.

* To be filed by amendment. ** Confidential treatment has been requested for portions of this document. </TEXT>