FORM 10-K/A

Annual report pursuant to section 13 and 15(d) [amend]

Filing Date: **1999-03-26** | Period of Report: **1999-01-01**
SEC Accession No. 0000934741-99-000003

FILER

SDL INC
CIK:**934741**| IRS No.: **770331449** | State of Incorp.:**DE** | Fiscal Year End: **1231**
Type: **10-K/A** | Act: **34** | File No.: **000-25688** | Film No.: **99574173**
SIC: **3674** Semiconductors & related devices

Mailing Address
80 ROSE ORCHARD WAY
SAN JOSE CA 95134

Business Address
80 ROSE ORCHARD WAY
SAN JOSE CA 95134
4089439411

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K/A

(MARK ONE)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED JANUARY 1, 1999

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

COMMISSION FILE NUMBER: 0-25688

SDL, INC.

(Exact name of registrant as specified in its charter)

Delaware	77-0331449
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
80 Rose Orchard Way, San Jose, California	95134
(Address of principal executive offices)	(Zip code)

Registrant's telephone number, including area code (408) 943-9411

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of exchange on which registered
None	N/A

Securities registered pursuant to Section 12(g) of the Act: Common Stock, $0.001 par value
(Title of Class)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [ ]

State the aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, based on the closing sale price of the Common Stock on March 19, 1999, as reported by Nasdaq was $635,232,358. Shares of Common Stock held by each officer and director and by each person who owns 5 percent or more of the outstanding Common Stock have been excluded from this computation in that such persons may be deemed to be affiliates. This determination of affiliate status is not a conclusive determination for other purposes.

(APPLICABLE ONLY TO CORPORATE REGISTRANTS)

As of March 19, 1999 the registrant had outstanding 14,650,862 shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Part II of this Report on Form 10-K incorporates information by reference from Registrant's 1998 Annual Report to Stockholders. Part III of this Report on Form 10-K incorporates information by reference from Registrant's Proxy Statement for its 1999 Annual Meeting of Stockholders.

PART I

ITEM 1. BUSINESS

Introduction

SDL, Inc. was established in 1983 as a joint venture between Xerox and Spectra-Physics to develop and commercialize semiconductor laser technology. SDL management led a group to buy-out the joint venture partners in 1992 and the Company went public in 1995. SDL designs, manufactures and markets semiconductor lasers, fiber optic related products and optoelectronic systems. Historically, the Company has been technology-driven, leading the deployment of semiconductor laser technology into a wide variety of applications including fiber optic and satellite communications, cable television, materials processing, printing, data storage, cancer and other medical treatment, display, defense and scientific instrumentation. The Company's technical staff, including over fifty PhDs, represents one of the largest investments in core technology in the photonics industry. From the original products introduced in 1984, SDL has expanded its product offering to over 200 standard products in addition to providing custom design and packaging for OEM customers. The Company's revenue also includes revenue from customer-funded research programs.

By 1995, SDL management recognized that its core technical strengths of high reliability and high power were particularly well-suited to the growing market opportunity in fiber optic communications. Since the acquisition of Seastar Optics in 1995, the Company's strategy has increasingly focused on providing solutions for optical communications. SDL's optical communications products power the transmission of data, voice and Internet information over fiber optic networks to meet the needs of telecommunications, dense wavelength division multiplexing (DWDM), cable television and satellite communications applications. Led by growth in shipments of its flagship 980 nm semiconductor laser pump module, revenue from fiber optic products for terrestrial, undersea and cable television communications increased by greater than 100% in 1998 over 1997. Overall communications-related revenue increased to 66% of total revenue in the fourth quarter of 1998.

Demand for Company communications products is benefiting from the build-out of fiber optic networks to meet the bandwidth needs created by the growth of the Internet. The existing telecommunications infrastructure has proved insufficient to meet the massive traffic flow created by the

Internet. To solve the demand for bandwidth, network providers have begun implementing DWDM technology to increase the capacity of existing fiber optic systems as well as implementing DWDM in new construction. SDL's fiber optic products, such as its high power, wavelength-stabilized pump module, are essential elements in DWDM systems.

With the increased focus on commercial communications products, the proportion of revenue derived from U.S. government-related projects declined from 43% in 1996 to 28% for all of 1998 and to 21% in the fourth quarter of 1998. SDL's revenue growth in 1997 - 1998 was constrained by a shortage in qualified manufacturing capacity, especially in the wafer fabrication area. The Company's new wafer fabrication facility received full qualification in June 1998, allowing a faster ramp-up in production to meet customer's DWDM demand. In order to satisfy customer requirements for DWDM products, the Company is also in the process of doubling the size of its semiconductor laser diode assembly and test facility, and constructing a new 40,000 square feet pump module packaging facility.

Company Strategy

SDL's objective is to be the customer's first choice for optoelectronics products by providing high levels of customer satisfaction, in terms of technology, value, quality, delivery and service. The key elements of SDL's business strategy are as follows:

Focus on Fiber Optic (DWDM) Communications

The demand for greater bandwidth capacity over fiber optic networks has created a strong demand for DWDM systems. DWDM offers the highest amount of bandwidth capacity for the lowest cost by enabling the transmission of multiple signals over a single optical fiber. SDL is a market leader in supplying high power semiconductor laser and amplifier components that power DWDM systems. DWDM-related revenue increased by greater than 100% in 1998 over 1997. The Company believes that there is an excellent match between its core technical strengths in high power, high reliability and wavelength stabilization, and the growing product requirements in the DWDM market.

Expand and Leverage Technology Leadership

The Company believes it is a technology leader in the semiconductor pump laser area and in many other product and market areas in which the Company is a primary competitor. With over 120 patents owned and over 90 patents pending, and with over fifty PhDs on staff, SDL's proprietary photonics technology base has expanded rapidly in the past several years. The Company plans to leverage its strong technology base in power, reliability and wavelength stabilization to maximize its market share in the pump laser area, for terrestrial, undersea and cable television applications, and to expand into other DWDM fiber optic product areas requiring high power and high reliability.

Increase Breadth of Fiber Optic Product Offering to Existing Customer Base

SDL has over twenty customers for its DWDM and fiber optics products. In the fourth quarter of 1998, six of these customers purchased over $1 million of products while another two bought over $500,000. Since SDL has already qualified its technology and manufacturing and quality processes with these customers, the Company believes it has the opportunity to successfully market additional products to these same customers. Through both internal product development and acquisition of advanced products developed by others, the Company intends to provide a wide variety of solutions to the optical communications needs of its existing customer base.

Increase Level of Integration on the Wafer

SDL pioneered the design of, and commercially developed, the first optoelectronic integrated circuit (OEIC) containing multiple semiconductor lasers. Semiconductor OEICs are expected to revolutionize the type and number of applications that can be served by optoelectronics. The Company believes that, as with silicon integrated circuits, advanced semiconductor OEICs in conjunction with new fiber optic technologies will, in the long run, represent an increasing portion of the communication network's value.

Upgrade Bellcore-Qualified Manufacturing Capability

The Company is pursuing programs to significantly expand manufacturing capacity, improve yields and reduce unit costs in key product areas. Bellcore-qualified wafer fabrication capacity is in place in San Jose, California to meet expected product demand into early 2000. Two additional reactors are on order and scheduled to be qualified in time to meet the potential increased product demands in 2000-2001. Construction is nearing completion on a doubling of semiconductor laser diode assembly and test floor space at the Company's Santa Clara, California facility. Construction of a new 40,000 square foot pump module packaging facility is also in process near Victoria, British Columbia, Canada; the Company expects to begin shipments from this facility by the fourth quarter of 1999. Due largely to improved yields in manufacturing, the Company was able to reduce pump laser costs in 1998 and increase overall corporate gross margins by over five percentage points. Continuous yield improvement remains a high priority.

Partner with Leaders

SDL strives to be the market share leader in each of the product segments in which it competes, and seeks partnerships with the largest customers in each segment. Typically, such major system business leaders are attracted by the Company's technical leadership at the component and subsystem level. For example, many of the largest manufacturers of highchannel-count optical amplifiers have partnered with SDL because its high power, wavelength-stabilized pump module improves amplifier performance. The Company continues to expand its worldwide sales and marketing organization with a goal of providing superior solutions and service. Examples of successful partnerships include DWDM-- Alcatel, Corning and Lucent; Printing-Kodak, Panasonic and Polaroid.

Increase Profitability of Non-Communications Businesses

Product and research revenue from non-communications markets, such as printing and materials processing, remains a significant proportion of total revenue (34% in the fourth quarter of 1998). These products are also important to overall manufacturing overhead utilization because all of the Company's semiconductor laser products are made in the same wafer fabrication and assembly facilities. This business area has been generally profitable but may not have the same growth prospects as SDL's communications business. Therefore, the Company is investing in non-communications product lines only where it has a credible plan for profitable growth. The Company discontinued several low margin non-communications product lines in 1998. Conversely, responding to an opportunity to increase margins through more vertical integration, the Company invested $5.2 million to acquire the fiber laser business of Polaroid Corporation in early 1999.

Products and Markets

The Company derives revenue from three principal market areas: fiber optic and satellite communications, printing and material processing and contract research.

Fiber Optic Communications

Dense wavelength division multiplexing (DWDM) technology is revolutionizing modern communications by dramatically increasing the amount of information that can be transported across fiber optic networks. It is very costly to install fiber cabling for long distance communication. Once cable is installed, therefore, there is a great incentive to utilize it to the greatest extent possible, rather than having to install additional cable. Rather than transmitting a single light signal over a fiber (as was historically done), with DWDM several different light signals each at a different wavelength, are combined (multiplexed) and transmitted over the fiber simultaneously. At the output end of the fiber cable, the various signals can be separated (demultiplexed) because each signal is at a slightly different wavelength. With technological improvements, the number of different wavelengths (or channels) that can be transmitted simultaneously continues to increase, from 28 to 40 to 80 to over 100.

With long haul fiber optic systems, light signals may travel over thousands of miles of fiber optic cable before reaching the destination. The light signals degrade and must be amplified periodically as they travel across the fiber. Optical amplifiers accomplish this task, and one of the most important elements in an optical amplifier is the semiconductor laser pump module.

```
                   OPTICAL AMPLIFIER WITH PUMP MODULE
                | ----------------------------------------|
                |                                         |
                | |-------------|                         |
                | |Semiconductor|          OPTICAL        |
                | | Laser Pump  |         AMPLIFIER       |
                | |   Module    |                         |
                | |-------------|                         |
                |        |                                |
                |        |                                |
                |        |                                |
   INPUT        |        |       |---------|              |      OUTPUT
------------    |         ---->  | Optical |              |     ---------
Transmitted     |                | Coupler |---------------------> Amplified
Light Signal------------------>  |---------| Doped Optical |       Light
  (Source)      |                              Fiber      |      Signal
                |                                         |
                | ----------------------------------------|
```

As shown above, the incoming source signal is combined with laser light produced by a semiconductor laser pump module via an optical coupler. The energy from the pump module excites the erbium dopant atoms in the doped fiber cable. When the input signal light enters the doped fiber, the input signal light causes the dopant atoms to "relax" and give off many photons at the same wavelength and with the same pulse shape as the input source signal. As a result, the output of the optical amplifier is a greatly boosted or amplified version of the input source signal.

SDL is a leading supplier of 980 nm pump modules for DWDM applications. The major component within a pump module is the semiconductor laser that actually produces the laser light. The Company also sells stand-alone semiconductor lasers to certain customers that prefer to build their own fiber optic modules. In addition to the laser, the module includes monitor photodiodes (to measure output of the module), a thermistor (to monitor temperature) and a cooler (to prevent overheating). The module also aligns the laser output with an optical fiber. Built into the output fiber of each SDL pump module is a proprietary fiber Bragg grating. Fiber Bragg gratings are precise incisions made into the fiber that act as reflective mirrors for particular wavelengths. Bragg gratings in conjunction with the semiconductor laser, produce more precise pump wavelengths resulting in improved DWDM amplifiers enabling greater bandwidth capacity.

SDL has also designed a series of powerful optical amplifiers, including erbium-doped fiber amplifiers, to complement its pump module product line.

The majority of SDL's DWDM revenue has been into the terrestrial long-haul market. However, the Company also provides products for DWDM systems for undersea and cable television communications.

The undersea market is emerging as the next large potential market for DWDM systems because it is very expensive to deploy fiber cable across oceans. Qualification testing for undersea cable equipment is particularly rigorous and time consuming because once deployed, equipment generally cannot be repaired. SDL was recently selected by Alcatel to supply its 980 nm pump lasers and fiber Bragg gratings for undersea DWDM systems. The Company also has received contracts to qualify its 980 nm pump laser and module for two additional undersea DWDM system contractors. Further, SDL recently announced the introduction of a 1480 nm pump laser module which delivers 1.5 watts of optical power, or about ten times the power available from traditional pump lasers. This product enables remote pumping of optical amplifiers for short-haul repeaterless undersea fiber optic networks such as those connecting islands or cities along a common coastline.

Cable television (CATV) represents another major potential market for DWDM equipment. A large portion of the CATV infrastructure is fiber optic cable and CATV operators have begun implementing DWDM in order to offer bi-directional services and Internet access. DWDM is well-suited for transmitting data between cable headends and hubs. SDL supplies 980 nm pump modules for use in CATV amplifiers.

Satellite Communications

SDL has been the leading supplier of fiber optic semiconductor laser components to the satellite communications industry since the mid- 1980s. The expertise gained in developing high power, space-qualified laser devices provided the technical and reliability base from which to successfully enter the terrestrial and undersea fiber optic communications markets in the 1990s. The Company's satellite products have been used for satellite-to-satellite and satellite-to-ground communications, and to provide a local area fiber optic network within a satellite. Laser-based solutions are selected, over microwave or coaxial cable technology, due to smaller size, lighter weight and greater efficiency or speed. To date, most satellite laser sales have been to programs funded by the U.S. government or foreign governments. However, recently, large commercial satellite projects have begun to consider laser-based communication solutions.

Printing and Material Processing

SDL offers a broad range of semiconductor laser-based products to a variety of non-communications markets. Historically, most of these functions were accomplished either electronically or by using solid state or gas lasers. These solutions had inherent performance limitations in terms of capacity, speed, noise, size, durability or reliability. Using its advanced semiconductor laser technology, the Company designs and manufactures products to overcome certain of the limitations of traditional electronic and optical technology.

Printing

The thermal printing industry currently represents SDL's largest non-communications market. The Company's laser diodes and fiber lasers serve as heat sources or light sources in high quality printing systems. SDL's fiber-coupled laser diodes enable customers to write high-resolution color images directly from computer files onto a printing press plate or film, thus eliminating a number of processing steps and resulting in significant cost savings for commercial printers. The Company also offers a line of fiber lasers for thermal printing applications. These are optical fibers which are pumped with high reliability semiconductor lasers. Printing customers are attracted to SDL's fiber lasers because of their high optical power and good beam quality. SDL recently announced the acquisition of Polaroid's fiber laser business. This element of Polaroid was both a supplier and a customer in the chain of supply of fiber laser technology into the printing market. Therefore, the Company believes that this acquisition will improve its ability to profitably service the needs of the printing industry.

Medical

Lasers are increasingly being used in medical applications. SDL provides high reliability laser diodes for these applications. For example, in 1998, the Company announced the highest-power, lowest-wavelength semiconductor laser for use in photo dynamic treatment of cancer cells. Treatment modalities include lung cancer and esophageal cancer.

Material Processing

Lasers are used in a variety of material processing applications, including welding, cutting, soldering, heat treating and marking. SDL provides high power semiconductor lasers and fiber laser-based systems for certain of these applications. In the market for laser marking systems, SDL's laser pumped products are generally smaller, more reliable and more efficient than competing lamp-pumped systems. Other laser pump products provide optical power to manufacturers of solid state lasers for material processing. For example, in 1998, the Company was selected to supply high power laser diode pump arrays for an advanced solid state laser capable of generating extreme ultra violet light that is designed to enable advanced photolithography for next-generation semiconductor integrated circuit manufacturing.

Instrumentation

SDL offers a variety of instrumentation products which provide control, power, interface or scientific measurement functions. For example, a fiber amplifier coupled to a wavelength tunable semiconductor laser, provides what the Company believes is the highest power tunable light source in the 1550 nm range of wavelengths serving the DWDM market.

Contract Research

In addition to developing standard products, SDL seeks contract research projects which complement its strategy. Historically, a majority of these projects have been funded by agencies of the U.S. government. Under such programs, the Company may bill the customers for a fixed non-recurring engineering charge or may bill for actual burdened costs. On some of these projects, the Company teams with a group of contractors to present a vertically integrated system solution. Certain of these projects also require research and development cost-sharing by the Company.

While not a significant direct contributor to Company earnings, management believes that this business activity has benefited the Company in two principal ways. First, the technology developed under these contracts is often directly or indirectly applicable to future product development. Second, the projects attract top technical talent to the Company.

Sales and Marketing

The Company markets its products through product line specific direct sales forces headquartered in San Jose, California. The Company also maintains technical support in the U.K., Canada and Japan. In addition, the Company sells its products through distributors in Europe, Japan and Southeast Asia and a worldwide network of representatives.

The Company seeks partnerships with the largest customers in each segment in which it competes. It believes that the key elements in attracting and maintaining such partners are superior technology, value, quality, delivery and service, which the Company strives to provide. Selected customers for communications products include Alcatel, Antec, Corning, JDS Fitel, Lockeed Martin, Lucent Technologies, Pirelli and Scientific Atlanta. Selected customers for non-communication products include Kodak, Panasonic, Polaroid and TRW.

The Company received approximately 14 percent, 19 percent and 21 percent of its 1998, 1997 and 1996 revenue, respectively, from Lockheed Martin Corporation through several U.S. government and commercial satellite communications programs. See "Factors Affecting Earnings and Stock Price -- Dependence Upon Government Programs and Contracts."

Research and Development

During 1998, 1997 and 1996, SDL incurred $10.7 million, $9.8 million and $6.7 million respectively, of research and development expense. In addition, the Company recorded cost of sales on customer-funded research contracts of $7.5 million, $11.6 million and $9.6 million in 1998, 1997 and 1996, respectively.

Research and development in the semiconductor laser and fiber optics industry is characterized primarily by product design and product engineering that invents new products or improves performance and functionality in existing products. The Company believes that its ability to successfully compete will be substantially dependent on its ability to design, develop and introduce, in a timely manner, new product offerings. In addition, the Company also focuses on reducing the cost of existing manufacturing processes, developing new process capabilities and adding new features to existing products.

The Company's product development strategy emphasizes highly differentiated standard products that are based on customer input and requests, as well as custom product design. The Company often develops new products at the customer's systems design stage in order to better optimize compatibility with the customer's system or requirements and to better ensure market performance.

The Company has successfully introduced what it believes to be leading edge products and has received numerous new product awards. There can be no assurance that the Company will succeed in identifying new product opportunities, or in developing and bringing to market any such new products, or that the Company will be able to respond effectively to technological advances by others. There also can be no assurance that the Company's end markets will accept the Company's new products. Moreover, the end markets for the Company's new standard products are subject to rapid technological change and there can be no assurance that as such markets change, the Company's product offerings will remain current.

Manufacturing

The Company's primary manufacturing operations are located at the Company's headquarters in San Jose, California, at a nearby facility in Santa Clara, California and near Victoria, British Columbia, Canada. The Company's manufacturing operation is vertically integrated and has capabilities in computer-aided chip and package design, wafer fabrication, wafer processing, device packaging, hybrid microelectronic packaging, printed circuit board testing, and final assembly and testing. Many of the functions within the Company's manufacturing operation are computer monitored or controlled, which are designed to enhance reliability and yield. The Company employs flexible manufacturing techniques, allowing the Company to switch readily, reliably and efficiently from one product to another. The Company believes that its flexible manufacturing capability differentiates it from its competitors.

The Company's semiconductor lasers and fiber optic products are fabricated using many proprietary processes and customized manufacturing equipment. Therefore, almost all steps in the manufacturing of the semiconductor lasers are performed by the Company. Any interruption in manufacturing resulting from shortages of parts or equipment, earthquake, fire, equipment failures, yield fluctuations or otherwise could have a material adverse effect on the Company's business and results of operations. In particular, a significant portion of the Company's production relies or occurs on equipment for which the Company does not have a backup. See "Factors Affecting Earnings and Stock Price -- Manufacturing Risks" and "Factors Affecting Earrings and Stock Price -- Need to Manage Growth". Outside contractors and suppliers are used to supply raw materials, packages and standard components, and to assemble printed circuit boards. The Company depends on a single or a limited number of suppliers. The Company generally purchases these single or limited source products through standard purchase orders or one year agreements. The Company seeks to maintain a sufficient safety stock to overcome shipping delays or supply interruptions by its suppliers. The Company also endeavors to maintain ongoing communications with its suppliers to guard against interruptions in supply and has, to date, generally (although not always) been able to obtain sufficient supplies in a timely manner. Operating results could be adversely affected by a stoppage or delay of supply, substitution of more expensive or less reliable alternate parts, receipt of defective parts or contaminated materials, an increase in pricing of such parts, or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures. See "Factors Affecting Earnings and Stock Price -- Dependence on Single Source and Other Third Party Suppliers."

The Company has on occasion been unable to manufacture certain products in quantities sufficient to meet the demand of its existing customer base and of new customers. In addition, the delivery of certain products has on a number of occasions been late causing a loss of market share. As a result, the Company expanded and requalified its wafer fabrication facility in San Jose, California in 1997-1998 and intends to further expand and remodel its manufacturing facilities in the near future. In the first half of 1999, the Company plans to complete construction of a doubling of semiconductor laser assembly and test floor space in Santa Clara, California. Construction of a new 40,000 square foot pump module packaging facility is also in process near Victoria, British Columbia, Canada. In addition, two additional reactors are on order and scheduled to be qualified in time to meet potential increased wafer fabrication demands in 2000-2001. The Company has experienced, and may in the future experience, lower than expected production yields on many of its products, including some of its key product lines. This reduction in yields adversely affects gross margins and delays component, product and system shipments. There can be no assurance that the Company will be able to achieve acceptable manufacturing yields or ship products on time in the future. Further, the Company's sales contracts often include sizeable price discounts for volume orders which require future manufacturing cost reductions to achieve desired margins. There is no guarantee that such manufacturing cost reduction activities will be successful in maintaining margins. See "Factors Affecting Earnings and Stock Price -- Manufacturing Risks" and "Factors Affecting Earnings and Stock Price -- Need to Manage Growth."

Environmental Regulations

The Company is subject to a variety of federal, state and local laws and regulations concerning the storage, use, discharge and disposal of toxic, volatile, or otherwise hazardous or regulated chemicals or materials used in its manufacturing processes. Further, the Company is subject to other safety, labeling and training regulations as required by local, state and federal law. The Company has established an environmental and safety compliance program to meet the objective of applicable federal, state and local laws. This compliance program is administered by the environmental and safety department of the Company and includes monitoring, measuring and reporting compliance, establishing safety programs and training Company personnel in environmental and safety matters. There can be no assurance that changes in or failure to meet regulations or laws will not have an adverse economic effect on the Company. Further, such regulations could restrict the Company's ability to expand its operations. Any failure by the Company to obtain required permits or operate within regulations for, control the use of, or adequately restrict the discharge of hazardous or regulated substances or materials under present or future regulations could subject the Company to substantial liability, require costly changes in the Company's manufacturing processes or facilities or cause its operations to be suspended.

Backlog

As of December 31, 1998, the Company's backlog was approximately $40.1 million. Orders constituting the Company's backlog are subject to delivery rescheduling, price renegotiations and cancellation at the option of the buyer without significant penalty. A significant portion of the Company's business, in line with that of much of the semiconductor and communications industries, is characterized by short lead-time orders and quick delivery schedules.

Competition

The Company's various markets are highly competitive. The Company faces current or potential competition from four primary sources: (i) direct competitors, (ii) potential entrants, (iii) suppliers of potential new technologies and (iv) suppliers of existing alternative technologies. Competitive factors in SDL's major markets include product performance, reliability, price, customer service, delivery and quality. SDL's competitors' products may often be preferred by customers with regard to one or more of these competitive factors. Also, many of the Company's competitors have significantly greater financial, technical, manufacturing, marketing, sales and other resources than SDL. In addition, many of these competitors may be able to respond more quickly to new or emerging technologies, evolving industry trends and changes in customer requirements and to devote greater resources to the development, promotion and sale of their products than the Company.

SDL has numerous competitors worldwide in each of its business areas. In communications, direct competitors include Uniphase, Nortel, Lasertron and Furukawa. In printing and material processing, direct competitors include Spectra-Physics, Coherent, Sony and Sanyo. The Company often competes with David Sarnoff Research Laboratories, among others, for research contract funding. The Company also sells its products to current competitors and companies with the capability of becoming competitors. Merger, joint ventures or acquisitions of the Company's customers with the Company's competitors has occurred in the past and could occur in the future causing the loss of sales by the Company. If the markets for the Company's products continue to grow, new competitors are likely to emerge and present competitors may increase their market share.

Potential new technologies may emerge to compete with the Company's products. In most of the Company's product lines, both the Company and competitors are working to develop or acquire new technologies, or improvements and modifications to existing technologies, which will obsolete present products. There can be no assurances that the Company will continue its development efforts, or that such efforts, if continued, will be successful. In addition, there can be no assurances that markets will develop for any such products, or that any such products would be competitive with other technologies or products that may be developed by others. There can be no assurance that the Company's current or potential competitors or customers will not develop or acquire products comparable or superior to those developed by the Company, combine or merge to form significant competitors, or adapt more quickly than the Company to new technologies, evolving industry trends and changing customer requirements. Increased competition has resulted and could, in the future, result in price reductions, reduced margins or loss of market share, any of which could materially and adversely affect the Company's business and results of operations. There can be no assurance that the Company will be able to compete successfully against current and future competitors or that competitive pressures faced by the Company would not have a material adverse effect on its business and results of operations. The Company expects that both direct and indirect competition will increase in the future. Additional competition could adversely affect the Company's results of operations through price reductions and loss of market share. See "Factors Affecting Earnings and Stock Price -- Competition"

Intellectual Property

The Company has been a leader in the development of new technologies in the optoelectronics field and as such, has actively sought to patent its inventions. The Company frequently reviews it inventions, and attempts to determine which inventions will provide substantial differentiation, or represent substantial advancement, between the Company's products and those of its competitors. In certain cases, the Company may also choose to keep an invention or a process as a trade secret. Trade secrets are routinely employed in the Company's manufacturing processes. The Company has entered into non-disclosure agreements to protect its proprietary technology with its employees and consultants, and in some instances, with its suppliers and customers.

To date, the Company owns over 120 U. S. Patents, domestic and foreign, on devices, processes, packages and systems. Over 90 additional patent applications are pending. The Company also has a royalty-free license to approximately 50 Xerox U.S. patents. It also has five royalty-bearing licenses under which the Company licenses additional patents from third parties. Management believes that the breadth of its issued and pending patents and licenses will allow the Company to compete effectively in its present and future businesses. However, because of rapid technological developments in the communications, electronics, optics and semiconductor industries and the broad and rapidly developing patent coverage, the patent position of any manufacturer, including the Company, is subject to uncertainties and may involve complex legal and factual issues. Consequently, the Company may encounter patents from other parties which may require licensing or may keep the Company from designing, manufacturing or selling certain products, or using certain process and could materially adversely effect the Company's results of operations (See Litigation, Risk of Patent Infringement Claims). Additionally, although the Company holds certain patents, is licensed under other patents and is currently prosecuting additional patent applications, there can be no assurance that patents will issue from any of the Company's pending applications or that claims allowed by any existing or future patents issued or licensed to the Company will not be challenged, invalidated, or circumvented, or that any rights granted thereunder will provide adequate protection to the Company. Moreover, the Company may be required to participate in interference proceedings to determine the priority of inventions, which could result in substantial cost to the Company. See "Factors Affecting Earnings and Stock Price -- Risk of Patent Infringement Claims and -- Dependence on Proprietary Technology."

Due to collaborative efforts with others, some of the Company's pending patent applications or issued patents are filed under undivided joint ownership. Approximately 39 of the Company's issued patents and pending applications were developed under Federal government funding and contain a provision for a non-exclusive, royalty-free license for Federal government use.

The Company participates in a number of research or product development consortia in which the Company has agreed to grant other partners or consortia members, along with the Federal government, a non-exclusive license to technologies developed with consortia funding. Some of these cross-license grants are royalty-free while others provide for market rate license fees. In certain situations, these consortia require the Company to invest its own research and development funds to match Federal government funds. The inventions of the Company and other consortia or team members made with matching research and development funds are also often subject to such cross-license grant provisions. Joint inventions made in such collaborations are normally jointly owned.

The Company has registered the letters SDL and its logo with the U.S. Patent and Trademark Office as trademarks.

Employees

As of December 31, 1998, the Company employed 738 people, including 470 in manufacturing, 170 in engineering, research and development, 34 in sales and marketing, and 64 in general and administrative capacities. The Company also employs, from time to time, a number of temporary employees and consultants on a contract basis. As of December 31, 1998, the Company employed 19 such people. None of the Company's employees is represented by a labor union. The Company has not experienced any work stoppages and considers it relations with its employees to be good.

FACTORS AFFECTING EARNINGS AND STOCK PRICE

The statements contained in this Report on Form 10-K that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectations, hopes, beliefs, intentions or strategies regarding the future. Forward looking statements include: the Company's plans to leverage its technology base to maximize its market share; the Company's ability to market additional products to existing customers; the Company's plans to provide a wide variety of customer solutions; ability to ramp manufacturing to meet demand, ability to reduce manufacturing costs and maintain margins on volume orders, the Company's ability to profitability serve the printing industry, all under the heading "Business-Company Strategy;" expected future levels of research and development (R&D) expenditures, under the heading "Business-Research and Development;" the Company's ability to switch readily, reliably and efficiently from manufacture of one product to another, under the heading "Business-Manufacturing," the Company's ability to compete effectively in the future, under the heading "Business-Intellectual Property;" the effect of R&D expenditures on manufacturing yields, gross margin and product introduction; the amount of future R&D and selling, general and administrative (SG&A) expenditures; the amount and realizability of the Company's net deferred tax assets; the amount and timing of capital equipment and leasehold improvements expenditures; the sufficiency of anticipated cash resources to meet the Company's future cash needs; and the expense, timing and impact of Year 2000 issues and solutions, all under the heading "Management's Discussion and Analysis of Financial

Condition and Results of Operations." All forward-looking statements included in this document are based on information available to the Company on the date hereof and the Company assumes no obligation to update any such forward looking statement. It is important to note that the Company's actual results could differ materially from those in such forward looking statements. Among the factors that could cause actual results to differ materially are the factors detailed below. You should consult the risk factors listed from time to time in the Company's Reports on Forms 10-Q and 8-K and the Company's Annual Reports to Stockholders.

Fluctuations In Quarterly Operating Results.

The Company has experienced and expects to continue to experience significant fluctuations in its quarterly results of operations due to a number of factors, many of which are beyond the Company's control. Among the factors that have in the past and/or could in the future affect the Company's results are: changes in market demand, market acceptance of new and existing products, receipt or cancellation of large customer orders, the Company's ability to timely and cost-effectively design, manufacture and ship products, the mix of products sold, the mix of customers, competitive pricing pressures, the introduction of new products by competitors and costs associated with the acquisition of businesses, products or technologies. In addition, the Company sells its products to large OEM manufacturers, customers in the research and development market and government customers. Sales to these customers can vary significantly due to many factors, including the development of markets for the Company's customers' products, market acceptance of the Company's customers' products, year-end budgetary constraints and government spending patterns. As a result of the above factors, operations are subject to significant variability and uncertainty from quarter to quarter.

Manufacturing Risks.

The manufacture of semiconductor lasers and related products and systems such as those sold by the Company is highly complex and precise, requiring production in a highly controlled and clean environment. Changes in the Company's or its suppliers' manufacturing processes or the inadvertent use of defective or contaminated materials by the Company or its suppliers has in the past and could in the future adversely affect the Company's ability to achieve acceptable manufacturing yields and product reliability. To the extent the Company does not achieve such yields or product reliability, its operating results and customer relationships would be adversely affected. The Company relies almost exclusively on its own production capability in computer-aided chip and package design, wafer fabrication, wafer processing, device packaging, hybrid microelectronic packaging, printed circuit board testing, final assembly and testing of products. Because the Company manufactures, packages and tests these components, products and systems at its own facility, and such components, products and systems are not readily available from other sources, any interruption in manufacturing resulting from shortages of parts of equipment, fire, natural disaster, equipment failures, poor yields or otherwise would have a material adverse effect on the Company's business and results of operations. A significant portion of the Company's production relies or occurs on equipment for which the Company does not have a backup. To alleviate, at least in part, this situation, the Company remodeled its front-end wafer fabrication facility and its packaging and test facility. There can be no assurances that the Company will not experience further start-up costs and yield problems in fully utilizing its increased wafer capacity targeted by these remodeling efforts. In addition, the Company is deploying a new manufacturing execution software system designed to further automate and streamline its manufacturing processes, and there may be unforeseen deficiencies in this system which could adversely affect the Company's manufacturing processes. In the event of any disruption in production by one of these machines or systems, the Company's business and results of operations could be materially adversely affected. Furthermore, the Company has a limited number of employees dedicated to the operation and maintenance of its equipment, loss of whom could affect the Company's ability to effectively operate and service such equipment. The Company experienced lower than expected production yields on some of its products, including certain key product lines during 1997 and the first half of 1998. This reduction in yields adversely affected gross margins, delayed component, product and system shipments and, to a certain extent, new orders booked. Although more recently the Company's yields have improved, there can be no assurance yields will continue to improve or not decline in the future, nor that in the future the Company's manufacturing yields will be acceptable to ship products on time. To the extent the Company experiences lower than expected manufacturing yields or experiences any shipment delays, gross margins will likely be adversely affected and the Company could lose customers and experience reduced or delayed customer orders and cancellation of existing backlog. The Company presently is ramping production of certain of its product lines. This requires hiring and training of new personnel, acquiring new equipment, and expanding its packaging facilities and capabilities. Difficulties in ramping production to meet expected demand and schedules have occurred in the past and may occur in the future. Quality problems could arise, yields could fall, and gross margins could be adversely impacted during such a ramp. Aggressive volume pricing for large long-term orders has been provided to certain customers. Cost reductions in manufacturing are required to avoid a drop in gross margins for certain products sold to such customers. Such cost reductions may not occur rapidly enough to avoid a decrease in gross margins on these products that could result from such volume pricing terms. In such event, the Company's business and results of operations would be materially adversely affected.

Competition.

The Company's various markets are highly competitive. The Company faces current or potential competition from four primary sources: (i) direct competitors, (ii) potential entrants, (iii) suppliers of potential new technologies and (iv) suppliers of existing alternative technologies. The Company offers a range of components, products and systems and has numerous competitors worldwide in various segments of its markets. As the markets for the Company's products grow, new competitors have recently emerged and are likely to continue to do so in the future. The Company also sells products and services to companies with which it presently competes or in the future may compete and certain of the Company's customers have been or could be acquired by, or enter into strategic relations with the Company's competitors. In most of the Company's product lines, both the Company and competitors are working to develop new technologies, or improvements and modifications to existing technologies, which will obsolete present products. Many of the Company's competitors have significantly greater financial, technical, manufacturing, marketing, sales and other resources than SDL. In addition, many of these competitors may be able to respond more quickly to new or emerging technologies, evolving industry trends and changes in customer requirements and to devote greater resources to the development, promotion and sale of their products than the Company. There can be no assurance that the Company's current or potential competitors have not already or will not in the future develop or acquire products or technologies comparable or superior to those developed by the Company, combine or merge with each other or the Company's customers to form significant competitors, expand production capacity to more quickly meet customer supply requirements, or adapt more quickly than the Company to new technologies, evolving industry trends and changing customer requirements. Increased competition has resulted and could, in the future, result in price reductions, reduced margins or loss of market share, any of which could materially and adversely affect the Company's business and results of operations. There can be no assurance that the Company will be able to compete successfully against current and future competitors or that competitive pressures faced by the Company would not have a material adverse effect on its business and results of operations. The Company expects that both direct and indirect competition will increase in the future. Additional competition could have a material adverse effect on the Company's results of operations through price reductions and loss of market share.

Dependence On Emerging Applications And New Products.

The Company's current products serve many applications in the communications and materials processing and printing markets. In many cases, the Company's products are substantially completed, but the customer's product incorporating the Company's products is not yet completed or the applications or markets for the customer's product are new or emerging. In addition, the Company and certain of its customers are currently in the process of developing new products, in various stages of development, testing and qualification, sometimes in emerging applications or new markets. The Company believes that rapid customer acceptance of its new products is key to the Company's financial results. A substantial portion of the Company's products address markets that are not now, and may never become, substantial commercial markets. The Company has experienced, and is expected to continue to experience, fluctuation in customer orders and competitive, technological and pricing constraints that may preclude development of markets for its products and its customers' products. The Company's customers are often required to test and qualify laser pump modules, transmitters, and marking systems among other new products for potential volume applications. No assurances can be given that the Company or its customers will qualify these new products, will continue their existing product development efforts, or if continued that such efforts will be successful, that markets will develop for any of the Company's technology or pricing will enable such markets to develop, or that the Company's and its customer's products will not be superseded by other technology or products. The Company may also be unable to develop new products on a timely schedule. Moreover, even if the Company is successful in the timely development of new products and such products are accepted in the market, the Company often initially experiences lower margins on new products due to lower yields and other factors, and thus the Company may be unable to manufacture and sell such new products at an acceptable cost so as to achieve acceptable gross margins.

Need To Manage Growth.

The Company has on occasion been unable to manufacture certain products in quantities sufficient to meet demand of its existing customer base and new customers. The expansion in the scope of its operations has placed a considerable strain on its management, financial, manufacturing and other resources and has required the Company to implement and improve a variety of operating, financial and other systems, procedures and controls. In addition, the Company is currently deploying a new enterprise resource planning (ERP) system. There can be no assurance that any existing or new systems, procedures or controls will be adequate to support the Company's operations or that its systems, procedures and controls will be designed, implemented or improved in a cost-effective and timely manner. Any failure to implement, improve and expand such systems, procedures and controls in an efficient manner at a pace consistent with the Company's business could have a material adverse effect on the Company's business and results of operations. The future success of the Company is dependent, in part, on its ability to attract, assimilate and retain additional employees, including certain key personnel. The Company will continue to need a substantial number of additional personnel, including those with specialized skills, to commercialize its products and expand all areas of its business in order to continue to grow. Competition for such personnel is intense, and there can be no assurance that the Company will be able to attract, assimilate or retain additional highly qualified personnel.

Risks Of Acquisitions.

The Company's strategy involves the acquisition and integration of additional companies' products, technologies and personnel. The Company has limited experience in acquiring outside businesses. Acquisition of businesses requires substantial time and attention of management personnel and may require also additional equity or debt financings. Further, integration of newly established or acquired businesses is often disruptive. Since the Company has acquired or in the future may acquire one or more businesses, there can be no assurance that the Company will identify appropriate targets, will acquire such businesses on favorable terms, or will be able to successfully integrate such organizations into its business. Failure to do so could materially adversely affect the Company's business, financial condition and results of operations.

Dependence Upon Government Programs And Contracts.

The Company derived approximately 28%, 38%, and 43% of its revenue during fiscal 1998, 1997, and 1996, respectively, directly and indirectly from a variety of Federal government sources. The Company received approximately 14%, 19% and 21% of its revenue for fiscal 1998, 1997 and 1996, respectively, from Lockheed Martin through several U.S. government and commercial programs. Almost all of the Company's revenue from Lockheed Martin during these periods was derived from Federally-funded programs. The demand for certain of the Company's services and products is directly related to the level of funding of government programs. The Company believes that the success and further development of its business is dependent, in significant part, upon the continued existence and funding of such programs and upon the Company's ability to participate in such programs. For example, substantially all of the Company's research revenue for 1998, 1997 and 1996 was funded by Federal programs. Most of the Company's Federally-funded programs are subject to renewal every one or two years, so that continued work by the Company under these programs in future periods is not assured. Federally-funded programs are subject to termination for convenience of the government agency, at which point the Company would be reimbursed for related allowable costs incurred to the termination date. Federally-funded contracts are subject to audit of pricing and actual costs incurred, which have resulted, and could result in the future, in price adjustments. The Federal government has in the past, and could in the future, challenge the Company's accounting methodology for computing indirect rates and allocating indirect costs to government contracts. The government is currently challenging certain indirect cost allocations. While management believes that amounts recorded on its financial statements are adequate to cover all related risks, the government has not concluded its investigation or agreed to a settlement with the Company. Although the outcome of this matter cannot be determined at this time, management does not believe that its 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. In addition, a change in the Company's accounting practices in this area could result in reduced profit margins on government contracts.

Dependence On Key Employees.

The Company's future performance also depends in significant part upon the continued service of its key technical and senior management personnel. The loss of the services of one or more of the Company's officers or other key employees could have a material adverse effect on the Company's business, operating results and financial condition. While many of the Company's current employees have many years of service with the Company, there can be no assurance that the Company will be able to retain its existing personnel. If the Company is unable to retain and hire additional personnel, the Company's business and results of operations could be materially and adversely affected. See " -- Need to Manage Growth."

Risk Of Patent Infringement Claims.

The semiconductor, optoelectronics, communications, information and laser industries are characterized by frequent litigation regarding patent and other intellectual property rights. From time to time the Company has received, and may receive in the future, notice of claims of infringement of other parties' proprietary rights and licensing offers to commercialize third party patent rights. In addition, there can be no assurance that additional infringement claims (or claims for indemnification resulting from infringement claims) will not be asserted against the Company, or that existing claims or any other assertions will not result in an injunction against the sale of infringing products or otherwise materially adversely affect the Company's business and results of its operations.

In 1985, the Company first received correspondence from Rockwell corporation alleging that a fabrication process used by the Company infringes Rockwell's patent rights. Those allegations led to two related lawsuits, one of which is still pending. The first lawsuit was filed in August 1993, when Rockwell sued the Federal government in the United States Court of Federal Claims, alleging infringement of these patent rights with respect to the contracts the Federal government has had with at least 15 companies, including the Company. Rockwell International Corporation v. The United States of America, No. 93-542C (U.S. Ct. Fed. Cl.) (the "Government Lawsuit"). The Company was not originally named as a party to the Government Lawsuit. However, the Federal government has asserted that, if it was held liable to Rockwell for infringement of Rockwell's patent rights in connection with some of its contracts with the Company, then the Company would be liable to indemnify the Federal government for a portion of its liability on certain contracts. In June 1995, after Rockwell filed a second lawsuit (the "California Lawsuit," described below), the Company filed a motion to intervene in the Government Lawsuit. That motion was granted on August 17, 1995. Upon intervening in the Government Lawsuit, the Company filed an answer to Rockwell's complaint, alleging that Rockwell's patent was invalid, that Rockwell's patent was not infringed by the Company, that Rockwell's patent was unenforceable under the doctrine of inequitable conduct, and that Rockwell's action is barred by the doctrines of laches and equitable estoppel. After extensive discovery, both the Government and the Company moved for summary judgment on the ground that Rockwell's patent was invalid. By order dated February 5, 1997, the Court of Federal Claims granted those motions and entered judgment in favor of the Government and the Company. However, Rockwell appealed the Court of Federal Claims' decision, and on June 15, 1998, the United States Court of Appeals for the Federal Circuit issued an opinion vacating the judgment that has been entered in favor of the Company and the Federal government. The U.S. Circuit Court for the Federal Circuit held that the Court of Federal Claims had erred in finding that there were no genuine disputes of material fact concerning the obviousness of the Rockwell patent, and that the resolution of these disputes requires a trial. The Federal Circuit thus remanded the case back to the trial court for further proceedings. The Federal Circuit also affirmed the Court of Federal Claims' denial of the Company's motion for summary judgment of invalidity based on anticipation, as well as the Court of Federal Claims' claim construction. Subsequent to the Federal Circuit's action, Rockwell and the United States reached a settlement in the Government Lawsuit. Pursuant to the settlement ending the Government Lawsuit, a judgment was entered in Rockwell's favor against the Federal government in the amount of $16,900,000. The Company did not participate in the settlement. The Federal government has not again raised the issue of the Company's potential indemnity obligation.

As noted above, the Company's decision to intervene in the Government Lawsuit was made after Rockwell filed suit against the Company in the Northern District of California in May 1995, alleging that the Company had infringed the Rockwell patent in connection with the Company's manufacture and sale of products to customers other than the United States. Again, the complaint alleges that a fabrication process used by the Company infringes the Rockwell patent.(Rockwell International Corporation v. SDL, Inc., No. C95-01729 MHP (U.S. Dist.Ct., N.D. Cal.)). By its complaint, Rockwell seeks a permanent injunction against the Company enjoining it from infringement of the Rockwell patent, damages in an unspecified amount for the Company's alleged past infringement of the patent, treble damages and attorneys' fees. The complaint was served on the Company on June 30, 1995, and the Company filed an answer to the complaint on August 18, 1995, alleging that Rockwell's patent is invalid, that Rockwell's patent is not infringed by the Company, that Rockwell's patent is unenforceable under the doctrine of inequitable conduct, and that Rockwell's action is barred by the doctrines of laches and equitable estoppel. On August 11, 1995, prior to filing its answer, the Company filed a motion to stay this action based upon the pendency of the Government Lawsuit. The District Court granted the Company's motion to stay on September 15, 1995. Subsequent to the settlement of the Government Lawsuit, the District Court lifted this stay, and discovery has re-commenced for the California Lawsuit. See "Factors Affecting Earnings and Stock Price--Risk of Patent Infringement Claims."

Although the Court of Federal Claims ruled in the Company's favor, finding the patent invalid on motion for summary judgment, the Court of Appeals for the Federal Circuit reversed the summary judgment ruling, meaning that the issue of validity needed to go to trial. Such a trial would now occur before a jury in California. The Company believes that it has meritorious defenses to Rockwell's allegations. It should be noted that the resolution of intellectual property disputes is often fact intensive and, therefore, the results are inherently uncertain. There can be no assurance that Rockwell will not ultimately prevail in this dispute. If Rockwell were to prevail, it could be awarded substantial monetary damages and/or an injunction against the sale of infringing products by the Company. If such an injunction were entered, the Company may seek to obtain a license to use Rockwell's patent. There can be no assurance, however, that a license would be available on reasonable terms or at all. The award of monetary damages against the Company, or the grant of an injunction and failure to obtain a license to use Rockwell's patent on commercially reasonable terms could have a material adverse effect on the Company's business and results of operations. Litigation of Rockwell's claim against the Company is expected to involve significant expense to the Company and could divert the attention of the Company's technical and management personnel and could have a material adverse effect on the Company's business and results of operations. In addition, the Company is involved in various legal proceedings arising in the ordinary course of its business.

Customer Order Fluctuations.

The Company's product revenue is subject to fluctuations in customer orders. Occasionally, some of the Company's customers have ordered more products than they need in a given period, thereby building up inventory and delaying placement of subsequent orders until such inventory has been reduced. The Company may also build inventory in anticipation of receiving new orders in the future. Also, customers have occasionally placed large orders which they have subsequently canceled. In addition, due to the fact that the Company's sales of its 980 nm pump module products comprise a significant portion of the Company's total revenues, the Company's revenues are particularly susceptible to customer order fluctuations for this product. Such fluctuations, cancellations and the failure to receive such new orders can have adverse effects on the Company's business and results of operations. The Company may also have incurred significant inventory or other expenses in preparing to fill such orders prior to their cancellation. Virtually all of the Company's backlog is subject to cancellation. Cancellation of significant portions of the Company's backlog, delays in scheduled delivery dates, or failure of the Company to sell the inventory built up in anticipation of orders, could have a material adverse effect on the Company's business and results of operations.

Dependence On Proprietary Technology.

The Company's future success and competitive position is dependent in part upon its proprietary technology, and the Company relies in part on patent, trade secret, trademark and copyright law to protect its intellectual property. There can be no assurance that any of the more than 120 patents owned or approximately 13 patents licensed by the Company will not be invalidated, circumvented, challenged or licensed to others, that the rights granted thereunder will provide competitive advantages to the Company or that any of the Company's approximately 90 pending or future patent applications will be issued with the scope of the claims sought by the Company, if at all. Furthermore, there can be no assurance that others will not develop technologies that are similar or superior to the Company's technology, duplicate the Company's technology or design around the patents owned by the Company, or patent or assert patents on technology which the Company might use or intend to use. In addition, effective copyright and trade secret protection may be unavailable, limited or not applied for in certain foreign countries. Certain of the Company's technology is licensed on a non-exclusive basis from Xerox and other third parties which may license such technology to others, including competitors of the Company. There can be no assurance that steps taken by the Company to protect its technology will prevent misappropriation of such technology. In addition, litigation has been necessary and may be necessary in the future to enforce the Company's patents and other intellectual property rights, to protect the Company's trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity of intellectual property rights developed internally or acquired from third parties. Such litigation has resulted in substantial costs and diversion of resources and could have a material adverse effect on the Company's business and results of operations. Moreover, the Company may be required to participate in interference proceedings to determine the priority of inventions which could result in substantial cost to the Company. See" Business -- Intellectual Property."

International Distribution Risks.

Revenues from customers outside of the United States accounted for approximately 24 percent, 17 percent and 15 percent, of the Company's total revenue in 1998, 1997 and 1996, respectively. International revenue carries a number of inherent risks, including reduced protection for intellectual property rights in some countries, the impact of unstable environments in economies outside the United States, generally longer receivable collection periods, changes in regulatory environments, tariffs and other potential trade barriers. In addition, certain of the Company's international revenue is subject to export licensing and approvals by the DoC or other Federal governmental agencies. Although not related to the distribution of any of the Company's products, a sales representative for the Company's products in China has been indicted for violation of the U.S. Export Control Act and, as a result, the Company is seeking another sale representative in China. To date, the Company has experienced little difficulty in obtaining such export licenses or approvals. However, the failure to obtain such export licenses or approvals or comply with such regulations in the future could have a material adverse effect on the Company's business and results of operations.

The Company currently uses local distributors in key industrialized countries and local representatives in smaller markets. Although the Company has formal distribution contracts with certain of its distributors and representatives, some of the Company's relationships are currently on an informal basis. Most of the Company's international distributors and representatives offer only the Company's products; however, certain distributors offer competing products and there can be no assurance that additional distributors and representatives will not also offer products that are competitive with the Company's products. There can be no assurance that the Company's international distributors and representatives will enter into formal distribution agreements at all or on acceptable terms, will not terminate informal or contractual relationships, will continue to sell the Company's products or that the Company will provide the distributors and resellers with adequate levels of support. The loss of, or a significant reduction in revenue through, a significant number of the Company's international distributors and representatives would have a material adverse effect on the Company's business and results of operations.

Environmental Risks.

The Company is subject to a variety of federal, state and local laws and regulations concerning the storage, use, discharge and disposal of toxic, volatile, or otherwise hazardous or regulated chemicals or materials used in its manufacturing processes. Further, the Company is subject to other safety, labeling and training regulations as required by local, state and federal law. The Company has established an environmental and safety compliance program to meet the objectives of applicable federal, state and local laws. This compliance program is administered by the environmental and safety department of the Company and includes monitoring, measuring and reporting compliance, establishing safety programs and training Company personnel in environmental and safety matters. There can be no assurance that changes in regulations and laws will not have an adverse economic effect on the Company. Further, such regulations could restrict the Company's ability to expand its operations. Any failure by the Company to obtain required permits or operate within regulations for, control the use of, or adequately restrict the discharge of hazardous or regulated substances or materials under present or future regulations could subject the Company to substantial liability, require costly changes in the Company's manufacturing processes or facilities or cause its operations to be suspended.

Dependence On Single Source And Other Third Party Suppliers.

The Company depends on a single or limited number of outside contractors and suppliers for raw materials, packages and standard components, and to assemble printed circuitboards. The Company generally purchases these single or limited source products through standard purchase orders or one year supply agreements and has no long-term guaranteed supply agreements with such suppliers. The Company seeks to maintain a sufficient safety stock to overcome short-term shipping delays or supply interruptions by its suppliers. The Company also endeavors to maintain ongoing communications with its suppliers to guard against interruptions in supply and has, to date, generally been able to obtain sufficient supplies in a timely manner. However, the Company's business and results of operations have in the past been and could in the future be adversely affected by a stoppage or delay of supply, substitution of more expensive or less reliable parts, receipt of defective parts or contaminated materials, an increase in the price of such supplies or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures.

Potential Volatility Of Stock Price.

Factors such as announcements of technological innovations, large customer orders, customer order delays or cancellations, customer qualification delays or new products by the Company, its competitors or third parties, possible acquisition of SDL by a third party, merger or acquisition announcements, acquisitions or mergers by competitors or customers, production problems as well as quarterly variations in the Company's actual or anticipated results of operations and developments in litigation involving the Company, may cause the market price of the Company's Common Stock to fluctuate significantly. Furthermore, the stock market has experienced extreme price and volume fluctuations, which have particularly affected the market prices of many high technology companies and which have often been unrelated to the operating performance of such companies. These broad market fluctuations may adversely affect the market price of the Company's Common Stock. Many companies in the optical communications industry have in the past year experienced historical highs in the market prices of their stock. There can be no assurance that the market price of the Company's Common Stock will not experience significant fluctuations in the future, including fluctuations that are unrelated to the Company's performance.

ITEM 2. PROPERTIES

The company leases two adjacent buildings comprising approximately 64,000 square feet of office and manufacturing space in San Jose, California. These facilities serve as the Company's headquarters and include manufacturing, marketing, research, engineering and administrative functions. The present leases expire in November 2001. The Company has renewal options to extend these leases through November 2016.

In January 1995, the Company leased an additional 50,000 square feet of manufacturing and office space in Santa Clara, California, approximately three miles from its headquarters. In 1997, the Company exercised an option for an adjacent additional 50,000 square feet. This lease, including the additional space, expires in March 2002. The Company has renewal options to extend this lease through 2017.

In April 1996, the Company leased an additional 10,000 square feet of office space in Santa Clara, California. This lease expires in April 1999.

SDL Optics leases 23,100 square feet of manufacturing and office space, and adjacent parking space, near Victoria, British Columbia, Canada. These facilities serve as SDL Optics' headquarters and include manufacturing, marketing, research, engineering and administrative functions. The present leases expire in December 1999. SDL Optics has an option to extend the leases for an additional three months.

During 1998, SDL Optics entered into a lease for a new building with an initial capacity of approximately 40,000 square feet located near Victoria, British Columbia, where it plans to expand in the third quarter of 1999. The Company has options to extend this lease through July 2009.

The Company also leases smaller facilities in Cambridge, Massachusetts and Bensalem, Pennsylvania.

ITEM 3. LEGAL PROCEEDINGS

In 1985, the Company first received correspondence from Rockwell corporation alleging that a fabrication process used by the Company infringes Rockwell's patent rights. Those allegations led to two related lawsuits, one of which is still pending. The first lawsuit was filed in August 1993, when Rockwell sued the Federal government in the United States Court of Federal Claims, alleging infringement of these patent rights with respect to the contracts the Federal government has had with at least 15 companies, including the Company. Rockwell International Corporation v. The United States of America, No. 93-542C (U.S. Ct. Fed. Cl.) (the "Government Lawsuit"). The Company was not originally named as a party to the Government Lawsuit. However, the Federal government has asserted that, if it was held liable to Rockwell for infringement of Rockwell's patent rights in connection with some of its contracts with the Company, then the Company would be liable to indemnify the Federal government for a portion of its liability on certain contracts. In June 1995, after Rockwell filed a second lawsuit (the "California Lawsuit," described below), the Company filed a motion to intervene in the Government Lawsuit. That motion was granted on August 17, 1995. Upon intervening in the Government Lawsuit, the Company filed an answer to Rockwell's complaint, alleging that Rockwell's patent was invalid, that Rockwell's patent was not infringed by the Company, that Rockwell's patent was unenforceable under the doctrine of inequitable conduct, and that Rockwell's action is barred by the doctrines of laches and equitable estoppel. After extensive discovery, both the Government and the Company moved for summary judgment on the ground that Rockwell's patent was invalid. By order dated February 5, 1997, the Court of Federal Claims granted those motions and entered judgment in favor of the Government and the Company. However, Rockwell appealed the Court of Federal Claims' decision, and on June 15, 1998, the United States Court of Appeals for the Federal Circuit issued an opinion vacating the judgment that has been entered in favor of the Company and the Federal government. The U.S. Circuit Court for the Federal Circuit held that the Court of Federal Claims had erred in finding that there were no genuine disputes of material fact concerning the obviousness of the Rockwell patent, and that the resolution of these disputes requires a trial. The Federal Circuit thus remanded the case back to the trial court for further proceedings. The Federal Circuit also affirmed the Court of Federal Claims' denial of the Company's motion for summary judgment of invalidity based on anticipation, as well as the Court of Federal Claims' claim construction. Subsequent to the Federal Circuit's action, Rockwell and the United States reached a settlement in the Government Lawsuit. Pursuant to the settlement ending the Government Lawsuit, a judgment was entered in Rockwell's favor against the Federal government in the amount of $16,900,000. The Company did not participate in the settlement. The Federal government has not again raised the issue of the Company's potential indemnity obligation.

As noted above, the Company's decision to intervene in the Government Lawsuit was made after Rockwell filed suit against the Company in the Northern District of California in May 1995, alleging that the Company had infringed the Rockwell patent in connection with the Company's manufacture and sale of products to customers other than the United States. Again, the complaint alleges that a fabrication process used by the Company infringes the Rockwell patent.(Rockwell International Corporation v. SDL, Inc., No. C95-01729 MHP (U.S. Dist.Ct., N.D. Cal.)). By its complaint, Rockwell seeks a permanent injunction against the Company enjoining it from infringement of the Rockwell patent, damages in an unspecified amount for the Company's alleged past infringement of the patent, treble damages and attorneys' fees. The complaint was served on the Company on June 30, 1995, and the Company filed an answer to the complaint on August 18, 1995, alleging that Rockwell's patent is invalid, that Rockwell's patent is not infringed by the Company, that Rockwell's patent is unenforceable under the doctrine of inequitable conduct, and that Rockwell's action is barred by the doctrines of laches and equitable estoppel. On August 11, 1995, prior to filing its answer, the Company filed a motion to stay this action based upon the pendency of the Government Lawsuit. The District Court granted the Company's motion to stay on September 15, 1995. Subsequent to the settlement of the Government Lawsuit, the District Court lifted this stay, and discovery has re-commenced for the California Lawsuit. See "Factors Affecting Earnings and Stock Price--Risk of Patent Infringement Claims."

Although the Court of Federal Claims ruled in the Company's favor, finding the patent invalid on motion for summary judgment, the Court of Appeals for the Federal Circuit reversed the summary judgment ruling, meaning that the issue of validity needed to go to trial. Such a trial would now occur before a jury in California. The Company believes that it has meritorious defenses to Rockwell's allegations. It should be noted that the resolution of intellectual property disputes is often fact intensive and, therefore, the results are inherently uncertain. There can be no assurance that Rockwell will not ultimately prevail in this dispute. If Rockwell were to prevail, it could be awarded substantial monetary damages and/or an injunction against the sale of infringing products by the Company. If such an injunction were entered, the Company may seek to obtain a license to use Rockwell's patent. There can be no assurance, however, that a license would be available on reasonable terms or at all. The award of monetary damages against the Company, or the grant of an injunction and failure to obtain a license to use Rockwell's patent on commercially reasonable terms could have a material adverse effect on the Company's business and results of operations. Litigation of Rockwell's claim against the Company is expected to involve significant expense to the Company and could divert the attention of the Company's technical and management personnel and could have a material adverse effect on the Company's business and results of operations. In addition, the Company is involved in various legal proceedings arising in the ordinary course of its business.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the security holders of the Company during the fourth quarter of fiscal 1998.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The information required by this item is included under the heading "Corporate Information" in the Company's 1998 Annual Report to Stockholders, and is incorporated herein by reference.

ITEM 6. SELECTED FINANCIAL DATA

The information required by this item is included under the heading "Selected Consolidated Financial Data" in the Company's 1998 Annual Report to Stockholders, and is incorporated by reference.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The information required by this item is included under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's 1998 Annual Report to Stockholders, and is incorporated by reference.

ITEM 7A Disclosures About Market Risk

The information required by this item is included under the heading "Interest Rate Risk" in the Company's 1998 Annual Report to Stockholders and is incorporated by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this item is included in the Company's 1998 Annual Report to Stockholders under the headings listed under Item 14(a). of Part IV of this Report on Form 10-K and under the heading "Unaudited Quarterly Consolidated Financial Data" in the Company's 1998 Annual Report to Stockholders, and is incorporated by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Stockholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Stockholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this item is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Stockholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated by reference to the Company's Proxy Statement for the 1999 Annual Meeting of Stockholders.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a)1. FINANCIAL STATEMENTS AND REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The following consolidated financial statements of the Registrant and Report of Ernst & Young LLP, Independent Auditors, are contained in the Company's 1998 Annual Report to Stockholders and are incorporated by reference in Item 8 of Part II of this Report on Form 10-K:

Consolidated Balance Sheets as of December 31, 1998 and 1997.

Consolidated Statements of Operations for the years Ended December 31, 1998, 1997 and 1996.

Consolidated Statements of Stockholders' Equity for the years Ended December 31, 1998, 1997, and 1996.

Consolidated Statements of Cash Flow for the years Ended December 31, 1998, 1997, and 1996.

Notes to Consolidated Financial Statements.

Report of Ernst & Young LLP, Independent Auditors.

2. FINANCIAL STATEMENT SCHEDULES. The following financial statement schedule is filed as part of this Report on Form 10-K on page 26 and should be read in conjunction with the Consolidated Financial Statements of SDL, Inc.:

Schedule II--Valuation and Qualifying Accounts.

Schedules not listed above have been omitted because the information required to be set forth therein is not applicable or is shown in the Consolidated Financial Statements or notes thereto.

3. EXHIBITS.

Exhibit Number	Exhibit Description
3.1	Form of Registrant's Restated Certificate of Incorporation.(1)
3.1.1	Form of Registrant's Certificate of Designation of the Series B Preferred Stock.
3.1.2	Form of Registrant's Certificate of Correction of Restated Certificate of Incorporation.
3.2	Form of Registrant's Amended and Restated Bylaws.(1)
4.1	Reference is made to Exhibits 3.1 and 3.2.

4.2		Specimen Common Stock certificate.(1)
4.3		Rights Agreement, dated as of November 6, 1997, between the Company and ChaseMellon Shareholder Services, L.L.C. together with: Exhibit A, Form of Rights Certificate; Exhibit B, Summary of Rights to Purchase Preferred Stock; and Exhibit C Form of Certificates of Designation of the Series B Preferred Stock.(2)
4.3.1		First Amended and Restated Rights Agreement, dated as of February 11, 1999, between the Company and Chase Mellon Shareholder Services, L.L.C., a New Jersey limited liability company. (3)
10.3	*	Form of Registrant's 1995 Stock Option Plan, including forms of option agreements thereunder.(1)
10.4	*	Form of Registrant's 1995 Employee Stock Purchase Plan, as amended.(1)
10.5		Technology Agreement between Xerox Corporation, Spectra-Physics, Inc. and the Registrant effective March 31, 1983 and Amendment No. 1 thereto, dated March 31, 1988.(1)
10.10		Lease Agreement between Rose Orchard I a Joint Venture and the Registrant, dated May 16, 1986, as amended October 24, 1989.(1)
10.11		Lease Agreement between Rose Orchard I a Joint Venture and the Registrant, dated April 28, 1989, as amended October 24, 1989.(1)
10.12	*	Employment Agreement between Donald R. Scifres and the Registrant, dated July 17, 1992, and amendments thereto, dated February 19, 1993 and July 29, 1994.(1)
10.13	*	Form of Employment Agreement between officers of the Registrant and the Registrant.(1)
10.14		Lease Agreement between Triangle Development Company and Registrant dated January 13, 1995, and Addendum thereto, dated January 13, 1995.(1)
10.15		Employment Agreement between Gregory P. Dougherty and the Registrant, dated October 1, 1998.
10.16		Promissory Note Secured by Deed of Trust dated May 1, 1997 made by Gregory P. Doughtery and Nancy E. Dougherty payable to the Company.

13.1 SDL, Inc. 1998 Annual Report to Stockholders. This Annual Report shall not be deemed to be filed except to the extent that the information is specifically incorporated by reference.

21.1 Subsidiaries

23.1 Consent of Ernst & Young LLP, Independent Auditors

27.1 Financial data schedule

----

(1) Incorporated by reference to identically numbered Exhibit to the Company's Registration Statement on Form 8-1 (Commission File No. 33-87752), which became effective on March 15, 1995.

(2) Incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-A (Commission File No. 000-25688), filed with the SEC on November 7, 1997.

(3) Incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-AA filed with the SEC on March 19, 1999.

(4) Incorporated by reference to identically numbered Exhibit to the Company's Registration Statement on Form 10-K, filed with the SEC on March 4, 1998.

* Management contracts or compensatory plans or arrangements.

SIGNATURES

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

SDL, INC.

March 24, 1999

By: /s/ Michael L. Foster

Michael L. Foster
Chief Financial Officer and Secretary
(Duly Authorized Officer and Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Donald R. Scifres Donald R. Scifres	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	March 24, 1999
/s/ Michael L. Foster Michael L. Foster	Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)	March 24, 1999
/s/ John P. Melton John P. Melton	Director	March 24, 1999
/s/ Keith B. Geeslin Keith B. Geeslin	Director	March 24, 1999
/s/ Anthony B. Holbrook Anthony B. Holbrook	Director	March 24, 1999
/s/ Mark B. Myers Mark B. Myers	Director	March 24, 1999
/s/ Frederic N. Schwettmann Frederic N. Schwettmann	Director	March 24, 1999

Schedule II

SDL, INC.

VALUATION AND QUALIFYING ACCOUNTS
(In thousands)

<TABLE>
<CAPTION>

Balance at Additions

Description	Beginning of Period	Charged to Expenses	Deductions(1)	Balance at End of Period
<S>	<C>	<C>	<C>	<C>
Allowance for doubtful accounts receivable				
Year ended December 31, 1998.....	$1,190	$401	($586)	$1,005
Year ended December 31, 1997.....	$780	$442	($32)	$1,190
Year ended December 31, 1996.....	$485	$355	($60)	$780

</TABLE>

----

(1) Uncollectible accounts written off.

EXHIBIT 3.1.1

SDL, INC.
CERTIFICATE OF DESIGNATION
OF THE
SERIES B PREFERRED STOCK

Pursuant to Section 151 of the General Corporation Law of the State of Delaware

---

The undersigned officers of SDL, Inc., a corporation organized and existing under the General Corporation Law of the State of Delaware (the "Corporation"), in accordance with the provisions of Section 103 thereof, DO HEREBY CERTIFY:

That, pursuant to the authority conferred upon the Board of Directors of the Corporation by its Restated Certificate of Incorporation (the "Certificate"), the said Board of Directors, at a duly called meeting held on November 5, 1997, at which a quorum was present and acted throughout, adopted the following resolution, which resolution remains in full force and effect on the date hereof creating a series of 300,000 shares of Preferred Stock having a par value of $.001 per share, designated as Series B Preferred Stock (the "Series B Preferred Stock") out of the class of 1,000,000 shares of preferred stock of the par value of $.001 per share (the "Preferred Stock"):

RESOLVED, that pursuant to the authority vested in the Board of Directors in accordance with the provisions of its Certificate, the Board of Directors does hereby create, authorize and provide for 300,000 shares of its authorized Preferred Stock to be designated and issued as the Series B Preferred Stock, having the voting powers, designation, relative, participating, optional and other special rights, preferences and qualifications, limitations and restrictions that are set forth as follows:

1. Dividends and Distributions. (A) Subject to the prior and superior rights of the holders of any shares of any other series of Preferred Stock or any other shares of stock of the Corporation ranking prior and superior to the shares of Series B Preferred Stock with respect to dividends, each holder of one one-hundredth (1/100) of a share (a "Unit") of Series B Preferred Stock shall be entitled to receive, when, as and if declared by the Board of Directors out of funds legally available for that purpose, (i) quarterly dividends payable in cash on the last day of February, May, August and November in each year (each such date being a "Quarterly Dividend Payment Date"), commencing on the first Quarterly Dividend Payment Date after the first issuance of such

Unit of Series B Preferred Stock, in an amount per Unit (rounded to the nearest cent) equal to the greater of (a) $.01 or (b) subject to the provision for adjustment hereinafter set forth, the aggregate per share amount of all cash dividends declared on shares of the Common Stock since the immediately preceding Quarterly Dividend Payment Date, or, with respect to the first Quarterly Dividend Payment Date, since the first issuance of a Unit of Series B Preferred Stock, and (ii) subject to the provision for adjustment hereinafter set forth, quarterly distributions (payable in kind) on each Quarterly Dividend Payment Date in an amount per Unit equal to the aggregate per share amount of all non-cash dividends or other distributions (other than a dividend payable in shares of Common Stock or a subdivision of the outstanding shares of Common Stock, by reclassification or otherwise) declared on shares of Common Stock since the immediately preceding Quarterly Dividend Payment Date, or with respect to the first Quarterly Dividend Payment Date, since the first issuance of a Unit of Series B Preferred Stock. In the event that the Corporation shall at any time after November 6, 1997 (the "Rights Declaration Date") (i) declare any dividend on outstanding shares of Common Stock payable in shares of Common Stock, (ii) subdivide outstanding shares of Common Stock or (iii) combine outstanding shares of Common Stock into a smaller number of shares, then in each such case the amount to which the holder of a Unit of Series B Preferred Stock was entitled immediately prior to such event under clause (b) of the preceding sentence shall be adjusted by multiplying such amount by a fraction the numerator of which shall be the number of shares of Common Stock that are outstanding immediately after such event and the denominator of which shall be the number of shares of Common Stock that were outstanding immediately prior to such event.

(B) The Corporation shall declare a dividend or distribution on Units of Series B Preferred Stock as provided in paragraph (A) above immediately after it declares a dividend or distribution on the shares of Common Stock (other than a dividend payable in shares of Common Stock); provided, however, that, in the event no dividend or distribution shall have been declared on the Common Stock during the period between any Quarterly Dividend Payment Date and the next subsequent Quarterly Dividend Payment Date, a dividend of $.01 per Unit on the Series B Preferred Stock shall nevertheless be payable on such subsequent Quarterly Dividend Payment Date.

(C) Dividends shall begin to accrue and shall be cumulative on each outstanding Unit of Series B Preferred Stock from the Quarterly Dividend Payment Date next preceding the date of issuance of such Unit of Series B Preferred Stock, unless the date of issuance of such Unit is prior to the record date for the first Quarterly Dividend Payment Date, in which case, dividends on such Unit shall begin to accrue from the date of issuance of such Unit, or unless the date of issuance is a Quarterly Dividend Payment Date or is a date after the record date for the determination of holders of Units of Series B Preferred Stock entitled to receive a quarterly dividend and before such Quarterly Dividend Payment Date, in either of which events such dividends shall begin to accrue and be cumulative from such Quarterly Dividend Payment Date. Accrued but unpaid dividends shall not bear interest. Dividends paid on Units of Series B Preferred Stock in an amount less than the aggregate amount of all such dividends at the time accrued and payable on such Units shall be allocated pro rata on a unit-by-unit basis among all Units of Series B Preferred Stock at the time outstanding. The Board of Directors may fix a record date for the determination of holders of Units of Series B Preferred Stock entitled to receive payment of a dividend or distribution declared thereon, which record date shall be no more than 30 days prior to the date fixed for the payment thereof.

2. Voting Rights. The holders of Units of Series B Preferred Stock shall have the following voting rights:

(A) Subject to the provision for adjustment hereinafter set forth, each Unit of Series B Preferred Stock shall entitle the holder thereof to one vote on all matters submitted to a vote of the stockholders of the Corporation. In the event the Corporation shall at any time after the Rights Declaration Date (i) declare any dividend on outstanding shares of Common Stock payable in shares of Common Stock, (ii) subdivide outstanding shares of Common Stock or (iii) combine the outstanding shares of Common Stock into a smaller number of shares, then in each such case the number of votes per Unit to which holders of Units of Series B Preferred Stock were entitled immediately prior to such event shall be adjusted by multiplying such number by a fraction the numerator of which shall be the number of shares of Common Stock outstanding immediately after such event and the denominator of which shall be the number of shares of Common Stock that were outstanding immediately prior to such event; and

(B) Except as otherwise provided herein, in the Certificate or the Bylaws of the Corporation or as required by law, the holders of Units of Series B Preferred Stock and the holders of shares of Common Stock shall vote together as one class on all matters submitted to a vote of stockholders of the Corporation, and such holders shall have no special voting rights and their consents shall not be required for taking any corporate action.

3. Certain Restrictions. (A) Whenever quarterly dividends or other dividends or distributions payable on Units of Series B Preferred Stock as provided herein are in arrears, thereafter and until all accrued and unpaid dividends and distributions, whether or not declared, on outstanding Units of Series B Preferred Stock shall have been paid in full, the Corporation shall not (i) declare or pay dividends on, make any other distributions on, or redeem or purchase or otherwise acquire for consideration any shares of junior stock; (ii) declare or pay dividends on or make any other distributions on any shares of parity stock, except dividends paid ratably on Units of Series B Preferred Stock and shares of all such parity stock on which dividends are payable or in arrears in proportion to the total amounts to which the holders of such Units and all such shares are then entitled; (iii) redeem or purchase or otherwise

acquire for consideration shares of any parity stock, provided, however, that the Corporation may at any time redeem, purchase or otherwise acquire shares of any such parity stock in exchange for shares of any junior stock; (iv) purchase or otherwise acquire for consideration any Units of Series B Preferred Stock, except in accordance with a purchase offer made in writing or by publication (as determined by the Board of Directors) to all holders of such Units.

(B) The Corporation shall not permit any subsidiary of the Corporation to purchase or otherwise acquire for consideration any shares of stock of the Corporation unless the Corporation could, under paragraph (A) of this Section 3, purchase or otherwise acquire such shares at such time and in such manner.

4. Reacquired Shares. Any Units of Series B Preferred Stock purchased or otherwise acquired by the Corporation in any manner whatsoever shall be retired and cancelled promptly after the acquisition thereof. All such Units shall, upon their cancellation, become authorized but unissued shares (or fractions of shares) of Preferred Stock and may be reissued as part of a new series of Preferred Stock to be created by resolution or resolutions of the Board of Directors, subject to the conditions and restrictions on issuance set forth herein.

5. Liquidation, Dissolution or Winding Up. (A) Upon any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, no distribution shall be made (i) to the holders of shares of junior stock unless the holders of Units of Series B Preferred Stock shall have received, subject to adjustment as hereinafter provided in paragraph (B), the greater of either (a) $.01 per Unit plus an amount equal to accrued and unpaid dividends and distributions thereon, whether or not earned or declared, to the date of such payment, or (b) the amount equal to the aggregate per share amount to be distributed to holders of shares of Common Stock, or (ii) to the holders of shares of parity stock, unless simultaneously therewith distributions are made ratably on Units of Series B Preferred Stock and all other shares of such parity stock in proportion to the total amounts to which the holders of Units of Series B Preferred Stock are entitled under clause (i)(a) of this sentence and to which the holders of shares of such parity stock are entitled, in each case upon such liquidation, dissolution or winding up.

(B) In the event the Corporation shall at any time after the Rights Declaration Date (i) declare any dividend on outstanding shares of Common Stock payable in shares of Common Stock, (ii) subdivide outstanding shares of Common Stock, or (iii) combine outstanding shares of Common Stock into a smaller number of shares, then in each such case the aggregate amount to which holders of Units of Series B Preferred Stock were entitled immediately prior to such event pursuant to clause (i)(b) of paragraph (A) of this Section 5 shall be adjusted by multiplying such amount by a fraction the numerator of which shall be the number of shares of Common Stock that are outstanding immediately after such event and the denominator of which shall be the number of shares of Common Stock that were outstanding immediately prior to such event.

6. Consolidation, Merger, etc. In case the Corporation shall enter into any consolidation, merger, combination or other transaction in which the shares of Common Stock are exchanged for or converted into other stock or securities, cash and/or any other property, then in any such case Units of Series B Preferred Stock shall at the same time be similarly exchanged for or converted into an amount per Unit (subject to the provision for adjustment hereinafter set forth) equal to the aggregate amount of stock, securities, cash and/or any other property (payable in kind), as the case may be, into which or for which each share of Common Stock is converted or exchanged. In the event the Corporation shall at any time after the Rights Declaration Date (i) declare any dividend on outstanding shares of Common Stock payable in shares of Common Stock, (ii) subdivide outstanding shares of Common Stock, or (iii) combine outstanding Common Stock into a smaller number of shares, then in each such case the amount set forth in the immediately preceding sentence with respect to the exchange or conversion of Units of Series B Preferred Stock shall be adjusted by multiplying such amount by a fraction the numerator of which shall be the number of shares of Common Stock that are outstanding immediately after such event and the denominator of which shall be the number of shares of Common Stock that were outstanding immediately prior to such event.

7. Redemption. The Units of Series B Preferred Stock and shares of Series B Preferred Stock shall not be redeemable.

8. Ranking. The Units of Series B Preferred Stock and shares of Series B Preferred Stock shall rank junior to all other series of the Preferred Stock and to any other class of Preferred Stock that hereafter may be issued by the Corporation as to the payment of dividends and the distribution of assets, unless the terms of any such series or class shall provide otherwise.

9. Fractional Shares. The Series B Preferred Stock may be issued in Units or other fractions of a share, which Units or fractions shall entitle the holder, in proportion to such holder's units or fractional shares, to exercise voting rights, receive dividends, participate in distributions and to have the benefit of all other rights of holders of Series B Preferred Stock.

10. Certain Definitions. As used in this resolution with respect to the Series B Preferred Stock, the following terms shall have the following meanings:

(A) The term "Common Stock" shall mean the class of stock designated as the common stock, par value $.001 per share, of the Corporation at the date hereof or any other class of stock resulting from successive changes or reclassification of the common stock.

(B) The term "junior stock" (i) as used in Section 3 shall mean the Common Stock and any other class or series of capital stock of the Corporation hereafter authorized or issued over which the Series B Preferred Stock has preference or priority as to the payment of dividends and (ii) as used in Section 5, shall mean the Common Stock and any other class or series of capital stock of the Corporation over which the Series B Preferred Stock has preference or priority in the distribution of assets on any liquidation, dissolution or winding up of the Corporation.

(C) The term "parity stock" (i) as used in Section 3 shall mean any class or series of stock of the Corporation hereafter authorized or issued ranking pari passu with the Series B Preferred Stock as to dividends and (ii) as used in Section 5, shall mean any class or series of capital stock ranking pari passu with the Series B Preferred Stock in the distribution of assets on any liquidation, dissolution or winding up.

IN WITNESS WHEREOF, SDL, Inc. has caused this Certificate to be signed by its Chairman and Chief Executive Officer and its Secretary this 14 day of November, 1997.

SDL, INC.

By: /s/ Donald R. Scifres
Name: Donald R. Scifres
Title: Chariman and Chief Executive Officer

By: /s/ John P. Melton
Name: John P. Melton
Title: Secretary

EXHIBIT 3.1.2

CERTIFICATE OF CORRECTION
OF
RESTATED CERTIFICATE OF INCORPORATION
OF SDL, INC.

SDL, Inc., a Delaware corporation (the "Corporation"), pursuant to Section 103(f) of the General Corporation Law of the State of Delaware, hereby certifies that:

1. the Restated Certificate of Incorporation of the Corporation (the "Restated Certificate of Incorporation") that was filed with the Secretary of State of Delaware on March 17, 1995 was an inaccurate record of the corporate action therein referred to;

2. the Restated Certificate of Incorporation was inaccurate in that paragraph E of Article XII thereof, relating to the power of the Board of Directors to make, alter or repeal the bylaws of the Corporation, was inadvertently omitted in its entirety; and

3. Paragraph E of Article XII of the Restated Certificate of Incorporation in its correct form as approved by the Board of Directors and by the stockholders of the Corporation, is as follows:

> "E. The board of directors is expressly authorized to make, alter, or repeal the bylaws of the Corporation."

IN WITNESS WHEREOF, the Corporation has caused this Certificate of Correction to be signed by its duly authorized officer this 8th day of December, 1997.

By: /s/ Donald R. Scifres

Donald R. Scifres
President

EXHIBIT 10.15

EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT ("Agreement") is entered into by and between Gregory P. Dougherty ("Employee") and SDL, Inc. (the "Company"), and is effective as of the 1st day of October, 1998 and supercedes any/all previous employment agreements.

The parties hereby agree as follows:

1. Period of Employment

The Company will employ Employee to render services to the Company in the position and with the duties and responsibilities described in Section 2, for the compensation specified in Sections 3 and 4 and for the period commencing on the effective date of this Agreement and ending on termination as provided in Section 5.

2. Position and Duties

Employee accepts employment with the Company as its Chief Operating Officer. As such, Employee shall have the responsibilities for the management and operations of the Company established for him from time to time by the Board of Directors.

3. Compensation

(a) Base Salary. Employee shall receive a base salary of $209,204 per year, payable in equal installments in accordance with the Company's current practices or as they may be amended. The foregoing base salary shall be subject to annual reviews each year during the term of the Agreement, as determined by the Board of Directors in its sole discretion.

(b) Annual Bonuses. The Board of Directors shall approve an annual operating plan for the Company. Employee shall receive cash bonuses in connection with each audit of the Company's results of operations conducted by the Company's independent certified public accountants. Such audits shall be conducted at least annually. Employee's bonuses shall be computed as provided in the matrix attached to this agreement as Exhibit A or other such criteria as determined by the SDL Board of Directors, provided that such bonuses shall be adjusted pro rata to reflect any audit period less than twelve (12) months. The Company's results of operations shall be determined by the Company's independent certified public accountants in accordance with generally accepted accounting principles applied consistent with the practice for prior periods and shall be accompanied by an audit report of such accountants, which shall be reasonably acceptable to the Company's Board of Directors. Such bonuses shall be calculated and paid within thirty (30) days following delivery of the audit report. Bonuses shall be deemed earned with respect to each fiscal year (or portion thereof) during which Employee has been employed hereunder as of the end of the fiscal period covered by the audit; such bonuses shall thereafter be paid on the dates set forth above, subject only to the determination of the Company's results of operations.

(c) Option Appreciation Guarantee. Offer letter dated February 21, 1997 states: "If at the end of your second complete year with SDL the options that you have been granted do not yield you $200,000 appreciation, SDL will make up the difference in cash. That is, if the options are below water SDL will pay $200,000 in cash less taxes. If the options are above water but their value is less than $200,000 above the exercise price, SDL will pay you the difference in cash less taxes. SDL will calculate the appreciation on the second anniversary of your option grant date based on a 3 day average of the last trade price as reported in the Wall Street Journal; day before, anniversary date, and day after." This agreement amends the above paragraph by adding the following sentence: Any such payout will actually occur on your tenth anniversary or termination from the Company for any reason, whichever comes first.

4. Benefits

(a) Employee will continue to receive benefits made generally available to employees of the Company. In addition, Employee shall receive in the future benefits generally made available to the Company's executives at a similar reporting level. The foregoing shall include stock option plan grants, with the number of shares, if any, covered by such grants determined by the Board of Directors in its sole discretion. The Company shall reimburse Employee for reasonable travel and other business expenses incurred by him in the performance of his duties hereunder in accordance with the Company's policies in this regard.

(b) During the term of this Agreement and for a period of six (6) months thereafter, the Company will maintain an insurance policy on Employee's life in an amount equal to his then-current base salary. The proceeds of the foregoing insurance policy shall be payable to such beneficiaries as Employee may designate from time to time or, in the absence of a designation, to his estate.

(c) New Loan. In the event Employee sells the Property and purchases a new residence, the Company agrees to enter into a new housing assistance loan (the "New Loan"), the terms of which will be the same in all material respects to the terms of Housing Assistance Loan, including but not limited to the terms related to the on-going loan repayment obligations of Employee and the repayment obligations of Employee in the event of termination by the Company, provided, however, that (i) at the time of the close of escrow for the new residence, the Employee must be currently employed at the Company, (ii) the amount of the New Loan will be equal to the price of the new residence minus $228,000, but in no event shall it exceed the amount outstanding under the Note at the time such amount became due and payable and (iii) the New Loan will be due and payable on the tenth anniversary of the date of the Note.

(d) See attached "Addendum, Terms of Employment Offer" Section 1)(d)(iii) under "Relocation Package" in the attached "Addendum, Terms of Employment Offer" dated February 21, 1997 is amended to read as follows: Dollar forgiveness on the anniversary of your employment date

1999	$40,000 -	2nd Anniversary
2000	$40,000 -	3rd Anniversary
2001	$40,000 -	4th Anniversary
2002	$80,000 -	5th Anniversary
2003	$40,000 -	6th Anniversary
2004	$40,000 -	7th Anniversary
2005	$40,000 -	8th Anniversary
2006	$40,000 -	9th Anniversary
2007	$40,000 -	10th Anniversary

5. Termination

In addition to the terms of termination defined in the "Addendum, Terms of Employment Offer" (see attached) the following will apply.

(a) Employee's employment by the Company hereunder shall be terminable by either Employee or the Company at any time and for any reason, with or without cause, effective upon written notice to the other party. Upon termination of employment the employee shall be deemed to have resigned from all offices and directorships then held with the Company or any affiliate.

(b) In the event the Company terminates Employee's employment pursuant to subsection (a) above other than for cause (as defined below), or the Employee resigns following a reduction in base pay and bonus when said reduction is not in conjunction with similar reductions in base pay and bonus with other Senior Executives or employee is no longer in the role of Chief Operating Officer or at least equivalent position, Employee shall be entitled to the following benefits:

(i) An amount, payable monthly for six (6) months, commencing on the effective date of termination of the Employee's employment equal to his then current monthly base salary;

(ii) Accelerated vesting, for six (6) additional months from the effective date of termination, under all outstanding stock options then held by Employee; and

(iii) An amount, payable monthly for six (6) months commencing on the effective date of termination of Employee's employment equal to 4.1667% of his then current annual base salary

(iv) For a period of six (6) months following the termination of Employee's employment pursuant to this Agreement, the Company will pay the cost to maintain medical benefits under COBRA, provided that Employee will continue to pay the amount he paid for medical insurance prior to such termination and provided the employee adheres to the terms of COBRA.

(v) $200,000 of "Housing Assistance Loan" described in the Terms of Offer dated February 21, 1997 will be forgiven if termination occurs during the first 5 years of employment at SDL and the balance of the loan is due upon close of escrow on the house repurchase or within 1 year which ever comes first,

(vi) At your option, SDL can repurchase your CA house, within 1 year of your termination date, at the higher of original purchase price or appraised value at the time of termination or you will need to pay the balance of the loan within 1 year.

(c) If Employee terminates his employment pursuant to this Agreement in accordance with Section 5(a), or if the Company terminates Employee's employment pursuant to Section 5(a) for cause (defined as willful breach of duty in the course of employment or habitual neglect of duty or continued inability to perform it), continued inability to perform it shall not include performance results, unwillingness to move (more than 100 miles)/accept transfer or unwillingness to accept excessive travel or any reasons/circumstances resulting from illness in family or child care, the following shall apply:

(i) No further salary shall be payable to Employee, except for amounts accruing prior to the termination date;

(ii) No further vesting of Employee's stock options or stock purchase, or similar rights shall occur; and

(iii) No further bonuses shall be payable pursuant to Section 3(b).

(iv) No forgiveness of the $200,000 "Housing Assistance Loan will be provided,

(v) "Housing Assistance Loan' balance in full is payable with 1 year, or upon sale of house whichever occurs first.

(d) Subsequent to the termination of Employee's employment hereunder, the payments and benefits provided for in Sections 4(b) and subsections 5 (b) (i), (ii), (iii) and (iv) shall terminate at such time, if any, as Employee commences employment.

(e) This Agreement shall terminate upon Employee's death or permanent disability. In such event, Employee (or his estate) shall be entitle to receive the benefits provided for under Section 5(b).

6. Miscellaneous

(a) Notices under this Agreement shall be in writing and shall be deemed given when delivered in person or three (3) days after deposit in the United States Mail, postage prepaid, certified or return receipt requested, and addressed as follows:

If to Employee:	NAME STREET ADDRESS CITY, STATE, ZIP
If to the Company:	80 Rose Orchard Way San Jose, California 95134 Attention: Corporate Secretary

The foregoing addresses may be changed by notice in accordance with this subsection (a).

(b) The prevailing party in any action to enforce the terms of this Agreement shall be entitled to reimbursement from the other party for its costs and expenses (including reasonable attorneys' fees) in connection therewith.

(c) The terms of this Agreement are intended by the parties to be the final expression of their agreement with respect to the employment of Employee by the Company and may not be contradicted by evidence of any prior or contemporaneous agreement. The parties further intend that this Agreement shall constitute the complete and exclusive statement of its terms and that no extrinsic evidence whatsoever may be produced in any legal proceeding involving this Agreement. This Agreement may be amended, and the observance of any of its terms may be waived, only by a writing signed by the party to be charged with such amendment or waiver.

(d) If any provision of this Agreement, or the application thereof to any person, place or circumstance, shall be held by a court of competent jurisdiction to be invalid, unenforceable or void, the remainder of this Agreement and such provisions as applied to other persons, places and circumstances shall remain in full force and effect.

(e) The validity, interpretation, enforceability and performance of this Agreement shall be governed by and construed in accordance with the laws of the State of California, without regard to its rules regarding conflicts of laws.

(f) Employee agrees that all disputes between him and the Company (including all affiliates, shareholders, directors, officers, employees, consultants, agents, successors and assigns), which arise during Employee's employment or after, will be resolved by arbitration. The arbitration will be conducted by a single arbitrator. The arbitrator will be selected and the arbitration conducted pursuant to the Employment Dispute Resolution rules of the American Arbitration Association (AAA). The arbitration agreement covers all disputes arising from Employee's employment, including (1) claims for wages, benefits or compensation, (2) all tort and contract claims of any kind, including disputes concerning this Agreement, and (3) claims based on any federal or state law, including discrimination, harassment or retaliation laws. For example, this arbitration agreement includes claims arising under Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Americans with Disabilities Act, and the California Fair Employment and Housing Act. The only claims not covered by this arbitration agreement are workers' compensation and unemployment compensation claims, and the Company may, at its option, seek injunctive relief, equitable relief and damages in court for any breach of this Invention and Proprietary Information Agreement, any other agreement, or any federal or state law, concerning Proprietary Information or Inventions. Except as provided in the previous sentence, arbitration is the exclusive remedy for all disputes covered by this arbitration agreement, including whether a particular dispute is covered by this agreement, and shall be final and binding on both parties, which means that BOTH EMPLOYEE AND THE COMPANY WAIVE ANY RIGHT TO A JURY TRIAL. Either Employee or the Company may bring an action in court to compel arbitration and to enforce an arbitration award. Otherwise, neither party shall initiate or prosecute any lawsuit or administrative action in any way related to any dispute covered by the arbitration agreement. The Federal Arbitration Act shall govern the interpretation and enforcement of this arbitration agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed as of the date first set forth above.

EMPLOYEE	SDL, INC.
By /s/ Gregory P. Dougherty	By /s/ Donald R. Scifres

EXHIBIT 13.1

SELECTED FINANCIAL DATA

The following selected financial data of the Company is qualified by reference to and should be read in conjunction with the consolidated financial statements of the Company, including the notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations.

<TABLE>
<CAPTION>

	Years Ended December 31,				
	1998(2)	1997(1)(2)(3)	1996	1995(1)	1994
	(in thousands, except per share data)				
<S>	<C>	<C>	<C>	<C>	<C>
Statement of operations data:					
Revenue	$106,138	$91,364	$82,475	$53,894	$33,024
Cost of revenue	68,419	65,154	54,956	33,390	19,991
Gross margin	37,719	26,210	27,519	20,504	13,033
Research and development	10,690	9,794	6,681	3,994	2,781
Selling, general, and administrative	13,597	40,609	12,166	7,649	4,574
In-process research and development	--	753	--	10,010	--
Amortization of purchased intangibles and goodwill	777	671	--	--	--
Operating income (loss)	12,655	(25,617)	8,672	(1,149)	5,678
Net income (loss)	$12,823	($24,679)	$7,121	($2,819)	$2,195
Net income (loss) per share-basic	$0.92	($1.83)	$0.59	($0.31)	$0.38
Net income (loss) per share-diluted	$0.87	($1.83)	$0.54	($0.31)	$0.29
Weighted average shares-basic	13,887	13,497	12,012	9,228	5,738
Weighted average shares-diluted	14,709	13,497	13,199	9,228	7,461

<CAPTION>

	As of December 31,				
	1998	1997	1996	1995(1)	1994
	(in thousands)				
<S>	<C>	<C>	<C>	<C>	<C>
Balance sheet data:					
Working capital	$54,358	$36,012	$63,243	$22,649	$5,556
Total assets	112,477	94,224	113,842	56,643	23,799
Long-term debt (less current portion)	--	--	--	--	22,519
Convertible redeemable preferred stock	--	--	--	--	10,545
Stockholders' equity (net capital deficiency)	$93,247	$76,587	$99,227	$40,500	($18,269)

</TABLE>

----

(1) The results of operations for the years ended December 31, 1995 and 1997 include a one-time write-off of in-process research and development of approximately $10 million and $0.8 million,

respectively, in connection with the acquisition of Seastar Optics and Mr. Laser, Inc.

(2) In 1997, the Company changed from a calendar year end to a 52-53 week year ending on the Friday closest to December 31. Fiscal year 1998 and 1997 ended January 1, 1999 and January 2, 1998, respectively. For ease of discussion and presentation all fiscal year ends are referred to as ending on December 31.

(3) The results of operations for the year ended December 31, 1997 include a one-time charge totaling $27.5 million related to costs associated with the litigation settlement and related legal costs of the Spectra-Physics legal dispute.

Risk Factors

The statements contained in this annual report that are not purely historical are forward-looking statements within the meaning of Section 27(a) of the Securities Act of 1993 and Section 21(e) of the Securities and Exchange Act of 1934, including statements regarding the Company's expectations, hopes, beliefs, intentions, plans or strategies regarding the future. Forward-looking statements include: the statement on page 1 regarding SDL's products playing a leading role in helping to light the way; the statements on page 9 regarding migration to DWDM, projected compound annual growth of more than 100% for DWDM systems over the next five years, and predicted growth of the market for DWDM components to more than $4 billion in 2000 and $12 billion in 2005; the statement on page 1 regarding DWDM system channels to come on the horizon; the statements under the heading "To Our Stockholders" regarding the Company's excellent position to take advantage of expanding market opportunities; the forecasted five-fold expansion by the year 2000 of the primary communications market that SDL serves, SDL's primary market to have grown to at least $8 billion by 2002, the fueling of SDL's growth by optical amplifier and multiwave transmitter applications, SDL's pump modules being well positioned to meet the advanced needs of the DWDM market place, new opportunities in 1999, and the future and prospects for SDL; statements on page 19 regarding SDL's movement up the integration chain; statements under "Management's Discussion and Analysis of Financial Condition and Results of Operation" ("MD&A") under the heading "Provision for Income Taxes" regarding generation of future taxable income sufficient to realize the benefit of SDL's net deferred tax assets recorded; statements in MD&A under the heading "Liquidity and Capital Resources" regarding the Company's expected expenditures for capital equipment purchases and leasehold improvements in 1999 and the sufficiency of the Company's current cash balances, cash generated from operations and cash available through equity markets for the foreseeable future; and statements in MD&A under the heading "Impact of Year 2000" regarding the Company's plans to have changes to critical systems completed and tested by mid-1999, the expected burden of remediation of the Company's tertiary business information systems, material exposure to contingencies related to the year 2000 issue, continuance of contingency planning activities throughout 1999, expenditures related to the year 2000 issue and capitalization and expensing thereof, the sufficiency of operating activities to fund year 2000 costs and management's beliefs about the impact of year 2000 matters on the Company's financial condition and overall results of operations. All forward-looking statements included in this document are based on information available to the Company on the date hereof and the Company assumes no obligation to update any such forward-looking statement. It is important to note that the Company's actual results could differ materially from those in such forward-looking statements. Among the factors that could cause actual results to differ materially are the factors detailed. You should consult the risk factors listed from time to time in the Company's Reports on Forms 10-Q and 8-K.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SDL designs, manufactures and markets semiconductor lasers, fiber optic related products and optoelectronic systems. Since 1996, the Company strategy has strongly focused on providing solutions for optical communications. The Company's optical communications products power the transmission of data, voice and Internet information over fiber optic networks to meet the needs of telecommunications, dense wavelength division multiplexing, cable television and satellite communications applications. With the increased focus on commercial communications products, the proportion of SDL's revenue derived from U. S. government related projects has declined from 43% in 1996 to 28% in 1998. SDL's optical products also serve a wide variety of non-communications applications, including materials processing, printing, medical and scientific instrumentation. From the original products introduced in 1984, the Company has expanded its product offering to over 200 standard products in addition to providing custom design and packaging for OEM customers. The Company's revenue also includes revenue from customer-funded research programs.

Because of the diversity of products, customers and applications, gross margins tend to fluctuate based in part on the mix of revenue in each reported period. SDL's revenue growth in 1997-1998 was constrained by a shortage in qualified manufacturing capacity, especially in the wafer fabrication area. The Company's new wafer fabrication facility received full qualification in June 1998, allowing a faster ramp-up in production.

In 1997, the Company changed its year-end from a calendar year ending December 31, to a 52-53 week year ending on the Friday closest to December 31. The Company's fiscal 1998 and 1997 ended January 1, 1999 and January 2, 1998, respectively. For ease of discussion and presentation, all fiscal year ends are referred to as ending on December 31.

Certain of the statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations are forward-looking statements regarding the Company's business, operations and prospects. The Company's actual results could differ materially from those in such forward-looking statements. See "Factors Affecting Earnings and Stock Price."

The following table sets forth certain operating results expressed as a percentage of total revenue for the periods indicated.

<TABLE>
<CAPTION>

	Years Ended December 31,		
	1998	1997(1)(2)	1996
<S>	<C>	<C>	<C>
Revenue:			
Product revenue	90.8%	84.0%	84.6%
Research revenue	9.2%	16.0%	15.4%
Total revenue	100.0%	100.0%	100.0%
Cost of revenue:			
Cost of product revenue (3)...........	63.2%	69.7%	65.0%
Cost of research revenue (3)..........	76.9%	79.6%	75.5%
Total cost of revenue	64.5%	71.3%	66.6%
Gross margin	35.5%	28.7%	33.4%
Operating expenses:			
Research and development	10.1%	10.7%	8.1%
Selling, general, and administrative..	12.7%	44.4%	14.0%
In-process research and development...	--	0.8%	--

Amortization of purchased intangibles and goodwill	0.8%	0.8%	0.8%
Total operating expense	23.6%	56.7%	22.9%
Operating income (loss)	11.9%	-28.0%	10.5%
Interest income and other, net	1.1%	1.5%	1.8%
Income (loss) before income taxes	13.0%	-26.5%	12.3%
Provision for income taxes	1.0%	0.5%	3.7%
Net income (loss)	12.0%	-27.0%	8.6%

</TABLE>

----

(1) The results of operations for the years ended December 31, 1997 include a one-time write-off of in-process research and development of approximately $0.8 million in connection with the acquisition of Mr. Laser, Inc.

(2) The results of operations for the year ended December 31, 1997 includes a one-time charge of $27.5 million related to costs associated with the litigation settlement and related legal costs of the Spectra Physics legal dispute.

(3) Cost of product revenue and cost of research revenue are stated as a percentage of product revenue and research revenue, respectively.

Results of Operations

Revenue. The Company recorded a 16 percent increase in revenue to $106.1 million during 1998, following an 11 percent increase in 1997 revenue to $91.4 million. Product revenue reported in 1998 increased 26 percent or $19.6 million, following a 10 percent or $7.0 million increase in 1997. The 1998 and 1997 increases in product revenue resulted primarily from growth in dense wavelength division multiplexing (DWDM) product sales caused by a continued strong demand for SDL's 980nm pump module. Research revenue decreased 33 percent or $4.8 million during 1998 as a result of the Company continuing to focus on commercial product opportunities. Research revenue grew 15 percent during 1997 and accounted for 16 percent and 15 percent of revenue for 1997 and 1996, respectively. There can be no assurances that the applications markets for SDL's products will grow in future periods at historical percentages. Further, there can be no assurances that the Company will be able to increase or maintain its market share in the future or to sustain historical growth rates.

The Company derived 28 percent, 38 percent, and 43 percent of its 1998, 1997 and 1996 revenue, directly or indirectly from a variety of Federal government sources. The demand for certain of the Company's services and products is directly related to the level of funding of government programs. The Company believes that the success and further development of its government business is dependent, in significant part, upon the continued existence and funding of such programs and upon the Company's ability to participate in such programs. For example, a majority of the Company's research revenue for 1998, 1997, and 1996 was funded by Federal programs. There can be no assurances that such programs will continue to be funded even if government agencies have available financial resources or that the Company will continue to be awarded contracts under such programs.

Approximately 14 percent, 19 percent, and 21 percent of 1998, 1997 and 1996 revenue was received from Lockheed-Martin through numerous government and commercial programs. Most of the revenue from Lockheed-Martin during this three year period was, and during 1999 is expected to be, derived from Federally-funded programs, which are subject to renewal every one or two years and to termination for convenience by the government agency. It is expected that revenue received under these current Lockheed-Martin programs will continue to decrease as a percentage of the Company's total revenue. However, a loss of the Company's contracts or failure to win new contracts with Lockheed-Martin could have an adverse effect on the Company's results of operations.

Revenues from customers outside of the United States represented 24 percent, 17 percent, and 15 percent of total revenue for 1998, 1997, and 1996, respectively. The 1998 growth was primarily within the European region, due to the growth in the communications market business, where revenue increased 98 percent compared to 1997.

Gross margin. Gross margin as a percentage of revenue was 36 percent in 1998, compared to 29 percent and 33 percent for 1997 and 1996, respectively. The increase in gross margin during 1998 as compared to 1997 resulted from: (i) increased yields and volumes from the new wafer fab and reduction of costs related to the 980nm pump module, and (ii) a more favorable mix in the ratio of commercial product revenue as compared to revenue derived from U.S. government sources. The decline in gross margin during 1997 as compared to 1996 primarily resulted from: (i) start-up costs for expansion of the Company's wafer fab and transition of the various product lines to the new fabrication equipment, and (ii) changes in estimable reimbursable costs in the June quarter.

The Company's gross margin can be affected by a number of factors, including product mix, customer mix, applications mix, pricing pressures and product yield. Generally, the cost of newer products has tended to be higher as a percentage of product revenue than that of more mature, higher volume products. In addition, the cost of research revenue is significantly higher as a percentage of revenue, as research revenue is typically based on costs incurred rather than market pricing. Considering these factors, gross margin fluctuations are difficult to predict and there can be no assurance that the Company will achieve or maintain gross margins at historical levels in future periods.

Research and development. The Company's future results depend, to a considerable extent, on its ability to maintain a competitive advantage in the products it provides. For this reason, SDL believes it is critical to continue to make investments in research and development to promote the flow of innovative, productive, and high-quality products. Research and development increased to $10.7 million compared to $9.8 million and $6.7 million during 1998, 1997 and 1996, respectively. Research and development as a percentage of revenue was 10 percent, 11 percent and 8 percent in 1998, 1997 and 1996, respectively. The 1998 research and development emphasis has been to bring new communication products to market. The 1997 research and development spending was on manufacturing process development efforts, together with the development of new communications and laser system products.

The Company is committed to continuing its significant research and development expenditures and expects that the absolute dollar amount of research and development expenses will increase as it invests in developing new products, expanding and enhancing its existing product lines, and reducing its costs, although research and development expenses may vary as a percentage of revenue.

Selling, general and administrative (SG&A). Selling, general and administrative (SG&A) expense of $13.6 million or 13 percent of revenue represents a decrease of $27.0 million or 44 percent of revenue from 1997. Excluding non-recurring amounts of approximately $27.5 million for the settlement and related legal costs incurred in 1997 for the Spectra-Physics vs. SDL, Inc. legal dispute, SG&A increased $0.5 million and $1.6 million from 1997 and 1996, respectively. Excluding non-recurring amounts, the increase in SG&A expense during 1998 was primarily due to continued expansion of the Company's sales and marketing staff and the commencement of the implementation process for the Company's new enterprise resource planning software. The Company expects that SG&A amounts, exclusive of the settlement and related legal costs, will continue to increase to support the Company's current and expected future volumes of business, including the expansion of SDL's domestic and international sales and marketing efforts. However, there can be no assurances that current SG&A levels as a percentage of total revenue are indicative of future SG&A as a percentage of total revenue.

In-process research and development. The acquisition of Mr. Laser, Inc. during 1997 resulted in the write-off of purchased in-process research and development of $0.8 million. In the future, additional in-process research and development write-offs can be anticipated as the Company may from time to time acquire companies or new product lines.

Amortization of purchased intangibles and goodwill. Amortization expense of $777,000 represents an increase of $106,000 and $132,000 compared to 1997 and 1996, respectively. The increase in 1998 compared to 1997 and 1996 is a result of the acquisition of Mr. Laser in November 1997.

Interest income, net. Interest income decreased slightly during 1998 compared to 1997 as result of lower average cash and investment balances during 1998. During 1997, the Company liquidated a portion of its interest income generating investments for payment of $27.5 million in settlement and related legal costs associated with the resolution of the Spectra-Physics legal dispute. The early liquidation of certain of these investment securities resulted in a realized loss of approximately $0.3 million, which is included within interest income on the statement of operations. Excluding that loss, interest income recorded during 1997 increased slightly from that recorded during 1996.

Provision for Income Taxes. The income tax provision for the years ending December 31, 1998 and December 31, 1997 of $1.0 million and $0.4 million, respectively, consist primarily of current foreign income taxes for the earnings of SDL Optics and federal and state minimum taxes. The federal and state tax provisions were reduced due to the utilization of previously unbenefitted net operating loss carryforwards. The deferred income tax benefit for 1998 and 1997 has been limited because realization of the deferred tax asset is dependent upon future taxable income, the amount and timing of which are uncertain. Accordingly, a partial valuation allowance has been established to record a net deferred tax asset that the Company believes is more likely than not to be realized.

The effective tax rate for the year ending December 31, 1996 was 30%. This rate was lower than the statutory rate due primarily to the benefits of State tax credits and tax-exempt interest income.

Although realization is not assured, the Company believes that it will generate future taxable income sufficient to realize the benefit of the $4.0 million of net deferred tax assets recorded. The amount of the net deferred tax assets considered realizable could be reduced or increased in the near term if estimates of future taxable income are changed. Management intends to evaluate the realizability of the net deferred tax assets on a quarterly basis to assess the need for the valuation allowance.

Quarterly Results of Operations

The following tables set forth certain unaudited quarterly financial data for the four quarters of each 1998 and 1997. The Company believes that all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts below to present fairly the selected quarterly information when read in conjunction with the Financial Statements and the Notes thereto included elsewhere herein. The results of operations for any quarter are not necessarily indicative of results that may be expected for any future period or for the entire year.

<TABLE>
<CAPTION>

	Quarters Ended	
	1998	1997

	Mar. 31	June 30	Sept. 30	Dec. 31	Mar. 31	June 30(1)	Sept. 30	Dec. 31(2)
Revenue	$25,357	$25,810	$25,571	$29,400	$21,016	$21,570	$23,951	$24,827
Cost of revenue ...	17,150	16,895	16,342	18,032	14,018	18,333	16,325	16,478
Gross margin	$8,207	$8,915	$9,229	$11,368	$6,998	$3,237	$7,626	$8,349
Operating income (loss)	$2,646	$2,832	$3,015	$4,162	$104	($29,577)	$2,324	$1,532
Net income (loss)..	$2,699	$2,906	$3,099	$4,119	$507	($29,471)	$2,451	$1,834
Net income (loss) per share-basic..	$0.20	$0.21	$0.22	$0.29	$0.04	($2.19)	$0.18	$0.13
Net income (loss) per share-diluted	$0.19	$0.20	$0.21	$0.28	$0.04	($2.19)	$0.17	$0.13
Weighted average shares-basic	13,708	13,830	13,882	14,125	13,331	13,462	13,546	13,643
Weighted average shares-diluted...	14,545	14,700	14,666	14,925	14,265	13,462	14,431	14,444

---

(1) The results of operations for the quarter ended June 30, 1997 include a one-time charge totaling $27.5 million for the settlement and related legal costs associated with the Spectra-Physics vs. SDL, Inc. legal dispute.

(2) The results of operations for the quarter ended December 31, 1997 include a one-time write-off of in-process research and development of approximately $0.8 million in connection with the acquisition of Mr. Laser, Inc.

Liquidity and Capital Resources.

The Company generated $12.6 million of cash from operating activities during 1998 principally from net income from operations adjusted for non-cash depreciation and amortization changes. These were offset by an increase in accounts receivables and inventories. In addition, the Company received $3.5 million for the issuance of stock under employee stock plans, which was offset by investments of $13.4 million for facilities expansion and capital equipment purchases. As a result cash, cash equivalents, and marketable securities increased from $26.6 million at December 31, 1997 to $29.4 million at December 31, 1998.

The payment of settlement and related legal costs of $27.5 million to conclude the Spectra-Physics legal dispute resulted in the use of cash by operating activities for the year ended December 31, 1997. An increase in accounts receivable in 1997, as compared with 1996, also contributed to a use of operating cash in 1997. In addition, the Company received $2.1 million from the issuance of stock under employee stock plans, which was offset by investments of $9.4 million for facilities expansion and capital equipment purchases and a cash payment of $2.7 million which completed the SDL Optics acquisition. As a result, cash, cash equivalents, and marketable securities decreased from $58.3 million at December 31 1996 to $26.6 million at December 31, 1997.

The Company currently expects to spend in the range of $18 million to $20 million for capital equipment purchases and leasehold improvements during 1999.

The Company believes that current cash balances, cash generated from operations, and cash available through the bank and equity markets will be sufficient to fund capital equipment purchases, acquisitions of complementary businesses, products or technologies and working capital requirements for the foreseeable future. However, there can be no assurances that events in the future will not require the Company to seek additional capital sooner or, if so required, that adequate capital will be available on terms acceptable to the Company.

Impact of Year 2000

Like many other companies, the year 2000 computer issue creates risks for SDL. Some of the Company's older computer programs were written using two digits rather than four to define the applicable year. As a result, those computer programs have time-sensitive software that recognize a date using "00" as the year 1900 rather than the year 2000. If internal systems do not correctly recognize and process date information beyond the year 1999, there could be a material adverse impact on the Company's business and results of operations.

To address these year 2000 issues within its internal systems, the Company has established a task team and initiated a comprehensive program designed to deal with the most critical systems first. Assessment and remediation are proceeding in tandem, and the Company currently plans to have changes to critical systems completed and tested by mid-1999. These activities are intended to encompass all systems software applications in use by the Company, including front and back-end manufacturing, facilities, sales, finance and human resources.

As newer, more functional software solutions are currently available and are Year 2000 compliant, the Company has concluded that the conversion to enterprise resource planning software programs supporting the Company's manufacturing, finance, distribution / logistics and human resource operations is more cost effective. The project is estimated to be completed during the quarter ended June 30, 1999. In addition, as a contingency plan, the Company's existing management information software applications have been successfully upgraded to a year 2000 compliant version.

Assessment and remediation of year 2000 issues in tertiary business information systems is on-going. Well over 80% of the Company's investment in desktop PC hardware is known to be year 2000 compliant. Additionally, the Company has concluded that the purchase of newer, more functional software for its network server applications is more cost effective than upgrading its existing software to a year 2000 compliant version. Completing the remediation of the Company's tertiary business information systems is not expected to be a significant burden on the Company.

To date, based on its current manufacturing process, SDL believes it has no material exposure to contingencies directly related directly to the Year 2000 issue for the products it has sold or will sell in the future.

SDL is also actively working with critical suppliers of products and services to determine that the suppliers' operations and the products and services they provide are year 2000 compatible or to monitor their progress toward year 2000 compatibility. In addition, the Company has commenced work on various types of contingency planning to address potential problem areas with internal systems and with suppliers and other third parties. It is expected that assessment, remediation and contingency planning activities will be on-going throughout 1999 with the goal of appropriately resolving all material internal systems and third party issues.

The costs incurred to date related to these programs are less than $1.9 million. The Company currently expects that the total cost of these programs, including both incremental spending and redeployed resources, will total approximately $2.8 million, more or less, which includes $1.8 million for the purchase of new software and hardware that will be capitalized and $1.0 million that will be expensed as incurred. The Company expects that operating activities will fund the year 2000 costs.

In some instances, the installation schedule of new software and hardware in the normal course of business is being accelerated to also afford a solution to year 2000 capability issues. The Company has not delayed any non year 2000 projects. The costs of these projects and dates on which the Company believes it will complete the year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources and other factors.

Based on currently available information, management does not believe that the year 2000 matters discussed above related to internal systems or products sold to customers will have a material adverse impact on the Company's financial condition or overall trends in results of operations; however, it is uncertain to what extent the Company may be affected by such matters. Any failure to timely, successfully and cost-effectively assess, remediate and resolve the Company's year 2000 issues, including those regarding its own as well as suppliers' and third parties' internal systems, products, services and contingency plans, may have a material adverse effect on the Company's business and results of operations. The Company is continuing its efforts to ensure year 2000 readiness, and there can be no assurance that there will not be new year 2000 issues not identified above and significant delays in or increased costs associated with such efforts which could have a material adverse effect on the Company's business and results of operations.

Interest Rate Risk

The Company's cash equivalents and short-term and long-term marketable securities are subject to market risk and changes in interest rates. The Company's marketable securities are managed by outside professional managers within guidelines established by the Company. The guidelines, which include security type, credit quality, and maturity, are intended to limit market risk by restricting the Company's high quality debt instruments. The Company's investments in debt securities are classified as available-for-sale; therefore, gains and losses due to changes in interest rates are included in other accumulated comprehensive income unless such securities are sold prior to maturity. The Company generally holds securities until maturity and carries the securities at fair value.

SDL, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

<TABLE>
<CAPTION>

	As of December 31,	
	1998	1997
<S>	<C>	<C>
ASSETS		
Current Assets:		
Cash and cash equivalents	$13,370	$4,593
Short-term investments	12,494	10,400
Accounts receivable, net	22,070	19,960
Inventories	19,679	13,938
Prepaid expenses and other current assets	3,306	2,738
Total current assets	70,919	51,629
Property and equipment, net	32,931	26,298
Long-term investments	3,552	11,613
Note due from related party	512	536
Other assets	4,563	4,148

	1998	1997
Total assets	$112,477	$94,224
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$9,385	$8,469
Accrued payroll and related expenses	2,354	2,945
Income taxes payable	1,890	828
Unearned revenue	643	393
Other accrued liabilities	2,289	2,982
Total current liabilities	16,561	15,617
Long-term liabilities	2,669	2,020
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value: Authorized shares - 1,000,000; none issued	--	--
Common stock, $0.001 par value: Authorized shares - 21,000,000; issued and outstanding shares - 14,285,938 and 13,674,534 in 1998 and 1997, respectively	15	14
Additional paid-in capital	120,033	116,268
Accumulated other comprehensive income	(4)	(73)
Accumulated deficit, $26.3 million relating to the repurchase of common stock in 1992 and $5.8 million relating to a recapitalization in 1992	(26,757)	(39,580)
	93,287	76,629
Less common stockholders' notes receivable	(40)	(42)
Total stockholders' equity	93,247	76,587
Total liabilities and stockholders' equity	$112,477	$94,224

</TABLE>

See accompanying notes.

SDL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

<TABLE>
<CAPTION>

<S>	Years Ended December 31, 1998 <C>	1997 <C>	1996 <C>
Revenue:			
Product revenue	$96,358	$76,750	$69,772
Research revenue	9,780	14,614	12,703
Total revenue	106,138	91,364	82,475
Cost of revenue:			
Cost of product revenue	60,898	53,523	45,365
Cost of research revenue	7,521	11,631	9,591
Total cost of revenue	68,419	65,154	54,956
Gross margin	37,719	26,210	27,519
Operating expenses:			
Research and development	10,690	9,794	6,681
Selling, general, and administrative	13,597	40,609	11,521

In-process research and development...	--	753	--
Amortization of purchased intangibles and goodwill.........................	777	671	645
Total operating expense	25,064	51,827	18,847
Operating income (loss)	12,655	(25,617)	8,672
Interest income and other, net	1,211	1,355	1,501
Income (loss) before income taxes	13,866	(24,262)	10,173
Provision for income taxes	1,043	417	3,052
Net income (loss)	$12,823	($24,679)	$7,121
Net income (loss) per share-basic	$0.92	($1.83)	$0.59
Net income (loss) per share-diluted	$0.87	($1.83)	$0.54
Number of weighted average shares-basic	13,887	13,497	12,012
Number of weighted of average shares-diluted	14,709	13,497	13,199

</TABLE>

See accompanying notes.

SDL, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except share data)

<TABLE>
<CAPTION>

	Common Stock		Additional Paid-in Capial	Accumulated Other Comprehensive Income	Accumulated Deficit	Stockholder's Notes Receivable	Total Stockholders' Equity
	Shares	Amount					
<S>	<C>	<C>	<C>	<C>	<C>	<C>	<C>
Balance at, December 31, 1995.	10,628,115	$11	$62,995	($6)	($22,022)	($478)	$40,500
Net income	--	--	--	--	7,121	--	7,121
Unrealized loss on investments...............	--	--	--	(44)	--	--	(44)
Comprehensive income........							7,077
Issuance of stock pursuant to employee stock plans	921,168	--	1,509	--	--	--	1,509
Proceeds from issuance of common stock (less offering expenses of $362)	1,755,000	2	44,650	--	--	--	44,652
Issuance of treasury stock	1,827	--	33	--	--	--	33
Payments on stockholders' notes receivable	--	--	--	--	--	222	222
Income tax benefit from exercise of employee stock options	--	--	5,234	--	--	--	5,234
Balance at, December 31, 1996.	13,306,110	13	114,421	(50)	(14,901)	(256)	99,227
Net loss	--	--	--	--	(24,679)	--	(24,679)

Unrealized loss on investments	--	--	--	(23)	--	--	(23)
Comprehensive loss							(24,702)
Issuance of stock pursuant to employee stock plans	368,424	1	1,847	--	--	--	1,848
Payments on stockholders' notes receivable	--	--	--	--	--	214	214
Balance at, December 31, 1997	13,674,534	14	116,268	(73)	(39,580)	(42)	76,587
Net income	--	--	--	--	12,823	--	12,823
Unrealized gain on investments	--	--	--	69	--	--	69
Comprehensive income							12,892
Issuance of stock pursuant to employee stock plans	611,404	1	3,547	--	--	--	3,548
Payments on stockholders' notes receivable	--	--	--	--	--	2	2
Income tax benefit from exercise of employee stock options	--	--	218	--	--	--	218
Balance at, December 31, 1998	14,285,938	$15	$120,033	($4)	($26,757)	($40)	$93,247

</TABLE>

See accompanying notes.

SDL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOW

(In thousands)

<TABLE>
<CAPTION>

	Years Ended December 31,		
	1998	1997	1996
Operating activities			
Net income (loss)	$12,823	($24,679)	$7,121
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	7,583	5,800	4,948
In-process research and development	--	753	--
Deferred income taxes	(948)	--	(223)
Changes in operating assets and liabilities:			
Accounts receivable	(2,110)	(8,076)	1,719
Inventories	(5,741)	(485)	(4,435)
Accounts payable	916	1,599	520
Accrued payroll and related expenses	(591)	730	195
Income taxes payable	1,280	2,392	--
Unearned revenue	250	(62)	(517)
Other accrued liabilities	(693)	339	(135)
Other	(139)	435	2,879
Total adjustments	(193)	3,425	4,951

Net cash provided by (used in) operating activities	12,630	(21,254)	12,072
Investing activities			
Acquisition of property and equipment, net	(13,439)	(9,407)	(9,909)
Purchase of marketable securities	(75,838)	(57,064)	(100,620)
Sales and maturities of marketable securities	81,874	90,707	53,413
Acquisition of Businesses	--	(3,055)	(1,560)
Net cash provided by (used in) investing activities	(7,403)	21,181	(58,676)
Financing activities			
Issuance of stock pursuant to employee stock plans	3,548	1,847	1,509
Payments on stockholders' notes receivable	2	214	222
Proceeds from issuance of common stock	--	--	44,652
Reissuance of treasury stock	--	--	33
Net cash provided by financing activities	3,550	2,061	46,416
Net increase (decrease) in cash and cash equivalents	8,777	1,988	(188)
Cash and cash equivalents at beginning of year	4,593	2,605	2,793
Cash and cash equivalents at end of year	$13,370	$4,593	$2,605
Supplemental disclosures of cash flow information			
Cash paid for income taxes	$803	$1	$170
Cash received from income taxes refunded	$214	$1,941	$773

</TABLE>

See accompanying notes.

SDL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Organization

SDL, Inc. (the Company), a Delaware corporation, designs, manufactures, and markets semiconductor lasers, fiber optic related products, and optoelectronic systems. The Company's revenue is derived from: (i) the sale of standard and customized products to a diverse worldwide customer base utilizing various market applications and, (ii) customer-funded research programs, principally through various government agencies.

Basis of Presentation

The consolidated financial statements include the accounts of SDL, Inc. and its wholly-owned subsidiary, SDL Optics, Inc. Intercompany accounts and transactions have been eliminated in consolidation. The functional currency of the Company's foreign subsidiary is the U.S. dollar. Subsidiary financial statements are remeasured into U.S. dollars for consolidation. Foreign currency transaction gains and losses are included in interest income and other, net and were immaterial for all periods presented. Beginning with 1997, the Company operates and reports financial results on a fiscal year of 52 or 53 weeks ending on the Friday closest to December 31. Accordingly, fiscal 1997 ended on January 2, 1998 and was a 53 week year with the fourth fiscal quarter having 14 weeks; fiscal 1998 ended on January 1, 1999 and was a 52 week year. For ease of discussion and presentation all years are referred to as ending on December 31.

Certain amounts in prior year financial statements and notes thereto have been reclassified to conform to current year presentation.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents
The Company considers all highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents. Cash equivalents are carried at cost, which approximates fair value.

Marketable Securities
The Company has classified its entire investment portfolio as available-for-sale. Available-for-sale securities are stated at fair market value. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Realized gains and losses are included in interest income and other, net. The cost of securities sold is based on the specific identification method.

Inventories
Inventories are stated at the lower of standard cost (which approximates actual costs on a first-in, first-out basis) or market. The market value is based upon estimated net realizable value.

Equipment and Leasehold Improvements
Property and equipment are stated at cost. Equipment and fixtures are depreciated using the straight-line method over estimated useful lives ranging from three to eight years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful lives or the remaining lease terms.

Goodwill and Purchased Intangibles
Goodwill and other purchased intangibles are being amortized using the straight-line method over three to seven years.

Revenue Recognition
Revenue recognition is based on the terms of the underlying sales agreements (purchase orders or contracts). Revenue for product sales is recognized upon shipment. Revenue for costs incurred plus specified fee contracts is recognized on the percentage-of-completion method. Revenue for fixed price milestone contracts is recognized upon the completion of the milestone. Customers entering into cost incurred and fixed price contracts with the Company include the U.S. government, prime or subcontractors for which the U.S. government may be the end customer, and other domestic and international end-users.

Concentrations

Dependence Upon Government Programs and Contracts - In 1998, 1997, and 1996, the Company derived approximately 28 percent, 38 percent, and 43 percent, respectively, of its revenue directly and indirectly from a variety of Federal government sources. The demand for certain of the Company's services and products is directly related to the level of funding of government programs. The Company believes that the success and further development of its business is dependent, in significant part, upon the continued existence and funding of such programs and upon the Company's ability to participate in such programs. For example, substantially all of the Company's research revenue for 1998, 1997, and 1996 was funded by Federal programs. There can be no assurance that such programs will continue to be funded even if government agencies have available financial resources or that the Company will continue to be awarded contracts under such programs.

Dependence on Single Source and Other Third Party Suppliers - The Company depends on a single or limited number of outside contractors and suppliers for raw materials, packages and standard components, and to assemble printed circuit boards. The Company generally purchases these single or limited source products through standard purchase orders or one-year supply agreements and has no long-term guaranteed supply agreements with such suppliers. While the Company seeks to maintain a sufficient safety stock of such products and also endeavors to maintain ongoing communications with its suppliers to guard against interruptions or cessation of supply, the Company's business and results of operations have in the past been and could in the future be adversely affected by a stoppage or delay of supply, substitution of more expensive or less reliable products, receipt of defective parts or contaminated materials, an increase in the price of such supplies, or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures.

Credit Risk - The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral from its customers. The Company maintains reserves for potential credit losses. Although such losses have been within management's expectations to date, there can be no assurance that such reserves will continue to be adequate.

Principal Business and Export Sales

The Company's operations are conducted in one principal line of business, the design, manufacture, and sale of semiconductor lasers, fiber optic products, and optoelectronic systems. The Company has operations in the United States and international operations in Canada. All sales are denominated in U.S. dollars

All U.S. operations sales to international customers constitute export sales. Export sales to Europe totaled approximately $9.3 million, $5.9 million, and $3.9 million for 1998, 1997, and 1996, respectively. Export sales to the Pacific Rim totaled approximately $8.9 million, $6.9 million, and $6.0 million for 1998, 1997, and 1996, respectively.

Net Income (Loss) Per Share

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

<TABLE>
<CAPTION>

	Years Ended December 31,		
	1998	1997	1996
<S>	<C>	<C>	<C>
Numerator:			
Net income (loss)	$12,823	($24,679)	$7,121
Denominator:			
Denominator for basic earnings per share-weighted average shares.........	13,887	13,497	12,012
Incremental common shares attributable to shares issuable under employee stock plans(1).......................	822	--	1,187
Denominator for diluted earnings per share - adjusted weighted average shares and assumed conversions........	14,709	13,497	13,199
Net income (loss) per share - basic.....	$0.92	($1.83)	$0.59

Net income (loss) per share - diluted...	$0.87	($1.83)	$0.54
	==========	==========	===========

</TABLE>

(1) Potential common shares relating to shares issuable under employee stock plans are not included in the 1997 calculation due to their anti-dilutive effect on the loss per share.

Options to purchase 62,363 shares of common stock were not included in the computation of the 1998 diluted earnings per share because the options' exercise price was greater than the average market price of common shares.

Comprehensive Income

As of January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130 (SFAS 130), "Reporting Comprehensive Income." SFAS 130 establishes new rules for the reporting and display of comprehensive income and its components; however, the adoption of this statement had no impact on the Company's net income or stockholders' equity. SFAS 130 requires unrealized gains or losses on the Company's available-for-sale securities, which prior to adoption were reported separately in stockholders' equity, to be included in other comprehensive income. Comprehensive income consists of net income and other comprehensive income. Prior year financial statements have been reclassified to conform to the requirements of SFAS 130.

Accumulated other comprehensive income presented in the accompanying consolidated balance sheets consists of the accumulated net unrealized gains and losses on available-for-sale marketable securities, net of the related tax effect for all periods presented. The tax effects for other comprehensive income were immaterial for all periods presented.

Segments of an Enterprise

Effective January 1, 1998, the Company adopted the Financial Accounting Standards Board's Statement of Financials Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (Statement 131). Statement 131 superseded FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise. Statement 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. Statement 131 also establishes standards for related disclosures about products and services, geographic areas, and major customers. The adoption of Statement 131 did not affect results of operations or financial position, but did affect the disclosure of segment information. See note 14.

Statement of Position 98-1

In March 1998, the Accounting Standards Executive Committee of the AICPA issued Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. The SOP, which has been adopted prospectively as of September 30, 1998, requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software. Prior to adoption of SOP 98-1, the Company expensed all internal use software related costs as incurred. The effect of adopting the SOP was to increase net income for the year ended December 31, 1998 by $71,000.

Recent Financial Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board issued Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, which is required to be adopted in years beginning after June 15, 1999. Because the Company has never used derivatives, management does not anticipate that the adoption of the new Statement will have a significant effect on earnings or the financial position of the Company.

2. Marketable Securities

Available-for-sale marketable securities consist of the following (in thousands):

<TABLE>
<CAPTION>

<S>	Amortized Cost <C>	Gross Unrealized Gains <C>	Gross Unrealized Losses <C>	Estimated Fair Value <C>
December 31, 1998:				
Medium term notes.................	$10,091	$1	$25	$10,067
Commercial Paper..................	4,959	20	--	4,979
Tax-exempt auction rate preferred stock..........................	5,950	--	--	5,950
Money Market Funds................	564	--	--	564
	$21,564	$21	$25	$21,560

Included in cash and cash equivalents..............................	$5,514
Included in short-term marketable securities.......................	12,494
Included in long-term marketable securities........................	3,552
	$21,560

<CAPTION>

<S>	Amortized Cost <C>	Gross Unrealized Gains <C>	Gross Unrealized Losses <C>	Estimated Fair Value <C>
December 31, 1997:				
Municipal bonds...................	$13,686	$1	$74	$13,613
Tax-exempt auction rate preferred stock..........................	8,400	--	--	8,400
Money Market Funds................	1,017	--	--	1,017
	$23,103	$1	$74	$23,030

Included in cash and cash equivalents..............................	$1,017
Included in short-term marketable securities.......................	10,400
Included in long-term marketable securities........................	11,613
	$23,030

<CAPTION>
The following is a summary of contractual maturities of the Company's marketable securities (in thousands):

<S>	Amortized Cost <C>	Estimated Fair Value <C>
December 31, 1998:		
Money Market Funds................	$564	$564
Amounts maturing within one year..	17,436	17,444
Amounts maturing after one year...	3,564	3,552
	$21,564	$21,560

</TABLE>

Realized losses on the sale of available-for-sale securities were $0.1 million and $0.3 million in 1998 and 1997, respectively.

3. Accounts Receivable

Accounts receivable consist of the following:

	As of December 31, 1998	As of December 31, 1997
	(In thousands)	
Trade receivables	$20,488	$17,334
Receivables under long-term contracts:		
Billed	1,865	765
Unbilled costs and estimated earnings, current portion	722	3,051
	23,075	21,150
Allowance for doubtful accounts	(1,005)	(1,190)
	$22,070	$19,960

The majority of unbilled costs and estimated earnings on uncompleted cost incurred and fixed price contracts are billable in the subsequent year.

Pursuant to the retainage provisions in certain long-term contracts, a specified portion of receivables do not become due and payable until completion of a final audit by the Defense Contract Audit Agency. Such retainage amounts total approximately $0.5 million in 1998 and 1997 and are included in other assets in the accompanying balance sheets.

4. Inventories

Inventories consist of the following:

	As of December 31, 1998	As of December 31, 1997
	(In thousands)	
Raw materials	$6,620	$6,087
Work-in-process	13,059	7,851
	$19,679	$13,938

No significant amounts of finished goods or work-in-process related to long-term contracts are maintained.

5. Property and Equipment

Property and equipment consist of the following:

<TABLE>
<CAPTION>

	As of December 31,	
	1998	1997
	(In thousands)	
<S>	<C>	<C>
Machinery and equipment	$48,636	$37,946
Leasehold improvements	8,431	7,697
Furniture and fixtures	898	846
Construction-in-progress	3,897	1,934
	61,862	48,423
Less accumulated depreciation and amortization	(28,931)	(22,125)
	$32,931	$26,298

</TABLE>

6. Goodwill and Purchased Intangibles

Purchased intangibles, which are included in other assets, consist of the following:

<TABLE>
<CAPTION>

	As of December 31,	
	1998	1997
	(In thousands)	
<S>	<C>	<C>
Goodwill	$1,363	$1,363
Other purchased intangibles	1,945	1,945
	3,308	3,308
Less accumulated amortization	(2,147)	(1,370)
	$1,161	$1,938

</TABLE>

See Note 11, Acquisitions.

7. Note due from Related Party

On May 1, 1997 the Company loaned an officer $612,000 secured by a deed of trust. The note is due on the tenth anniversary of the date of the note, however; certain amounts may be forgiven. After five years continuous employment with the Company, $200,000 will be forgiven. After ten years continuous employment with the Company, an additional $200,000 will be forgiven. Other terms provide for mandatory prepayment if certain events of default occur. The note shall bear interest at 8% only in the event of a default. The amount expected to be forgiven is being amortized to compensation expense over ten years.

8. Income Taxes

The provision for income taxes consists of the following:

<TABLE>
<CAPTION>

Years Ended December 31,

	1998	1997	1996
	(In thousands)		
Current:			
Federal	$181	$ --	$2,617
State	26	--	312
Foreign	1,784	417	346
	1,991	417	3,275
Deferred:			
Federal	(948)	--	(371)
State	--	--	148
	(948)	--	(223)
	$1,043	$417	$3,052

The tax benefits resulting from the exercise of nonqualified stock options and the disqualifying disposition of shares acquired under the Company's incentive stock option and employee stock purchase plans were $0.2 million, zero and $5.2 million in 1998, 1997 and 1996, respectively. Such benefits were credited to additional paid-in capital.

Pre-tax income from foreign operations was $4.6 million, $1.1 million and $0.8 million in 1998, 1997 and 1996, respectively.

The difference between the provision for income taxes and the amount computed by applying the Federal statutory income tax rate to income before taxes is explained below:

	Years Ended December 31,		
	1998	1997	1996
	(In thousands)		
Tax at federal statutory rate	$4,853	($8,492)	$3,560
State income tax, net of federal tax benefit	17	--	299
Non-deductible in-process, research and development write-off	--	264	--
Net operating loss not benefited (utilized)	(3,809)	9,057	--
Valuation allowance	(216)	--	--
Tax-exempt interest income	(124)	(453)	(455)
Other	322	41	(352)
Provision for income taxes	$1,043	$417	$3,052

Significant components of the Company's deferred tax assets are as follows:

	As of December 31,	
	1998	1997
	(In thousands)	
Deferred tax assets:		
Net operating loss carryforwards	$9,132	$9,680

Reserves and other accrued expenses not yet deductible for tax	1,832	2,070
Inventory	3,088	1,584
Intangible assets	4,157	3,838
Tax credit carryforward	1,800	970
Other	--	52
Total deferred tax assets	20,009	18,194
Valuation allowance	(15,128)	(14,030)
Net deferred tax assets	4,881	4,164
Deferred tax liabilities:		
Depreciation	(743)	(550)
Other	(138)	(562)
Total deferred tax liabilities	(881)	(1,112)
Net deferred tax assets	$4,000	$3,052

</TABLE>

The valuation allowance increased by approximately $1.1 million and $12.0 million in 1998 and 1997, respectively. Approximately $7.6 million of the valuation allowance is related to the benefits of stock option deductions, which will be credited to paid-in capital when realized.

As of December 31, 1998, the Company had federal and state net operating loss carryforwards of approximately $26.0 million and $4.8 million, respectively, and federal and state tax credit carryforwards of approximately $0.9 million and $1.3 million, respectively. The net operating loss and credit carryforwards will expire at various dates beginning in years 2001 through 2018, if not utilized.

Management has determined, based on the Company's history of prior operating earnings, its expectations for the future, and the extended period over which the benefits of certain deferred tax assets will be realized, that a partial valuation allowance should be provided. The realization of the Company's net deferred tax assets, which relate primarily to temporary differences, net operating loss carryforwards and tax credit carryforwards is dependent on generating sufficient taxable income during the periods in which the temporary differences are expected to reverse. Although realization is not assured, management believes it is more likely than not that the net deferred tax assets will be realized.

9. Stockholders' Equity

Common Stock Offerings

On June 26, 1996, the Company issued 1,500,000 shares of common stock in a follow-on public stock offering at a per share price of $27.00. In addition, SDL's Underwriters exercised their over-allotment option to purchase 255,000 additional shares of the Company's common stock. Net proceeds to the Company approximated $44.7 million.

Shareholder Rights Plan

The Company has adopted a Shareholder Rights Plan (Rights Agreement). Pursuant to the Rights Agreement, rights were distributed at the rate of one right for each share of Common Stock owned by the Company's stockholders of record on November 17, 1997. The rights expire on November 5, 2007 unless extended or earlier redeemed or exchanged by the Company. Under the Rights Agreement, each right entitles the registered holder to purchase one-hundredth of a Series B Preferred share of the Company at a price of $110. The rights will become exercisable only if a person or group acquires beneficial ownership of 15 percent or more of the Company's common stock or commences a tender offer or exchange offer upon consummation of which such person or group would beneficially own 15 percent or more or the Company's common stock.

Stockholders' Notes Receivable

Certain exercises of stock options occurred in conjunction with the issuance of full-recourse stockholders' notes receivable. The notes bear interest between 5 percent and 8 percent per annum with annual interest payments. The principal on the notes is due beginning in 1999 through 2001.

10. Stock-Based Compensation Plans

Stock Option Plans

The 1992 Stock Option Plan provided for the granting of incentive stock options and nonqualified options to purchase up to 4,558,125 shares of the Company's common stock to officers, directors and key employees at exercise prices of not less than fair value on the date of grant as determined by a committee of the Board of Directors. Options granted were immediately exercisable; however, unexercised options and shares purchased upon the exercise of the options are subject to vesting over a one- to five-year period. Shares not vested at the date of termination of employment may be repurchased by the Company at the original exercise price. No further options will be granted under the 1992 Stock Option Plan.

The Company's 1995 Stock Option Plan was approved by the Board of Directors in January 1995 and by the stockholders in February 1995. The purposes of the 1995 Option Plan are to give the Company's employees and others who perform substantial services to the Company incentive, through ownership of the Company's common stock, to continue in service to the Company, and to help the Company compete effectively with other enterprises for the services of qualified individuals. The 1995 Stock Option Plan permits the grant of incentive stock options to employees, including officers and Directors who are employees, and the award of nonqualified stock options to the Company's employees, officers, Directors, independent contractors, and consultants. The number of shares available for grant was initially 712,500 shares. Beginning on the first day of each fiscal year, the number of shares reserved for grant will be increased by 5 percent of the number of shares of common stock outstanding as of the end of the preceding fiscal year. Options granted under the 1995 Stock Option Plan are subject to vesting over a one to five year period and must generally be exercised by the optionee during the period of employment or service with the Company or within a specified period following termination of employment or service. Options currently expire no later than ten years from the date of grant.

The Company has reserved 3,323,738 shares of common stock for future issuance under its Stock Option Plans as of December 31, 1998.

Information with respect to stock option activity is summarized as follows:

<TABLE>
<CAPTION>

		Outstanding Options	
	Available for Grant	Number of Shares	Weighted-Average Exercise Price
<S>	<C>	<C>	<C>
Balance at December 31, 1995......	130,350	2,860,863	$3.59
Options granted................	(373,642)	373,642	20.53
Options canceled...............	182,274	(182,274)	15.32
Options exercised..............	--	(821,569)	0.70

Additional options authorized...	531,375	--	--
Option authorizations canceled..	(14,520)	--	--
Balance at December 31, 1996......	455,837	2,230,662	6.48
Options granted................	(552,645)	552,645	16.06
Options canceled...............	140,268	(140,268)	16.79
Options exercised..............	--	(249,734)	2.33
Additional options authorized...	665,305	--	--
Balance at December 31, 1997......	708,765	2,393,305	8.51
Options granted................	(646,863)	646,863	22.58
Options canceled...............	156,080	(156,080)	19.58
Options exercised..............	--	(462,059)	4.06
Additional options authorized...	683,727	--	--
Balance at December 31, 1998......	901,709	2,422,029	$12.41

</TABLE>

The following table summarizes information about options outstanding at December 31, 1998:

<TABLE>
<CAPTION>

	Options Oustanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
<S>	<C>	<C>	<C>	<C>	<C>
$0.34 - $5.10	822,109	3.7	$0.84	822,109	$0.84
5.11 - 11.00	237,409	6.1	10.02	184,471	9.87
11.01 - 16.00	336,695	8.2	13.60	107,346	14.11
16.01 - 21.00	470,679	8.4	18.60	120,169	18.44
21.01 - 25.00	492,774	9.0	24.01	40,041	22.79
25.01 - 30.00	53,313	7.5	27.64	25,925	27.74
30.01 - 39.63	9,050	10.0	39.63	--	--
$0.34 - $39.63	2,422,029	6.7	$12.41	1,300,061	$6.05

</TABLE>

Employee Stock Purchase Plan

To provide employees with an opportunity to purchase common stock of the Company through payroll deductions, the Company established the 1995 Employee Stock Purchase Plan (the ESPP) and initially reserved 450,000 shares of common stock for issuance to participants. In May 1998, 400,000 additional shares of common stock were reserved for issuance to participants. Under the ESPP, the Company's employees, subject to certain restrictions, may purchase shares of common stock at the lesser of 85 percent of the fair market value at either the beginning of each two-year offering period or the end of each six-month purchase period within the two-year offering period. Under the ESPP, the Company sold 149,345, 118,690, and 110,658 shares in 1998, 1997 and 1996, respectively.

Stock-Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), and related interpretations in accounting for its employee stock-based awards because, as discussed below, the alternative fair value accounting provided for under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), requires use of option valuation models that were not developed for use in valuing stock-based compensation plans. Under APB 25, the Company generally recognizes no compensation expense with respect to such awards.

Pro forma information regarding net income and earnings per share is required by SFAS 123 as if the Company has accounted for its employee stock options granted subsequent to December 31, 1994 under the fair value method. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Since the Company's stock-based awards have characteristics significantly different from those of traded options, and since 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 stock-based awards. The fair value of the Company's stock-based awards to employees was estimated assuming no expected dividends and the following weighted-average assumptions:

	Options			ESPP		
	1998	1997	1996	1998	1997	1996
Expected Life...........	4 years	4 years	3 years	6 months	6 months	6 months
Expected Volatility.....	0.72	0.66	0.6	0.84	0.82	0.72
Risk Free Interest Rate.	5.15%	6.17%	6.04%	5.06%	5.64%	5.45%

For the purpose of pro forma disclosures, the estimated fair value of the above stock-based awards is amortized over the awards' vesting period. The Company's pro forma information follows (in thousands, except for per share information):

	Years Ended December 31,		
	1998	1997	1996
Pro forma net income (loss).....	$6,789	($27,523)	$5,947
Pro forma net income (loss) per share - basic.............	$0.49	($2.04)	$0.50
Pro-forma net income (loss) per share - diluted..........	$0.46	($2.04)	$0.45

Because SFAS 123 is applicable only to options granted subsequent to December 31, 1994, its pro forma effect will not be fully reflected until approximately 1999.

Weighted-average fair value of options granted during 1998, 1997 and 1996 were $13.02, $8.92 and $9.65, respectively. The weighted-average fair value of ESPP rights granted in 1998, 1997 and 1996 were $7.53, $5.64 and $3.97, respectively.

11. Acquisitions

In November 1997, the Company acquired all of the outstanding stock of Mr. Laser, Inc., a company involved in the design and development of compact laser marking systems. The acquisition was accounted for under the purchase method of accounting. The total purchase price was approximately $1,202,000, which includes related transaction costs of $22,000, $187,000 for net acquired liabilities. At the time of acquisition, the Company recorded $753,000 as in-process research and development for development projects that had not yet reached technologic feasibility. To determine the value of in-process research and development, the Company considered, among other factors, the state of development of the compact laser marking system, the costs needed to complete development, and the expected income and risks associated with the inherent difficulties and uncertainties in completing development. Purchase price in excess of amounts allocated to in-process research and development and net acquired liabilities was approximately $453,000 and was allocated to goodwill. Goodwill is being amortized straight-line over a three year life. Mr. Laser's operating results are included in the accompanying consolidated financial statements beginning with November 1997. The results of Mr. Laser prior to the acquisition were not material to the Company's consolidated results of operations.

12. Commitments

The Company leases all of its facilities and certain equipment under operating leases. The operating facilities leases contain renewal options. The future minimum rental payments as of December 31, 1998, under operating leases are as follows (in thousands):

Fiscal Year	Amount
1999	$2,218
2000	2,275
2001	2,246
2002	640
2003	167
	$7,546

Rental expense was approximately $2.2 million, $1.7 million and $1.4 million, for 1998, 1997 and 1996, respectively.

13. Contingencies

In 1985, Rockwell International Corporation (Rockwell) asserted, and in 1995 filed suit in the Northern California Federal District Court against the Company alleging that a Company fabrication process infringed certain Rockwell patent rights. Rockwell sought to permanently enjoin the Company from infringing Rockwell's alleged patent rights and sought unspecified actual and treble damages plus costs. The Company answered Rockwell's complaint asserting, among other defenses, that Rockwell's patent is invalid. Rockwell's suit was stayed in 1995 pending resolution of another suit, involving the same patent, brought by Rockwell against the Federal government, and in which SDL had intervened. The suit between the Federal government and Rockwell was resolved in Janaury 1999, by way of a settlement payment from the Federal government to Rockwell. The Company did not participate in the settlement. As a result of that settlement, the Company anticipates that the stay of Rockwell's suit against the Company will be lifted. A status conference is scheduled in that case for March 8, 1999. The resolution of this litigation is fact intensive so that the outcome cannot be determined and remains uncertain. If Rockwell prevailed in the litigation, it could be awarded monetary damages against the Company. The Company believes, however, that it has meritorious defenses to the Rockwell's allegations in the litigation.

Shortly after the aforementioned suit between Rockwell and the Federal government was filed, the Federal government had notified the Company that, if the Federal government were liable to Rockwell, then the Federal government might seek indemnification for a portion of its liability from the Company. The Federal government never stated the amount of the

Company's alleged indemnity obligation, nor has it ever repeated its assertion that the Company might have some indemnity obligation to the Federal government.

SDL is engaged in various cost-reimbursement type contracts with the Federal government. These contracts utilize allowable costs plus contract fee to determine revenue. Federally-funded contracts are subject to audit of pricing and actual costs incurred, which have resulted and could result in the future, in price adjustments. The government has in the past and could in the future, challenge the Company's accounting methodology for computing indirect rates and allocating indirect costs to government contracts. The government is currently challenging certain indirect cost allocations. While management believes that amounts recorded on its financial statements are adequate to cover all related risks, the government has not concluded its investigation or agreed to a settlement with the Company. Although the outcome of this matter cannot be determined at this time, management does not believe that its outcome will have a material adverse affect on the Company's financial position, results of operations or cash flows. Nevertheless, based on future developments, the Company's estimate of the outcome of these matters could change in the near term.

Trial of the Spectra-Physics vs. SDL, Inc. litigation began before the Santa Clara County, California Superior Court on May 7, 1997. On May 19, 1997, before the trial was concluded, the Company, Spectra-Physics and its subsidiary Opto Power Corporation, and Xerox Corporation made a comprehensive settlement of their disputes.

During the second quarter of fiscal 1997, the Company included approximately $27.5 million in general and administrative expenses for settlement and related legal costs associated with the resolution of the dispute with Spectra-Physics, Inc.

14. Segments of an Enterprise and Related Information

Reportable Segments

SDL has three reportable segments: communications, research, and printing and materials processing. The communications business unit develops, designs, manufactures and distributes lasers for applications in the telecom, cable television, satellite and dense wavelength division multiplexing markets. The research business unit conducts research, development or product customization, involving both communications and printing and material processing applications, for Fortune 500 companies, major international customers, smaller domestic and international companies, and multiple Federal government agencies. The operating results of the research business unit include solely the results generated from that business unit. Research revenue on the Consolidated Statement of Operations included research, development, and product customization conducted by all segments of the Company. The printing and materials processing business unit develops, designs, manufacturers and distributes lasers for applications in the surface heat treating, product labeling, digital imaging, digital proofing, and thermal printing solutions markets.

The operating segments reported below are the segments of the Company for which separate financial information is available and for which operating income/loss amounts are evaluated regularly by executive management in deciding how to allocate resources and in assessing performance. The accounting policies of the operating segments are the same as those described in the summary of accounting policies.

The Company's reportable segments are business units that offer different products. The reportable segments are each managed separately because they manufacture and distribute distinct products with different applications. The Company does not allocate assets to its individual operating segments.

Information about reported segment income or loss is as follows (in thousands):

<TABLE>
<CAPTION>

<S>	Communication Products <C>	Research <C>	Printing and Material Processing <C>	Total <C>
Year ended December 31, 1998:				
Revenue from external customers...	$55,391	$7,354	$43,393	$106,138
Amortization.....................	645	--	132	777
Segment Operating Income.........	$7,744	$135	$4,776	$12,655

<CAPTION>

<S>	Communication Products <C>	Research <C>	Printing and Material Processing <C>	Total <C>
Year ended December 31, 1997:				
Revenue from external customers...	$38,354	$11,020	$41,990	$91,364
Amortization.....................	645	--	26	671
In Process R&D...................	--	--	753	753
Segment Operating Income (Loss)...	$2,657	$138	($912)	$1,883

<CAPTION>

<S>	Communication Products <C>	Research <C>	Printing and Material Processing <C>	Total <C>
Year ended December 31, 1996:				
Revenue from external customers...	$35,557	$11,900	$35,018	$82,475
Amortization.....................	645	--	--	645
Segment Operating Income.........	$3,804	$518	$4,350	$8,672

</TABLE>

A reconciliation of the totals reported for the operating segments to the applicable line items in the consolidated financial statements is as follows (in thousands):

<TABLE>
<CAPTION>

	Years Ended December 31,		
<S>	1998 <C>	1997 <C>	1996 <C>
Operating Income (Loss)			
Total operating income from operating segments..............................	$12,655	$1,883	$8,672
Spectra Physics Lawsuit and related legal costs...........................	--	(27,500)	--
Total consolidated operating income (loss)..	$12,655	($25,617)	$8,672

</TABLE>

Geographic Information

Information regarding geographic areas for the years ended December

31, 1998, 1997 and 1996 is as follows (in thousands):

	Revenue(a)	Long-Lived Assets
Year ended December 31, 1998:		
United States	$80,665	$33,624
Canada	6,503	3,016
Germany	4,771	--
France	4,308	--
Japan	6,886	--
Other foreign countries	3,005	--
Total	$106,138	$36,640

	Revenue(a)	Long-Lived Assets
Year ended December 31, 1997:		
United States	$75,832	$28,249
Canada	2,175	1,366
Germany	2,936	--
France	3,221	--
Japan	4,123	--
Other foreign countries	3,077	--
Total	$91,364	$29,615

	Revenue(a)	Long-Lived Assets
Year ended December 31, 1996:		
United States	$69,883	$23,777
Canada	1,144	1,075
France	3,329	--
Japan	3,740	--
Other foreign countries	4,379	--
Total	$82,475	$24,852

(a) Revenue is attributed to countries based on the location of customers.

Major Customers

The Company received approximately 14 percent, 19 percent and 21 percent of its 1998, 1997, and 1996, respectively, revenue from Lockheed-Martin through several government and commercial programs. Sales to Lockheed-Martin are reported in the communication products and printing and material processing segments. Almost all of the Company's revenue from this customer during 1998, 1997 and 1996 was derived from Federally-funded programs. Most of the Company's Federally-funded programs are subject to renewal every one or two years and to termination for convenience by the government agency. The loss of the Company's contracts or failure to win new contracts with Lockheed-Martin, or other major customers, could have an adverse effect on the Company's results of operations.

15. Employee Benefit Plan

In 1990, the Company established the SDL, Inc. Profit Sharing and Saving Plus Plan (the Plan) that covers substantially all U.S. full-time employees and is qualified under Sections 401(a) and 401(k) of the Internal Revenue Code. Participants may defer up to 20 percent of their pre-tax earnings (up to the Internal Revenue Service limit). The Company matches 50 percent of employee contributions up to a maximum of 5 percent of the participant's pre-tax earnings. The participants' as well as the Company's matching contributions are fully vested. Company contributions to the Plan were approximately $0.6 million, $0.5 million, and $0.4 million for 1998, 1997, and 1996, respectively.

16. Subsequent Events (unaudited).

In February 1999, the Company acquired the fiber laser business of Polaroid for $5.2 million cash. The business acquired includes all the physical assets, intellectual property, including the assignment of 38 patents and the licensing of 22 patents in the fiber laser area, and the ongoing operation of the fiber manufacturing facilities and fiber laser subsystem. The acquisition will be accounted for under the purchase method of accounting and the Company anticipates it will write-off in-process research and development up to $1.5 million in the first quarter of 1999. The results of the fiber laser business are not material to the Company's historical consolidated results of operations.

Report of Independent Auditors

The Board of Directors and Stockholders, SDL, Inc.

We have audited the accompanying consolidated balance sheets of SDL, Inc., as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These consolidated 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 SDL, Inc. at December 31, 1998 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, 1998, in conformity with generally accepted accounting principles.

/s/ Ernst & Young LLP

San Jose, California

January 29, 1999

CORPORATE INFORMATION

Directors

Donald R. Scifres
Chairman of the Board
Chief Executive Officer
SDL, Inc.

Keith B. Geeslin (1)
Senior Vice President
The Sprout Group

Anthony B. Holbrook(1)
Vice Chairman (retired)
Advanced Micro Devices, Inc.

John P. Melton
Executive Vice President (retired)
SDL, Inc.

Mark B. Myers(2)
Senior Vice President
Xerox Corporation

Frederic N. Schwettmann(2)
President (retired)
Read-Rite Corporation

(1) Member of Audit Committee
(2) Member of Compensation Committee

SDL, Inc. Officers

Donald R. Scifres
Chief Executive Officer

Gregory P. Dougherty
Chief Operating Officer

David F. Welch
Vice President, Corporate Development and Chief Technology Officer

Michael L. Foster
Vice President, Finance, Chief Financial Officer and Secretary

Richard R. Craig
Vice President, Materials Processing and Printing

Robert J. Lang
Vice President, Research and Development

Dennis M. Samaritoni
Vice President, Manufacturing

SDL, Inc. General Information

Annual Meeting
The annual meeting of the stockholders of SDL, Inc. will be held on May
13, 1999. All stockholders are encouraged to attend.

Stockholder Report
Additional copies of this annual report and of the Company's Form 10-K as filed with the Securities and Exchange Commission can be obtained without charge by contacting the Investor Relations Department of SDL, Inc. at
Tel: (408) 943-4343
Fax: (408) 943-1258
http://www.sdli.com

Stockholder Communications
Communications concerning address changes, stock certificates, and stockholder accounts should be directed to:
Chase Mellon
Shareholder Services
P.O. Box 3315
South Hackensack, NJ 07606
Tel: (800) 356-2017
Fax: (201) 329-8960
http://www.chasemellon.com

Market Price of Common Stock
The Company's common stock is traded on the Nasdaq National Market under the symbol SDLI. The high and low sales prices are as reported by the Nasdaq National Market.

Price Range of Common Stock

	High	Low
Q4 1998	$41.88	$9.75
Q3 1998	$29.06	$12.50
Q2 1998	$27.50	$19.63
Q1 1998	$24.00	$15.13
Q4 1997	$22.38	$13.50
Q3 1997	$25.25	$16.00
Q2 1997	$21.50	$8.00
Q1 1997	$29.00	$14.00

Corporate Headquarters
80 Rose Orchard Way
San Jose, CA 95134-1365
(408) 943-9411

Manufacturing
3530 Bassett Street
Santa Clara, CA 95054

SDL Optics, Inc.
6703 Rajpur Place
Saanichton, BC V8M 1Z5
(250) 544-2244

Registrar and Transfer Agent
Chase Mellon
Shareholder Services
San Francisco, California

Counsel
Morrison & Foerster LLP
Palo Alto, California

Independent Accountants
Ernst & Young LLP
San Jose, California

EXHIBIT 21.1

SUBSIDIARIES OF SDL, INC.

The following are the material subsidiaries of the Registrant as of December 31, 1998, all of which are included in the Registrant's Consolidated Financial Statements. The Registrant beneficially owns 100 percent of the outstanding voting securities of these subsidiaries.

Name	Jurisdiction of Incorporation
SDL Optics, Inc.	British Columbia, Canada

EXHIBIT 23.1

CONSENT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

We consent to the incorporation by reference in this Annual Report (Form 10-K) of SDL, Inc. of our report dated January 29, 1999, included in the 1998 Annual Report to Stockholders of SDL, Inc.

Our audits also included the financial statement schedule of SDL, Inc. listed in Item 14(a). This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion based on our audits. In our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 33-90848, 33-92200, 333-57683) pertaining to the 1995 Stock Option Plan, 1995 Employee Stock Purchase Plan, 1992 Stock Option Plan and the Amended and Restated 1984 Incentive Stock Option Plan of SDL, Inc. of our report dated January 29, 1999, with respect to the consolidated financial statements incorporated here by reference, and our report included in the preceding paragraph with respect to the financial statement schedule included in this Annual Report (Form 10-K) of SDL, Inc.

/s/ Ernst & Young LLP

San Jose, California
March 22, 1999

```
<TABLE> <S> <C>

<ARTICLE>  5
<LEGEND>   This schedule contains summary financial information extracted
           from the Balance Sheet and Statement of Operations included in the
           Company's Form 10-K for the year ended December 31, 1998 and is
           qualified in its entirety by reference to such Financial Statements.
</LEGEND>
<MULTIPLIER>1000

<S>                                          <C>
<FISCAL-YEAR-END>                            Dec-31-1998
<PERIOD-START>                               Jan-01-1998
<PERIOD-END>                                 Dec-31-1998
<PERIOD-TYPE>                                12-MOS
<CASH>                                          13,370
<SECURITIES>                                    12,494
<RECEIVABLES>                                   23,075
<ALLOWANCES>                                     1,005
<INVENTORY>                                     19,679
<CURRENT-ASSETS>                                70,919
<PP&E>                                          61,862
<DEPRECIATION>                                  28,931
<TOTAL-ASSETS>                                 112,477
<CURRENT-LIABILITIES>                           16,561
<BONDS>                                              0
<PREFERRED-MANDATORY>                                0
<PREFERRED>                                          0
<COMMON>                                            15
<OTHER-SE>                                      93,232
<TOTAL-LIABILITY-AND-EQUITY>                   112,477
<SALES>                                         96,358
<TOTAL-REVENUES>                               106,138
<CGS>                                           60,898
<TOTAL-COSTS>                                   68,419
<OTHER-EXPENSES>                                25,064
<LOSS-PROVISION>                                     0
<INTEREST-EXPENSE>                                   0
<INCOME-PRETAX>                                 13,866
<INCOME-TAX>                                     1,043
<INCOME-CONTINUING>                             12,823
<DISCONTINUED>                                       0
<EXTRAORDINARY>                                      0
<CHANGES>                                            0
<NET-INCOME>                                    12,823
<EPS-PRIMARY>                                    $0.92
<EPS-DILUTED>                                    $0.87
```

</TABLE>