SILICOM LTD
Form 20-F
March 17, 2011

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

FORM 20-F

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

Or

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2010

Or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report...................

For the transition period from to

Commission File number: 000-23288

SILICOM LTD.
(Exact name of Registrant as specified in its charter and as translated into English)

ISRAEL
(Jurisdiction of incorporation
or organization)

8 Hanagar Street,
Kfar Sava 44000, Israel
(Address of principal executive offices)

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

None	None
Title of each class	Name of each exchange on which registered

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Ordinary Shares, NIS 0.01 nominal value per share
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

6,879,688

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No x

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Note—Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this fling:

US GAAP x	International Financial Reporting Standards as issued by the International Accounting Standards Board o	Other o

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

This annual report on Form 20-F includes certain "forward-looking" statements within the meaning of Section 21E of the Securities Exchange Act of 1934. The use of the words "projects," "expects," "may," "plans" or "intends", or words similar import, identifies a statement as "forward-looking." There can be no assurance, however, that actual results will not differ materially from our expectations or projections. Factors that could cause actual results to differ from our expectations or projections include the risks and uncertainties relating to our business described in this report at Item 3 titled “Risk Factors.”

As used herein or any in any document incorporated by reference hereto, the “Company”, “Silicom Ltd.”, “Silicom”, “Registrant”, “we”, “us”, or “our” refers to Silicom Ltd. and its subsidiary. We have prepared our consolidated financia statements in United States dollars and in accordance with accounting principles generally accepted in the United States. All references herein to “dollars” or “$” are to United States dollars, and all references to “Shekels” or “NIS” are to New Israeli Shekels.

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Part I.

Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not Applicable.

Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not Applicable.

Item 3. KEY INFORMATION

Selected Financial Data

The selected data presented below under the captions "Consolidated Statements of Operations Data" and "Consolidated Balance Sheets Data" for and as of the end of each of the years in the five-year period ended December 31, 2010, are derived from our audited consolidated financial statements. The consolidated financial statements as of December 31, 2009 and 2010, and for each of the years in the three-year period ended December 31, 2010, and the report thereon, are included elsewhere in this annual report. The selected data set forth below should be read in conjunction with our consolidated financial statements and the notes thereto, which are set forth in Item 18 – "Financial Statements" and the other financial information appearing elsewhere in this annual report.

CONSOLIDATED STATEMENTS OF OPERATIONS DATA:

	Year Ended December 31 In US$ Thousands				
	2006	2007	2008	2009	2010
Sales	$ 16,118	$ 26,784	$ 25,554	$ 20,526	$ 30,399
Cost of sales	9,827	16,094	15,405	12,461	17,490
Gross profit	6,291	10,690	10,149	8,065	12,909
Research and development costs	1,820	2,208	3,048	2,716	3,280
Sales and marketing expenses	1,105	1,537	2,093	1,821	2,207
General and administrative expenses	980	1,189	1,427	1,313	1,523
Total operating expenses	3,905	4,934	6,568	5,850	7,010
Operating income	2,386	5,756	3,581	2,215	5,899
Financial income, net	167	956	1,188	909	617
Income before income taxes	2,553	6,712	4,769	3,124	6,516
Income tax expenses (benefit)	(46)	432	124	305	801
Net income(1)	2,599	6,280	4,645	2,819	5,715
Income per share					
Basic income per ordinary share	$ 0.51	$ 1.03	$ 0.69	$ 0.42	$ 0.84
Diluted income per ordinary share	$ 0.49	$ 1.00	$ 0.69	$ 0.41	$ 0.82
Weighted average number of ordinary shares used to compute basic income per share (in thousands)	5,138	6,122	6,685	6,720	6,821
Weighted average number of ordinary shares used to	5,341	6,309	6,780	6,843	6,938

compute diluted income per share (in thousands)

(1) Net income is after deduction of taxes on income, which have been reduced by virtue of tax benefits to which the Company is entitled in its capacity as an “Approved Enterprise” under Israeli law. As such, the Company was required to pay taxes at a reduced effective rate. The Company selected the 2004 tax year, the 2006 tax year and the 2009 tax year as its Year of Election, from which the period of benefits under the Investment Law are to commence. See Note 14C to the Financial Statements and “Item 10" - Additional Information - Taxation.”

	2006	2007	2008	2009	2010
Total assets	$ 17,853	$ 45,642	$ 51,974	$ 55,591	$ 63,479
Total current liabilities	$ 3,452	$ 4,712	$ 4,735	$ 4,399	$ 5,827
Long-term liability	$ 1,220	$ 1,596	$ 1,905	$ 1,967	$ 2,222
Shareholders' equity	$ 13,181	$ 39,334	$ 45,334	$ 49,225	$ 55,430
Capital stock	$ 16	$ 20	$ 20	$ 20	$ 20
Number of ordinary shares issued (1)	5,213,600	6,585,847	6,709,034	6,824,284	6,894,659

(1) Including 14,971 held by our subsidiary.

The table below sets forth the high and low NIS to U.S. Dollar exchange rates for each period, as published by the Bank of Israel:

	HIGH	LOW
February 2011	3.713	3.602
January 2011	3.710	3.528
December 2010	3.665	3.549
November 2010	3.684	3.580
October 2010	3.645	3.569
September 2010	3.798	3.665

The table below sets forth, for the five most recent full financial years, the average NIS to U.S. Dollar exchange rates for each period, calculated by using the average of the exchange rates on the last day of each month for each period, as published by the Bank of Israel:

2010	3.733
2009	3.933
2008	3.568
2007	4.085
2006	4.442

The NIS to U.S. Dollar exchange rate on February 28, 2011, as published by the Bank of Israel, was NIS 3.622.

Risk Factors

This annual report and statements that we may make from time to time may contain forward-looking information. There can be no assurance that actual results will not differ materially from our expectations, statements or projections. Factors that could cause actual results to differ from our expectations, statements or projections include the risks and uncertainties relating to our business described below.

We depend on one line of products for most of our revenues.

Our current business is based almost in its entirety on our Multi-Port Gigabit-Ethernet Server Adapter product line and the majority of our revenue is generated from such product line. We expect that in the foreseeable future we will continue to be dependent on this line of products for most of our revenue due the nature of our business. We cannot assure you that revenue generated from our Multi-Port Gigabit-Ethernet Server Adapters will reach or exceed historical levels in any future period. A decrease in the price of, or demand for, any of these products, or a significant increase in our costs of manufacturing could have a material adverse effect on our business, results of operations and financial condition.

Increased demand for products with characteristics similar to our products may cause manufacturers to integrate such characteristics into server motherboards, eliminating the need for our add-on products.

Our main products are add-on adapters that are added to existing servers in order to improve their functionality. If demand for such improved functionality increases significantly, server manufacturers may begin incorporating such functionality as a part of the basic design of their servers, thereby eliminating the need to achieve such functionality through add-on adapters. In the past we suffered from a similar trend with respect to our legacy products. We cannot assure you that a similar trend will not occur in connection with our add-on adapters. Such a trend would have a material adverse effect on our business, results of operations and financial condition.

Significant growth in markets demanding functionality similar to the functionality offered by our products may increase the market share of appliances that already have such functionality in-built, eliminating the need for our add-on products.

Our main products are add-on adapters that are added to existing servers in order to improve their functionality. If the demand for functionality similar to the functionality of our add-on adaptors continues to grow significantly, the market share of special purpose appliances that already have such functionality in-built may increase, consequently reducing the market share of solutions based on servers with add-on adaptors. A reduction in the market share of solutions based on servers with add-on adaptors, could, in turn, reduce the demand for our add-on adaptors. We cannot assure you that such a trend will not occur. Such a trend would have a material adverse effect on our business, results of operations and financial condition.

We may experience difficulty in developing solutions for appliances with proprietary interfaces which may be used by some of our potential customers.

The market for networking appliances includes appliances that make use of proprietary interfaces. These appliances are offered to our potential customers in addition to the customary server-based appliances which use standard interfaces. Our potential customers may decide to use appliances with proprietary interfaces instead of the customary server-based appliances for which several manufacturers may provide add-on cards. There could be no assurance that we would be able to develop non-standard add-on cards for appliances with proprietary interfaces or, if we are successful in developing such cards, that manufacturers of the proprietary interfaces or the customers electing to use these interfaces will make use of our cards in such non-standard environments.

Our Multi-Port Gigabit-Ethernet Server Networking Adapters including our Bypass Adapters which are sold mainly to OEMs, are characterized by long sales cycles.

We sell our Multi-Port Gigabit-Ethernet Server Networking Adapters (including our Bypass Adapters) mainly to original equipment manufacturers, or OEMs. The decision making process of our OEM customers includes several time consuming processes, resulting from the critical importance of our products in their systems. They need to define the required configuration of their server system/appliance, derive the need and type of adapters, evaluate adapters, intensively test and qualify adapters and then (or in parallel) negotiate the terms for a purchase. It may therefore take 12 months or more from the time we first contact a prospective customer before such customer implements our cards in its system constituting what is known as a Design Win. Additionally, once a Design Win is secured, our sales of these products typically involve significant capital investment decisions by prospective end customers, as well as a significant amount of time to educate such end customers as to the benefits of systems and appliances that include our products. As a result, before purchasing systems and appliances which include our products (and consequently facilitating sales of our products), companies spend a substantial amount of time performing internal reviews and obtaining capital expenditure approvals, consequently lengthening the period of time required for a Design Win to mature into consistent sales. These long sales cycles make it difficult to predict when and to what extent discussions with potential customers will materialize into sales and could cause our revenue and operating results to fluctuate widely from period to period. In addition, our allocation of significant resources to potential sales opportunities that do not materialize into sales could have a material adverse effect on our business, results of operations and financial condition.

The short lead time of customer orders combined with the long lead time of our suppliers when ordering certain components for our products could result in either a surplus or lack of sufficient supplies, and impact negatively on our finances.

While we are generally required to fill orders for our products within one or two weeks following the receipt of a firm purchase order, we must place orders of certain components for our products between sixteen and twenty weeks prior to delivery. As a result, we must have a significant amount of components in our inventory to be able to meet our best forecasts of projected purchase orders as opposed to on the basis of firm purchase orders. In the event that firm purchase orders are significantly lower than such forecasts, a significant part of our inventory will not be used and we may be unable to adjust costs in a timely manner to compensate for revenue shortfalls and in the event that firm purchase orders exceed such forecasts, we will not be able to fill such purchase orders which may lead to the loss of business from a customer.

Our visibility of future sales is severely limited due to the short lead time of customer orders.

As a result of the short lead time for firm purchase orders, we are unable to accurately forecast future revenues from product sales. As a result, even dramatic fluctuation in revenue (whether increase or decrease) might not be detected until the very end of a financial quarter, which may not enable us to monitor costs in a timely manner to compensate for such fluctuation.

The loss or ineffectiveness of our original equipment manufacturers or a reduction of purchase orders or sales efforts by such original equipment manufacturers may have a material adverse effect on our operations and financial results.

Our sales and marketing strategy is to develop and maintain strategic relationships with leading OEMs in the servers industry and server-based systems industry, which integrate our products into their systems. These OEMs are not within our control, are not obligated to purchase our products, and may select other products that may compete with our lines of products. A reduction in their sales efforts or discontinuance of sales of our products by our OEMs could lead to reduced sales and could materially adversely affect our operating results. Use of OEMs also entails the risk that they will build up inventories in anticipation of a growth in sales. If such growth does not occur as anticipated, such OEMs may substantially decrease the amount of products ordered in subsequent quarters or discontinue product orders. The termination or loss of one of our key OEMs or several OEMs at approximately the same time, without being able to compensate this loss with sales to other OEM customers might have a material adverse effect.

Our OEM customers may replace the appliances they currently use with appliances that do not require our cards or incorporate cards other than ours.

Many of the OEMs that use appliances which include our cards do so for a few years, and then consider migration to newer generations of appliances. We cannot guarantee that our cards will be needed or selected for such new appliances or compatible with them. A decision by a current OEM customer or customers to select a new appliance without including our cards in such new appliance may have a significant adverse effect on our results of operations.

The loss of a significant customer may have a material adverse effect on us.

We depend on a small amount of customers for our products. Our top three customers accounted for 36% of our revenues in 2010. We expect that a small number of customers will continue to account for a significant portion of our revenues for the foreseeable future. Loss or cancellation of business from, significant changes in deliveries to, or decreases in the prices of services sold to, one or more of our key customers has, in the past, significantly reduced our revenues for a reporting period and could, in the future, harm our margins, financial condition and business.

The markets for our products change rapidly and demand for new products is difficult to predict.

The markets for our products are characterized by rapidly changing technology and evolving industry standards. For example, the migration to 10Gbps solutions, the European Union’s directive regarding Restriction Of Hazardous Substances (ROHS) which requires products to be ROHS compliant, the Chinese ROHS directive and the migration from the PCI-X server bus to the PCI-Express (PCI-E) server bus, causes our OEMs to demand such new products and technologies. In the event that our OEMs decide to begin using such new technologies, we may not be able to develop products for the new technologies in a timely manner. Our OEMs may also select competing products despite our ability to develop products incorporating new technologies. Furthermore, the migration to 10Gbps, while presenting an opportunity for more cards and solutions to be sold, may also result in a decrease in the need for Multi-Port cards as throughput performance may be achieved via a single port of 10Gbps. Consequently, we may suffer from reduced sales to such OEMs and accumulate unusable inventory which can be used only with older technologies. We intend to continue investing in product and technology development. Although we have recorded growing sales of our line of products (to which the majority of our revenues are attributable), there can be no assurance that we will continue to be successful in the marketing of our current products and in developing, manufacturing and marketing enhanced and new products in a timely manner.

We may experience difficulty in developing new, commercially successful products at acceptable release times.

We conduct extensive research, development and engineering activities. Our efforts emphasize the development of new products, cost reduction of current products, and the enhancement of existing products, generally in response to rapidly changing customer preferences, technologies and industry standards. We cannot guarantee the continued success of our latest lines of products, Multi-Port Gigabit-Ethernet Server Networking Adapters and Bypass Adapters, that they will be widely accepted by the marketplace or that any of our development efforts will result in commercially successful products, that such products will be released in a timely manner or that we will be able to respond effectively to technological changes or new product announcements by others.

Loss of our sources for certain key components could harm our operations.

Although we generally use standard parts and components for our products, certain key components used in our products are currently available from only one source, and others are available from a limited number of sources. We believe that we maintain a sufficient inventory of these components to protect against delays in deliveries. However, we cannot guarantee that we will not experience delays in the supply of critical components in the future or that we will have a sufficient inventory of critical components at such time to produce products at full capacity. Additionally, a key component in many of our cards is manufactured by Intel, one of our competitors. While we have not encountered difficulties in purchasing such components from Intel's distributors, we cannot guarantee that we will continue to be able to purchase such components without delays or at reasonable prices. In the event that we are not able to purchase key components of our products from our limited sources, or are able to purchase these key components only under unreasonable terms, we may need to redesign certain products. We cannot guarantee that we will have adequate resources for such a redesign or that such a redesign will be successful. Such inability to obtain alternative resources or to successfully redesign our products could have a material adverse effect on our business, results of operations and financial condition.

Inability to receive information from our key component manufacturers could affect our ability to develop new products required by our OEMs and by the industry in which we operate.

Our products are based on networking controllers which are manufactured by either Broadcom or Intel. In order to design our products we need to receive information that enables us to design products with the use of such controllers. There can be no assurance that we will continue to receive all the information required for designing products with the use of new controllers continuously released by both Intel and Broadcom. Intel is our competitor and Broadcom may also compete with our products. Such competition may also affect their decisions regarding the sharing of information with us. The inability to obtain such information may adversely affect our ability to develop new products required by our OEMs and by the industry in which we operate.

We may need to invest significantly in research and development and business development in order to diversify our product offering and enter new markets.

Most of our revenues are generated from the sale of our add-on Server Adapters. The technology industry in which we operate is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. While these changes could lead to a reduction in the demand for our existing products, they could also create an opportunity for us to expand our product offering to our existing customers and to new customers. Accordingly, our future success may depend on our ability to diversify our product offering and enter new markets, which could involve numerous risks, including:

- Substantial research and development and business development expenditures, which could divert funds from other corporate uses and/or have a significant negative effect on our short-term results;
- Diversion of management’s attention from our core business; and
- Entering markets in which we have little or no experience.

There can be no assurance that we will be able to successfully complete the development and market introduction of new products and no assurance that we will be able to successfully enter new markets. This could have a material adverse effect on our business, results of operations and financial condition.

We may make acquisitions or pursue mergers that could disrupt our business and harm our financial condition.

As part of our business strategy, we may invest in or acquire other businesses, technologies or assets, or we may enter into joint ventures or other strategic relationships with third parties.

We may assume liabilities, incur amortization expenses related to intangible assets or realize large and immediate write-offs in connection with future acquisitions. In addition, the future valuation of these acquisitions may decrease from the market price paid by us, which may result in the writing-off, or impairment, of the relevant assets. In addition, our operation of any acquired or merged businesses, technologies or assets could involve numerous risks, including:

- Post-merger integration problems resulting from the combination of any acquired operations with our own operations or from the combination of two or more operations into a new merged entity;
- Diversion of management's attention from our core business;
- Substantial expenditures, which could divert funds from other corporate uses;
- Entering markets in which we have little or no experience; and
- Loss of key employees of the acquired operations.

We cannot be certain that any future acquisition or merger will be successful. If the operation of the business of any future acquisition or merger disrupts our operations, our business may suffer. In addition, even if we successfully integrate the acquired business with our own, we may not receive the intended benefits of the acquisition.

The market for our products is highly competitive and some of our competitors may be better positioned than we are.

The market for our products is highly competitive. We face competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial, production and marketing resources than we do. For example, in the server networking industry for which we have developed our Multi-Port Gigabit-Ethernet Server Networking cards, our main competitor is Intel. We cannot guarantee that our present or contemplated products will continue to be distinguishable from those of our competitors or that the marketplace will find our products preferable to those of our competitors. Furthermore, there can be no assurance that competitive pressures will not result in price reductions that could materially adversely affect our business and financial condition and the results of our operations.

We may not be able to prevent others from claiming that we have infringed their proprietary rights.

We cannot guarantee that one or more parties will not assert infringement claims against us. The cost of responding to claims could be significant, regardless of whether the claims have merit. Significant and protracted litigation may be necessary to determine the scope of the proprietary rights of others or to defend against claims of infringement, regardless of whether the claims have merit. Although we believe that all our products use only our intellectual property, or intellectual property which is properly licensed to us, in the event that any infringement claim is brought against us and infringement is proven, we could be required to discontinue the use of the relevant technology, to cease the manufacture, use and sale of infringing products, to incur significant litigation damages, costs and expenses, to develop non-infringing technology or to obtain licenses to the alleged infringing technology and to pay royalties to use such licenses. There can be no assurance that we would be able to develop any such alternative technologies or obtain any such licenses on terms commercially acceptable to us. Although in the past we have resolved a claim of infringement through a license agreement, the terms of which did not have a material effect on our business, any infringement claim or other litigation against us could seriously harm our business, operating results and financial condition. While there are no lawsuits or other claims currently pending against us regarding the infringement of patents or intellectual property rights of others, we have been a party to such claims in the past and may be party to such claims in the future.

We are dependent on key personnel.

Our success has been, and will be, dependent to a large degree on our ability to retain the services of key personnel and to attract additional qualified personnel in the future. Competition for such personnel is intense. There can be no assurance that we will be able to attract, assimilate or retain key personnel in the future and our failure to do so would have a material adverse effect on our business, financial condition and results of operations.

Exchange rate fluctuations and international risks could increase the cost of our operations.

Substantially all of our international sales are denominated in U.S. dollars and may be subject to government controls and other risks, including, in some cases, export licenses, federal restrictions on export, currency fluctuations, political instability, trade restrictions, and changes in tariffs and freight rates. Our dollar costs in Israel will increase further to the extent that inflation in Israel exceeds the devaluation of the NIS against the dollar, if the timing of such devaluation lags behind inflation in Israel or if the dollar devalues against the NIS.

If we are characterized as a passive foreign investment company for U.S. federal income tax purposes, our U.S. shareholders may suffer adverse tax consequences.

We will be a passive foreign investment company, or PFIC, if 75% or more of our gross income in a taxable year, including our pro-rata share of the gross income of any company, U.S. or foreign, in which we are considered to own, directly or indirectly, 25% or more of the shares by value, is passive income. Alternatively, we will be considered to be a PFIC if at least 50% of our assets in a taxable year, averaged over the year and ordinarily determined based on fair market value and including our pro-rata share of the assets of any company in which we are considered to own, directly or indirectly, 25% or more of the shares by value, are held for the production of, or produce, passive income. If we were to be a PFIC, and a U.S. Holder does not make an election to treat us as a “qualified electing fund,” or QEF, or a “mark-to-market” election, “excess distributions” to a U.S. Holder, and any gain recognized by a U.S. Holder on a disposition or our ordinary shares, would be taxed in an unfavorable way. Among other consequences, our dividends, to the extent that they constituted excess distributions, would be taxed at the regular rates applicable to ordinary income, rather than the 15% maximum rate applicable to certain dividends received by an individual from a qualified foreign corporation, and certain "interest" charges may apply. In addition, gains on the sale of our shares would be treated in the same way as excess distributions. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to the determination of PFIC status. In addition, under the applicable statutory and regulatory provisions, it is unclear whether we would be permitted to use a gross loss from sales (sales less cost of goods sold) to offset our passive income in the calculation of gross income. As a result of our substantial cash position, if the value of our shares declines, there is a substantial risk that we will be classified as a PFIC under the asset test described above. There can be no assurance that we will not be classified as a PFIC by the U.S. Internal Revenue Service. In light of the uncertainties described above, no assurance can be given that we will not be a PFIC in any year. A U.S. Holder who makes a QEF election is taxed currently on such holder's proportionate share of our earnings. If the IRS determines that we are a PFIC for a year with respect to which we have determined that we were not a PFIC, however, it might be too late for a U.S. Holder to make a timely QEF election, unless the U.S. Holder qualifies under the applicable Treasury regulations to make a retroactive (late) election. U.S. Holders who hold ordinary shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to exceptions for U.S. Holders who made a timely QEF or mark-to-market election, or certain other elections. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. Accordingly, our shareholders are urged to consult their tax advisors regarding the application of PFIC rules.

The tax benefits available to us under Israeli law require us to meet several conditions and applying plan administration rules, and may be terminated or reduced in the future, which would increase our taxes.

Our production facilities have been granted “Approved Enterprise” status and since and as such, we are entitled to certain tax benefits. To be eligible for these tax benefits, we must meet conditions and applying plan administration rules. If we fail to meet these conditions in the future, the tax benefits would be canceled and we could be required to refund any tax benefits we might already have received. These tax benefits may not be continued in the future at their current levels, or at any level. In recent years, the Israeli government has reduced the benefits available and has indicated that it may further reduce or eliminate some of these benefits in the future. The termination or reduction of these benefits may increase our income tax expense in the future. To the best of our knowledge, to date we have met the conditions for benefits under our “Approved Enterprise” program in all material respects. There can be no assurance, however, that we will continue to meet such conditions in the future. See Item 10 "Additional Information – Taxation – Law for the Encouragement of Capital Investments, 1959" for more information about our "Approved Enterprise" status.

The trading volume of our shares has been low in the past and may be low in the future, resulting in lower than expected market prices for our shares.

Our shares have been traded at low volumes in the past and may be traded at low volumes in the future for reasons related or unrelated to our performance. This low trading volume may result in lower than expected market prices for our ordinary shares and our shareholders may not be able to resell their shares for more than they paid for them.

Israeli courts might not enforce judgments rendered outside of Israel.

We are incorporated in Israel. All of our executive officers and all of our directors are non-residents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any such persons. It may also be difficult to enforce civil liabilities under U.S. federal securities laws in original actions instituted in Israel. However, subject to certain time limitations, Israeli courts may enforce U.S. final executory judgments for liquidated amounts in civil matters obtained after due trial before a court of competent jurisdiction (according to the rules of private international law currently prevailing in Israel) which enforces similar Israeli judgments, provided that the requisite procedural and legal requirements are adhered to. If a foreign judgment is enforced by an Israeli court, it generally will be payable in NIS, which can then be converted into foreign currency at the rate of exchange of such foreign currency on the date of payment. Pending collection, the amount of the judgment of an Israeli court stated in NIS (without any linkage to a foreign currency) ordinarily will be linked to the Israeli consumer price index plus interest at the annual statutory rate prevailing at such time. Judgment creditors bear the risk of unfavorable exchange rates.

The political environment and hostilities in Israel could harm our business.

Since the establishment of the State of Israel in 1948, a state of hostility has existed between Israel and the Arab countries in the region. This state of hostility has varied in degree and intensity over time. There has also been conflict and unrest between Israel, the Palestinian Authority and certain terrorist groups operating within the Palestinian Authority and Lebanon. A significant increase in violence began in September 2000 and has continued with varying levels of severity through 2009, the most severe of which was Israel's war with the Hizbullah militant group in July and August of 2006. In addition, in December 2008 and January 2009 there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel's border with the Gaza Strip, which resulted in missiles being fired from the Gaza Strip into Southern Israel. While such previous hostilities did not have a material adverse impact on our business, we cannot guarantee that hostilities will not be renewed and have such an effect in the future. The political and security situation in Israel may result in parties with whom we have contracts claiming that they are not obligated to perform their commitments under those agreements pursuant to force majeure provisions. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect our operations and could make it more difficult for us to raise capital. Since many of our facilities are located in Israel, we could experience serious disruptions if acts associated with this conflict result in any serious damage to our facilities. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. Any future armed conflicts or political instability in the region would likely negatively affect business conditions and harm our results of operations.

Many of our employees in Israel are required to perform military reserve duty.

All non-exempt male adult permanent residents of Israel under the age of 40 are obligated to perform military reserve duty and may be called to active duty under emergency circumstances. In recent years, there have been significant call-ups of military reservists, and it is possible that there will be additional call-ups in the future. While we have operated effectively despite these conditions in the past, we cannot assess what impact these conditions may have in the future, particularly if emergency circumstances arise. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of our other employees due to military service. Any disruption in our operations would harm our business.

We are affected by volatility in the securities markets.

The securities markets in general have experienced volatility which has particularly affected the securities of many high-technology companies and particularly those in the fields of communications, software and internet, including companies that have a significant presence in Israel. This volatility has often been unrelated to the operating performance of these companies and may cause difficulties in raising additional financing required to effectively operate and develop their businesses. Such difficulties and the volatility of the securities markets in general may affect our financial results.

We are affected by worldwide downturns in industries based on technology.

The volatility in the securities markets discussed above and its effect on high-technology companies may have a ripple effect on our performance. In the downturn which the markets experienced beginning in 2001, technology companies dealing in communications and computers were severely affected and some were forced to cease operations. We felt the effects of this downturn in 2001 through 2003. Currently, we are affected by the downturn in the economic markets which began in 2008, posing a risk to industries based on technology as well as the overall economy. We can give no assurance that our results will not be affected on a going forward basis by the current downturn and by any future downturns.

General economic conditions may adversely affect the Company’s results.

Current uncertainty in global economic conditions, including the recent disruption in financial and credit markets, pose a risk to the overall economy that could impact demand for our and our customers’ products, as well as our ability to manage commercial relationships with our customers, suppliers and creditors. If the current situation continues or worsens, our business could be negatively impacted, including such areas as reduced demand for our products and services, or supplier or customer disruptions, which could reduce our revenues or our ability to collect our accounts receivable and have a material adverse effect on our financial condition and results of operations.

We may experience a further decline in our share price and there is no guarantee that our share price will rise at all.

Our share price has taken a fall during the current uncertainty in global economic conditions and we expect it to continue to be affected by such uncertainty to the extent that it continues. We cannot assure you that our share price will recover in the coming fiscal year.

Our investment portfolio may be impaired by disruptions in the financial and credit markets.

Our investment portfolio currently consists of corporate debt securities and securities of US government agencies, which the Company classified at December 31, 2010 as "held-to-maturity". As of December 31, 2010, we hold approximately $29.9 million in corporate debt securities and securities of US government agencies.

Due to recent significant disruptions in the financial and credit markets, corporate debt securities in our portfolio are subject to a possible increased risk of default due to bankruptcy, lack of liquidity, operational failure or other factors affecting the issuers of those securities. In addition, securities in our portfolio are subject to other risks, such as credit, liquidity, market and interest rate risks, which may be exacerbated by the recent market disruptions. We may be required to adjust the carrying value of our investment securities due to a default, lack of liquidity or other event, if the event constitutes an impairment which is considered to be other-than-temporary. As of December 31, 2010, we were not required to adjust the carrying value of our investment securities since there were no other-than-temporary impairments.

This loss would be recorded in our consolidated statement of operations which could materially adversely impact our consolidated results of operations and financial condition.

Item 4. INFORMATION ON THE COMPANY.

History and Development of the Company

Our legal and commercial name is Silicom Ltd. We were incorporated under the laws of Israel in 1987, and we operate under Israeli law and legislation. Our registered and principal executive offices are located in Israel at 8 Hanagar Street, Kfar Sava, Israel 44000, and our telephone number is 011-972-9-764-4555. Our website is http://www.silicom.co.il. We do not intend for any information contained on our internet website to be considered part of this annual report.

We are currently engaged in the design, manufacture, marketing and support of connectivity solutions for a broad range of servers and server based systems. Our first products were integrated circuits for information technology (or IT) manufacturers. In the early 1990s, we began focusing our strategy on designing, manufacturing, marketing and supporting a range of connectivity solutions for mobile and personal computers users. In subsequent years we developed several broadband internet related products.

In 2002, we leveraged our expertise and know-how in networking and operating systems to develop a line of high-end Multi-Port server networking cards, which in the past had contributed to our sales growth and which we expect to continue being the principal driver of our sales growth in the coming years. In November and December of 2003 we began implementing our “Design Win” business model, as described below in “Item 4. Business Overview”, pursuant to which we began selling our products to customers that incorporate such products within their networking appliances and/or server based systems and sell such systems with our products embedded in them. Since then we have identified the server-based network appliances market and specifically the server-based security appliances and WAN (Wide Area Network) optimization appliances within such market as demonstrating a strong demand for our products. We have added Bypass Adapters, which are networking products that include special functionalities for the server based appliances, to our product lines and received significant orders for both our Bypass Adapters and our non-Bypass adapters. We secured additional Design Wins during 2004-2010, several of which were with leading companies engaged in a number of industries. In 2009, we have added to our product lines the new patent-pending SErver To Appliance Converter ("SETAC"), which are products that enable us to offer a full network appliance platform solution and address new market segments.

On December 20, 2005, we obtained the approval of the Tel Aviv Stock Exchange, or TASE, for the listing of our shares on TASE. Trading of our shares on TASE commenced on December 27, 2005. Our shares are included in the Tel-Tech index. Our shares have been listed on the NASDAQ Global Market (previously known as the NASDAQ National Market) under the ticker symbol “SILC” (previously “SILCF”) since February 11, 2008. Prior thereto, our shares were listed on the NASDAQ Capital Market (previously known as the NASDAQ Small-Cap). See Item 9. “The Offer and Listing -Markets and Share Price History”.

In January 2006, we completed an offering and sale of 10,000 units in Israel, composed of 800,000 of our ordinary shares and 400,000 warrants, pursuant to a prospectus filed with the Israeli Securities Authority and TASE. Each warrant sold in the offering was exercisable into one of our ordinary shares until January 31, 2008 at an exercise price in NIS equivalent to $8.64 calculated on the date of exercise of such warrant. The sale of units resulted in net proceeds of approximately $5.6 million. As of January 31, 2008 (i.e. the expiration date of the warrants), 399,934 warrants were exercised, resulting in additional proceeds of approximately $3.5 million in the aggregate. The offering and sale of the units pursuant to the January 2006 prospectus was made only in Israel and was not intended for the public in the United States or any other country. All purchasers of securities pursuant to the January 2006 prospectus were deemed to have stated that they are not “U.S. Persons” as defined in Regulation S under the Securities Act of 1933, or the Securities Act, that they did not purchase securities for the benefit of any U.S. Person and that they were not present in the United States at the time the request for purchase of the securities was submitted. A similar statement was required from anyone requesting to exercise warrants purchased in the offering. The January 2006 prospectus and the securities offered thereunder are subject to Israeli law. The January 2006 prospectus was not filed with the Securities Exchange Commission and the securities offered thereunder are not registered in accordance with the Securities Act. We have not assumed any obligation to register any of the securities offered under the January 2006 prospectus, in accordance with the Securities Act.

In May 2007, we conducted a private placement, pursuant to which we issued to certain “accredited investors” and “qualified institutional purchasers” 875,000 ordinary shares at a purchase price of $20.50 per share and warrants to purchase up to 218,750 ordinary shares at an exercise price of $28.25 per share. We issued to the placement agents warrants to purchase up to an aggregate of 10,937 ordinary shares on the same terms as the warrants issued to the investors. Net proceeds from the private placement were approximately $16.8 million, net of $1.2 million of issuance costs. The warrants issued to the investors and to the placement agents expired in July 2010. Prior to their expiration in July 2010, no such warrants were exercised into shares.

Business Overview

We are currently active in the product line of high-end server networking cards with and without bypass (Server Adapters), which is described in greater detail below. For the purpose of these products we are leveraging our expertise in networking and operating systems and facilitating improved connectivity for servers by increasing the number of ports on the server adapters and by adding bypass and other special functionality for security appliances, WAN (Wide Area Network) optimization appliances and other network appliances. Starting at 2006, we have extended our product line by adding intelligent and programmable cards, such as encryption acceleration cards and redirector cards. We also added intelligent stand alone bypass units. In 2008, we extended the line of Server Adapters by adding 10 Gbps products with and without bypass, with a variety of interfaces. Revenues of our 10Gbps products are currently rising.

Furthermore, in 2009 we introduced our patent-pending SETAC (Server To Appliance Converter) product family. The SETAC product family is a unique solution that enables standard servers to be configured as network appliances with high-density front networking ports and easy port modularity. We believe that the SETAC products will turn into one of our growth drivers in the coming years.

Server Adapters

In an effort to leverage our strengths, in late 2002 we began exploring a new direction which has become our primary growth driver and which we project will continue being our main source of growth in the next few years: high-end server networking cards. Our core expertise has always been our broad range of Ethernet and connectivity products, which provided personal computer users with solutions to their connectivity problems. In late 2002, we decided to employ our core know-how in the realm of server-based systems. Doing so takes advantage of our competitive edge by using the expertise we have developed in connectivity solutions for personal computers in industries which require broader connectivity solutions with very high-performance environments. Examples of these industries are security, WAN optimization, load balancing and other network appliances, data storage, video on demand, internet content delivery, high-performance computing and web servers.

We have developed a line of products for the server networking industry which facilitates interaction between servers, allowing them to communicate with each other through a larger number of ports and with higher performance than their original capabilities. These are powerful products that allow server-based systems to fully exploit the high speed potential of Gigabit Ethernet. The products have either one, two, four or six ports, which plug into the servers between which interaction is facilitated. We believe that our products cover a broader scope of features than those of our main competitor, Intel. We believe that our expanded feature set coupled with the fact that our products are based on two different industry leader chip sets (Intel and Broadcom), which makes them more compatible with our potential customers' needs, gives us a competitive edge. To the best of our knowledge we are currently the only company offering such a comprehensive range of server networking products.

Following demands from customers and potential customers, we developed some of these same products with a bypass feature. Intended for mission-critical environments, Silicom’s Gigabit Ethernet Bypass Networking Cards feature innovative bypass circuitry to maintain continuity of network connectivity in the event of an appliance failure. Upon the occurrence of an appliance failure, the card’s bypass mechanism automatically reroutes traffic to bypass faulty components, enabling customers to have reliable and always available network accessibility. As with all of Silicom’s Multiport Gigabit Ethernet Networking Cards, the Bypass Cards also improve server throughput and performance during normal operations by introducing more ports and better throughput while reducing network congestion, simplifying network management, and minimizing CPU utilization. In addition, we have also developed stand-alone bypass solutions which do not include the networking component. The addition of the innovative bypass capability makes Silicom Gigabit Ethernet Bypass Networking Cards and stand-alone bypass solutions an appropriate connectivity solution for security and WAN optimization appliances, as well as for appliances targeted at other high-potential, growing markets such as network monitoring, load balancing, network event management, network optimization, LAN policy enforcement, intrusion detection, virus protection, e-mail content filtering, and more. To the best of our knowledge we are currently the only company offering such a comprehensive line of bypass products, which offers dual port and quad port cards, copper and fiber interfaces and dual chip set (Intel and Broadcom). Although the situation may change in the future, we believe that our competition in the bypass card market is less significant than our competition in the non-bypass card market.

Our Server Adapter products are divided into three groups: Multi-port 1/10 Gigabit Ethernet Server Adapters, innovative internal and external Bypass solutions and advanced Smart Adapters (which include SSL encryption solutions and Redirector Adapters). See "Item 4. Information on the Company – Research and Product Development".

The principal applications of such products, all of which demand high performance Multi-Port connectivity, are as follows:

- Security appliances
- WAN optimization appliances
- Load balancing and traffic management appliances
- Network-attached storage (NAS)
- Video on Demand servers
- Content Delivery servers
- Internet Service Providers / Web Hosting
- High end computing

It would be difficult to design such high-end products without a high level of cross-disciplinary knowledge. The products we have developed use our Ethernet and operating systems expertise. The products in this line include more than one hundred Multi-Port Gigabit Ethernet Server Networking cards (bypass and non-bypass).

Our business model for our Server Adapter line of products is called the Design Win Model. The following are the main aspects of this model:

- We approach a potential customer or are approached by such customer.

- If the customer shows interest in the products and we believe that achievement of a business relationship with the customer is possible, we ship products for such customer's evaluation.

- During the evaluation process the customer receives a few of our Server Networking Cards for initial basic testing. If the evaluation process is successful, we ship products for qualification.

- During the qualification process the customer receives a larger amount of our Server Networking Cards for more specific testing, which may include certain customization of our products to its specific needs.

- If the qualification process is successful, we enter into negotiations regarding the terms of a business relationship.

- In some cases, typically with the larger customers, the evaluation and qualification process may take 12 months or more.

- Once all phases mentioned above are concluded, the customer will purchase products from us, in order to incorporate them within its server based systems and sell such systems with our cards embedded in them. The sale of our products within such systems is the objective of our Design Win Model. In most cases once we secure a Design Win our customer will continue to buy our cards for as long as it continues to sell its server based system. Yet, in some cases, we may only be a second source from which a customer purchases, in which case the customer may not necessarily make continuous orders.

We believe that the high-end server networking cards (with and without bypass) will continue to be a key driver of our growth in the coming years. A distinct advantage of these products is that the demand in the server based industry has been almost continuously growing. Certain fields within this industry, such as the security appliances market, WAN optimization appliances market, other network appliances market, the storage market and several additional markets have demonstrated strong growth. This industry continues to require innovative solutions that must become faster and must provide additional functionalities each time they are implemented. However, achieving Design Wins pursuant to the process described above and obtaining new customers is time consuming as a result of the fact that the sales cycles for products in this industry are long. Nevertheless, each Design Win we achieve, may represent an opportunity for sustained, long-term revenues.

Server To Appliance Converter ("SETAC")

In a continuous effort to leverage our strength in networking solutions, in 2009 we launched our SETAC products, which convert standard servers to network appliances and are designed for systems that require front input/output (“I/O”) ports, I/O ports replaceable without opening the system chassis, high quantity of I/O ports and flexibility to provide high quantity of different configurations. This new product line responds to the dilemma currently faced by network appliance providers in designing their network appliances, which is either using a general server with standard add-on adapters, assuring server-grade reliability and a stable state of the art technological environment but sacrificing flexibility, or using specific appliance-oriented hardware solutions, allowing superior flexibility and field re-configurability but lacking in server grade reliability and technological stability. SETAC products offer the benefits of these two options, enabling branded high technology servers to be configured as hardware appliances, and creating an ideal network appliance that combines server grade reliability, front-end access, field-replaceable architecture and a stable, cutting edge technology environment.

The SETAC product line includes SETAC converters (comprised of PCI-Express G2 adapter, cables and Silicom's backplane), which interface with Silicom's front loading I/O Express Modules adapters. SETAC products are installed by a simple process of placing Silicom's I/O Express Modules adapters into a server's "hot-swap" hard drive slots. This combination enables standard servers to be configured as network appliances with server-grade reliability, front-end access, field replaceable architecture and a stable technology environment, creating a complete network appliance platform solution that provides us with a competitive edge. To the best of our knowledge we are currently the only company offering such a unique solution in the hardware networking appliance industry.

The principal applications of the SETAC products are the same as the principle applications of our Server Adapter products described above (including security appliances, WAN optimization appliances, video on demand servers, and internet service providers/web hosting). The SETAC products apply to the same target markets as the Server Adapter products, but also extend to two additional types of customers- server manufacturers and system integrators.

As with our Server Adapter line of products, the business model for our SETAC products is the Design Win Model.

Interest for the specific solution provided by the SETAC products is continuously growing in the hardware networking appliances market and orders for such products were placed throughout 2010. We cooperate with security industry companies, system integrators and server manufacturers, integrating SETAC units with a "server grade" motherboard and other system components. In August 2010, for instance, we established significant cooperation with a pioneering developer and manufacturer of high-performance server platforms, and with a major vendor in the security industry, who will be incorporating our SETAC products in their next-generation lines of security appliances to be launched in 2011. Further, as of January 2011, a leading server manufacturer will begin offering appliances which integrate Silicom's SETAC products with a popular model of its standard servers, thus enabling its customers to use the manufacturer's top quality servers as highly-flexible customized network appliances.

In light of increasing demand for SETAC products throughout 2010, we believe that such products will become one of the drivers for our revenues in the coming years.

Principal Markets

The principal markets in which we compete are set forth more particularly in, and are incorporated by reference to Note 12 to the consolidated financial statements set forth in Item 18 of this annual report. In 2008, 2009, and 2010, approximately, 8%, 17%, and 14% respectively, of our sales were in Europe, 66%, 71% and 72% respectively, were in North America, and 26%, 12% and 14% respectively, were in other countries. Our main business is not seasonal, and we believe that there are sufficient sources and raw materials available to sustain it.

Sales and Marketing

Over the last few years, our sales and marketing has been carried out through a network of strategic relationships with leading original equipment manufacturers which sell our products, generally as a part of their systems and sometimes under their own private labels. Our current original equipment manufacturer customers are mostly active in the security appliances market, WAN optimization market, other network appliances markets (such as load balancing and traffic management), storage market, general servers market and other server based applications. They are referred to in this report as OEMs, or OEM customers. Our strategy of carrying out strategic relationships with OEM customers continues to be the strategy under which we operate. We believe that these relationships enable us to take advantage of the superior financial resources and market presence of these companies to increase our sales and establish, maintain and strengthen our position and reputation in the market. In addition, we believe that relationships with OEMs improve access to new technologies developed by such OEMs, thereby ensuring smooth integration of our products and technology with those of the OEMs. In furtherance of this strategy, from 2005 through 2010 we entered into strategic arrangements with OEMs and continued securing successful Design Wins with OEMs who purchase our products. Revenues from sales of our products to OEM customers in 2010 constituted approximately 99% of our revenues. We expect the percentage of our revenues that is derived from sales of connectivity products to OEM customers to continue being approximately 99% as we continue to focus our efforts on our Server Adapter products, which are sold mostly to OEMs, and begin to focus on SETAC products, which are currently and will continue to be sold mostly to OEMs.

As such, the loss of some of our OEM customers may have a material adverse effect on our operations and financial results and we cannot assure you that we will be able to enter into strategic relationships with OEMs in the future. Our other non-OEM products are marketed directly, through our U.S.-based subsidiary and through a network of independent distributors. Normal payment terms of our OEM customers are up to 90 days net. Substantially all of our international sales are denominated in U.S. dollars and may be subject to government controls and other risks, including, in some cases, export licenses, federal restrictions on export, currency fluctuations, political instability, trade restrictions and changes in tariffs and freight rates. We have experienced no material difficulties to date as a result of these factors.

Our arrangements with OEMs (and distributors and resellers when applicable) are generally non-exclusive. We have generally experienced good relations with our customers and are not aware of any pending terminations other than with respect to products that newer technologies have eliminated the need for.

Our OEMs, distributors and resellers are not within our control. They are not obligated to purchase products from us and may represent other lines of products. A reduction in sales effort or discontinuance of sales of our products by our OEMs could lead to reduced sales and could materially adversely affect our operating results. Use of OEMs also entails the risk that OEMs will build up inventories in anticipation of a growth in sales. If such growth does not occur as anticipated, these OEMs may substantially decrease the amount of products ordered in subsequent quarters, discontinue product orders or even attempt to return unsold products. The loss or ineffectiveness of several of our OEMs at approximately the same time might have a material adverse effect on us.

Research and Product Development

Since we commenced operations, we have conducted extensive research, development and engineering activities. Our efforts emphasize the development of new products, cost reduction of current products, and the enhancement of existing products, generally in response to rapidly changing customer preferences, technologies and industry standards. During 2003-2010 we fully matured our line of Multi-Port Server Adapter products and further invested in the development of other products including development of cards incorporating bypass functionality, addition of a full line of PCI-Express cards based on both chipsets we used for the PCI-X based cards, supplementing a line of PCI-Express bypass cards and adding a line of ROHS compliant cards for PCI-X cards (as PCI-Express cards were originally designed to be ROHS compliant). During 2006 we launched a new product line of high-performance encryption cards designed to improve the throughput of internet security appliances and network gateways. The products improve the performance of networking appliances by independently executing encryption tasks, thereby accelerating the encryption process and freeing the CPUs of such appliances for other activities. During 2007, we enhanced our offering of encryption cards by adding a line of encryption products which is based on a second chipset manufacturer, positioning ourselves again (just like with the networking adapters) as an independent supplier which is able to deliver such cards based on chipsets delivered by the leaders in this industry. In addition, during 2007, we developed a line of stand-alone bypass solutions which allow the use of our solutions even where the networking component of the solution is already present. Also, during 2007, we worked to develop a series of 10Gbps adapters, based both on Intel chips and on Broadcom chips. During 2008, due to market demand we added two more stand-alone bypass units: 1. Entry level bypass switch 1/10Gbps, directed at power failure bypass. 2. High end 10Gbps intelligent bypass switch with self generating heartbeat and versatile monitoring and control options.

During 2008-2010 we continued to focus our efforts on the 10Gbps series, and we currently have the following families of 10Gbps cards: 1. Our main family of 10Gbps cards consists of 10Gbps adapters with and without bypass, with both Intel and Broadcom controllers, including several interface options (such as XFP, CX4, SFP+ and 10GbaseT). 2. The family of redirector cards, which was launched during 2008, which integrates intelligent packet filtering, multi-port connectivity and automated bypass on a single networking card. In addition to the abovementioned redirector cards, we are also developing a family of intelligent cards which enable intelligent offloading of server tasks.

From 2008 to 2010 we have developed the SETAC, a new, patent pending, product family. SETAC enables branded high technology servers to be configured as hardware appliances, and creates an ideal network appliance that combines server grade reliability, front-end access, field-replaceable architecture and a stable state-of-the-art technology environment. The SETAC product line includes SETAC converters (comprised of PCI-Express G2 adapter, cables and the Silicom backplane) that are used to interface with Silicom's front loading I/O Express Modules. Leveraging a standard server's configuration, the SETAC products are installed through placing Silicom's I/O Express Modules into the server's "hot-swap" hard drive slots. Through the use of the SETAC, the customer will be giving its new security appliance field re-configurability, flexibility and other desirable functions without sacrificing the use of a branded, highly-reliable and supportable basic platform.

We cannot assure you that any of our development efforts will result in commercially successful products, that such products will be released in a timely manner or that we will be able to respond effectively to technological changes or new product announcements by our competitors.

The markets for our products are characterized by rapidly changing technology and evolving industry standards. We believe that success will depend upon our ability to successfully market new networking and connectivity concepts and, to a lesser extent, upon our ability to enhance our existing products and to continue to introduce new products on a timely basis. Accordingly, we intend to make substantial investments in technology development. Notwithstanding these efforts, we cannot assure you that we will be successful in selecting, developing, manufacturing and marketing our technology or our enhanced and new products in a timely manner.

Manufacturing and Suppliers

Our manufacturing operations consist primarily of producing finished goods from components and sub-assemblies purchased from third parties. In addition, we perform testing and quality assurance procedures with respect to the components and sub-assemblies which are incorporated into our final products and the final products themselves.

We seek to monitor quality with respect to each stage of the production process including, but not limited to, the selection of component suppliers, warehouse procedures and final testing, packaging and shipping. We have been certified as complying with "ISO 9001:2000", which is a quality control standard used in our industry. We believe that our quality assurance procedures have been instrumental in achieving a high degree of reliability for our products. We intend to continue to maintain and improve the efficiency of such procedures.

Although we generally use standard parts and components for our products, certain key components used in our products are currently available from only one source, and others are available from a limited number of sources. Components currently available from one source include proprietary Gigabit Ethernet chipsets and other components, including other semiconductor devices and transformers, as well as plastic and metal product housings. We believe that we maintain a sufficient inventory of these components to protect against delays in deliveries. There can be no assurance that we will not experience delays in the supply of critical components in the future or that we will have a sufficient inventory of critical components at such time to produce products at full capacity. If we do experience such delays and there is an insufficient inventory of critical components at that time, our operations and financial results would be adversely affected.

We are generally required to fill orders for our products within one or two weeks after receipt of a firm purchase order. Consequently, we need to maintain inventory at levels that are in accordance with our forecasts and those of our customers. There can be no assurance that such forecasts will indeed materialize into firm purchase orders and consequently we cannot guarantee that the full volume of such inventory will be delivered against firm purchase orders and not remain unused.

Competition

The data server adapters industry is highly competitive. We face competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial, production and marketing resources than we do. We cannot guarantee that our present or contemplated products will continue to be distinguishable from those of our competitors or that the marketplace will find our products preferable to those of our competitors. Furthermore, there can be no assurance that competitive pressures will not result in price reductions that could materially adversely affect our business and financial condition and the results of our operations.

In the server networking industry for which we have developed our Multi-Port Gigabit-Ethernet Server Networking cards, our main competitor is Intel. In the bypass cards industry, our competition is not as significant. To the best of our knowledge, our only significant competitors in this industry are Interface Masters, Portwell and Adlink. There may be other local solutions which might compete with our products. In the external bypass cards industry (in which solutions are offered in the form of an external box instead of an embedded card), to the best of our knowledge our main competitor is Netoptics, and to some degree also Interface Masters.

To the best of our knowledge, there is no direct competition to our unique SETAC products. As network appliances may be built based on either standard servers or special hardware appliances, our SETAC products improve and enhance the competitive positioning of standard servers in the network appliance industry compared to the special hardware appliances alternative. The products offered by suppliers of special hardware appliances such as Portwell, Nexcom, Lanner and Advantech do not provide the advantages of the SETAC solution and therefore constitute only non-direct competition.

Intellectual Property Rights and Software Protection

Our success and ability to compete are dependent to a significant degree on our technology. In order to establish and protect the technology we use in our products, we primarily rely on a combination of non-disclosure agreements and technical measures, and to a lesser degree on patent. These measures afford only limited protection, and accordingly, there can be no assurance that the steps we take will be adequate to prevent misappropriation of our technology or the independent development of similar technologies by others. Despite our efforts to protect our technology, unauthorized parties may attempt to copy aspects of our products and develop similar hardware or software or to obtain and use information that we regard as proprietary. In addition, there can be no assurance that one or more parties will not assert infringement claims against us. The cost of responding to claims could be significant, regardless of whether the claims are valid.

On April 8, 2010, we filed a patent application in the United States the "Server-Based Network Appliance", to protect our proprietary intellectual property with respect to SETAC products.

On November 15, 2010, we filed a provisional patent application in the United States, the "NIC with Ethernet-Managed Bypass", to protect our proprietary information with respect to Ethernet-managed network interface cards.

We cannot assure you that a patent will actually be issued or that the scope of any issued patent will adequately protect our intellectual property rights.

Governmental Regulation Affecting the Company

We are affected by the terms of research and development grants we have received from the Office of the Chief Scientist of Israel (“OCS”). Under the terms of Israeli Government participation, a royalty of 3% or up to 6% of the net sales of products developed from a project funded by the OCS must be paid, beginning with the commencement of sales of products developed with grant funds and ending when 100% or 150% of the grant is repaid. For projects approved after January 1, 1999, the amount of royalties payable is up to a dollar-linked amount equal to 100% of such grants plus interest at LIBOR. The terms of Israeli Government participation also impose significant restrictions on manufacturing outside Israel of products developed with government grants and the transfer to third parties of technologies developed through such projects is subject to approval of the OCS. There can be no assurance that such approval, if requested, will be granted on reasonable commercial terms.

In addition, we receive certain tax benefits and reduced tax rates from the Israeli government due to our status as an “Approved Enterprise” under the Law for the Encouragement of Capital Investments-1959, as amended. See “Item 10. Additional Information – Taxation.” The entitlement to these benefits is conditional upon our fulfillment of the conditions stipulated by the law, regulations promulgated thereunder and the instruments of approval for the specific investments. In the event of failure to comply with these conditions, the benefits could be canceled and we would be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences and interest.

Organizational Structure

We have one wholly owned subsidiary, which is incorporated in the United States, under the name Silicom Connectivity Solutions, Inc. Two of our founders, Messrs. Yehuda and Zohar Zisapel, are also founders, directors and principal shareholders of several other corporations. See Item 7. “Major Shareholders and Related Party Transactions".

Property, Plant and Equipment

We do not own any real property, but we lease property at three locations. Our executive offices and research and development facilities are located in Kfar Sava, Israel. The original term of our lease with respect to such space expired on October 31, 1998 and was renewed for additional one-year periods through October 31, 2007. In November 2007, we renewed the term of the lease for our Kfar Sava offices until December 31, 2008, and have been extending such lease each year. On December 31, 2010 we extended the lease further for an additional year until December 31, 2011. The facility is 725 square meters in size and we currently pay a monthly rent of approximately $11,000.

We conduct our manufacturing from a facility in Yokneam, Israel. In December 31, 2008, we did not renew our lease for the facility we were leasing in Yokneam since 2000, but instead signed a new lease and, as of January 2009, moved to a new facility in Yokneam. The new lease was for a period of two years, ending in December 31, 2010, with an option to renew the terms for an additional period of three years. On December 31, 2010 we renewed the lease for such additional period, until December 31, 2013. This facility is 1,001 square meters in size, and the monthly rent payments are approximately $13,000.

As of February 2004, we sub-lease office space in Paramus, New Jersey, from our affiliate. This sub-lease was in effect until January 31, 2006 and was renewed for additional one-year periods through January 31, 2011. On January 31, 2011, we extended the sub-lease for an additional one-year period until January 31, 2012. Currently, the monthly rent payments for this space are approximately $800. See “Item 7 – Major Shareholders and Related Party Transactions.”

We believe that our facilities in Israel and in the United States are suitable and adequate for our operations as currently conducted. In the event that additional facilities are required or we need to seek alternative rental properties, we believe that we could obtain such additional or alternative facilities at commercially reasonable prices.

Item 4A. UNRESOLVED STAFF COMMENTS

There are no unresolved staff comments.

Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

General

Silicom was incorporated in Israel and commenced operations in 1987. We have traditionally been engaged in the design, manufacture, marketing and support of connectivity solutions for computers. In the years 2000 and 2001, we leveraged the IP developed in this area for use in the broadband internet access market. In late 2002, we leveraged our expertise and know-how in networking and operating systems to develop a line of high-end server networking cards, recording growing sales of these products in 2004-2007. In 2008 we recorded sales of these products of approximately $25.6 million, and in 2009 we recorded sales of approximately $20.5 million. In 2010 we leveraged our expertise and know-how in networking solutions and launched our new SETAC (Server To Appliance Converter) product line. In 2010 we recorded sales from all of our networking solutions of approximately $30.4 million. We primarily sell our products through original equipment manufacturers and, to a lesser extent, through independent distributors (on a non-exclusive basis).

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies are limited to those described below.

- Inventories - Inventories are stated at the lower of cost or market. Cost is determined using the "average-cost" method. We write down obsolete or slow moving inventory to its market value.

- Marketable securities – We account for investments which we intend and are able to hold to maturity, that are classified as held-to-maturity investments as defined in ASC 320-10 (SFAS No. 115), “Accounting for Certain Investments in Debt and Equity Securities”. Effective April 1, 2009, we adopted ASC 320-10 (FSP FAS 115-2) and ASC 958-320 (FAS 124-2), "Recognition and Presentation of Other-Than-Temporary Impairments" (ASC 320-10 and ASC 958-320), which significantly changes the existing other-than-temporary impairment model for debt securities. It also modifies the presentation of other-than-temporary impairment losses and increases the frequency and expands required disclosures about other-than-temporary impairment for debt and equity securities.

When other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the amortized cost basis of the investment and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings.

ASC 320-10 and ASC 958-320 did not have material effect on our financial statements. See also Note 2F to our consolidated financial statements.

- Allowance for doubtful accounts - Trade receivables are recorded less the related allowance for doubtful accounts receivable. We consider accounts receivable to be doubtful when it is probable that we will be unable to collect all amounts, taking into account current information and events regarding our customers' ability to repay their obligations. The balance sheet allowance for doubtful debts is determined as a specific amount for those accounts the collection of which is uncertain. We perform our estimates regarding potential doubtful debts based on payment history and correspondence with our customers, and based on new information we receive about the customers’ financial situation. As of December 31, 2010, the allowance for doubtful debts was $20 thousand.

- Deferred Taxes - We account for income taxes under ASC 740-10 (formally known as SFAS No. 109), "Accounting for Income taxes". Under ASC 740-10, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred taxes assets to the amount expected to be realized. Valuation allowances in respect of deferred taxes were recorded in respect of the following matters:

§ Deferred tax assets that, as we believe, are more likely than not to be realized. In assessing the potential of realization of deferred tax assets, we consider projected future taxable income and tax planning strategies.

§ Carry forward tax losses - As of December 31, 2010, our subsidiary had federal carry forward tax losses of approximately $582 thousand to be realized through 2029 and New Jersey state carry forward tax losses of approximately $23 thousand to be realized through 2015. There is no assurance that all of these carry forwards will be realized.

Deferred tax assets and liabilities are classified as current or non-current items in accordance with the nature of the assets or liabilities to which they relate. When there are no underlying assets or liabilities the deferred tax assets and liabilities are classified in accordance with the period of expected reversal. Income tax expenses represent the tax payable for the period and the changes during the period in deferred tax assets and liabilities. As of December 31, 2010, the deferred tax assets were $269 thousand.

- Accounting for uncertainty in income taxes - Beginning with the adoption of ASC 740 (FASB Interpretation No. 48), "Accounting for Uncertainty in Income Taxes" (FIN 48) as of January 1, 2007, the Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. Prior to the adoption of FIN 48, the Company recognized the effect of income tax positions only if such positions were probable of being sustained.

FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with ASC 740-10 (SFAS No. 109). This interpretation prescribes a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition of tax positions, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position.

The Company and its subsidiary adopted the provisions of FIN 48 as of January 1, 2007, and there was no material effect on the financial statements. As a result, the Company and its subsidiary did not record any cumulative effect related to adopting FIN 48.

As of January 1, 2010 and for the twelve months ended December 31, 2010, the Company and its subsidiary did not have any unrecognized tax benefits. In addition, the Company and its subsidiary do not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

- Impairment or disposal of long lived assets - We account for long-lived assets in accordance with the provisions of ASC subtopic 360-10 (SFAS No. 144), “Accounting for the Impairment or Disposal of Long-Lived Assets”. This Statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset. Fair value is being determined using discounted cash flow models. Assets to be disposed would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell.

- Accounting for Stock-Based Compensation - Effective January 1, 2006, the Company adopted ASC topic 718 (SFAS No. 123(R)), “Share-Based Payment”. This Statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation cost on a prospective basis. Under this method, the Company recorded stock-based compensation expense for awards granted prior to, but not yet vested as of January 1, 2006, the Company recognizes compensation expense based on estimated grant date fair value using the Black-Scholes option-pricing model. The share-based awards granted after January 1, 2008, include features that are not supported by the Black and Scholes valuation model, such as expiration date to occur if the closing price of the Shares falling below 50% of grant date Share price, therefore for share-based awards granted after January 1, 2008, the Company recognizes compensation expense based on estimated grant date fair value using the Monte Carlo option-pricing model, or the Binomial option-pricing model.

Recently Enacted Accounting Pronouncements Not Yet Adopted

In October 2009, the FASB issued ASU 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (EITF Issue No. 08-1, Revenue Arrangements with Multiple Deliverables). ASU 2009-13 amends ASC 650-25 to eliminate the requirement that all undelivered elements have vendor specific objective evidence of selling price ("VSOE") or third party evidence of selling price ("TPE") before an entity can recognize the portion of an overall arrangement fee that is attributable to items that already have been delivered. In the absence of VSOE and TPE for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. The overall arrangement fee will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity’s estimated selling price. Application of the “residual method” of allocating an overall arrangement fee between delivered and undelivered elements will no longer be permitted upon adoption of ASU 2009-13. Additionally, the new guidance will require entities to disclose more information about their multiple-element revenue arrangements. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The Company expects that the adoption of ASU 2009-13 in 2011 will not have a material impact on its consolidated financial statements.

Operating Results

You should read the following management's discussion and analysis of our financial condition and operating results in conjunction with the consolidated financial statements and the related notes thereto included in this annual report. The following table sets forth, for the periods indicated, the relationship (in percentages) of items from our Consolidated Statement of Operations Data to our total sales:

Year Ended December 31,

	2008		2009		2010	
Sales	100	%	100	%	100	%
Cost of sales	60.3		60.7		57.5	
Gross profit	39.7		39.3		42.5	
Research and development costs	11.9		13.2		10.8	
Selling and marketing expenses	8.2		8.9		7.3	
General and administrative expenses	5.6		6.4		5.0	
Operating Income	14.0		10.8		19.4	
Financial income, net	4.7		4.4		2.0	
Income before income taxes	18.7		15.2		21.4	
Income tax expenses	0.5		1.5		2.6	
Net Income	18.2		13.7		18.8	

Sales in 2010 increased by 48.1% to $30,399 thousand compared to $20,526 thousand in 2009. The increase in sales is mostly attributed to the fact that many existing customers increased their ongoing orders, the fact that some of our larger customers began integrating additional Silicom products into their product lines, and the fact that we continue expanding our customer base. The increase in sales is also affected, among other factors, by an increasing market demand in light of signs of economic recovery in 2010 following the global economic downturn in 2009.

Sales in 2009 decreased by 19.7% to $20,526 thousand compared to $25,554 thousand in 2008. The decrease in sales is mostly attributed to the generally lower demand caused by the global economic downturn. As a result of this economic downturn, during 2009 we have experienced a significant reduction in ongoing purchase orders, particularly from some of our major customers.

Gross profit in 2010 was $12,909 thousand compared to $8,065 thousand in 2009. Gross profit as a percentage of sales in 2010 was 42.5%, compared to 39.3% in 2009. Our gross profit is largely dependent on the mix of products we sell during a specific year. The higher gross profit percentage in 2010 was primarily a result of changes to the mix of sold products. Gross profit is also affected, among other factors, by write-downs of inventory made with respect to any obsolete or slow moving inventory we can no longer use. The inventory write-downs as a percentage of sales in 2010 has decreased to 2.6%, compared to 4.2% in 2009.

Gross profit in 2009 was $8,065 thousand compared to $10,149 thousand in 2008. Gross profit as a percentage of sales in 2009 was 39.3%, compared to 39.7% in 2008. Our gross profit is largely dependent on the mix of products we sell during a specific year. The slightly lower gross profit percentage in 2009 was primarily a result of changes to the mix of sold products. Gross profit is also affected, among other factors, by write-downs of inventory made with respect to any obsolete or slow moving inventory we can no longer use. The inventory write-downs as a percentage of sales in 2009 has slightly increased to 4.2%, compared to 3.6% in 2008.

Research and development costs in 2010 increased by 20.8% to $3,280 thousand compared to $2,716 thousand in 2009. This increase was mainly attributed to our continued investment in new product development, enhancements to existing products and the development of new networking and connectivity technologies, which contributed approximately $360 thousand to such increase, and to a relative weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our research and development expenses are incurred in New Israeli Shekels), which contributed approximately $200 thousand to such increase.

Research and development costs in 2009 decreased by 10.9% to $2,716 thousand compared to $3,048 thousand in 2008. This decrease was mainly attributed to a relative strengthening of the US dollar against the New Israeli Shekel (since a significant portion of our research and development expenses are incurred in New Israeli Shekels).

Selling and marketing expenses in 2010 increased by 21.2% to $2,207 thousand compared to $1,821 thousand in 2009. This increase was mainly attributed to our continued investment in the promotion of our server networking products, which contributed approximately $300 thousand to such increase, and to a relative weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our research and development expenses are incurred in New Israeli Shekels), which contributed approximately $90 thousand to such increase.

Selling and marketing expenses in 2009 decreased by 13.0% to $1,821 thousand compared to $2,093 thousand in 2008. This decrease was mainly attributed to a relative strengthening of the US dollar against the New Israeli Shekel (since a significant portion of our selling and marketing expenses are incurred in New Israeli Shekels).

General and administrative expenses in 2010 increased by 16.0% to $1,523 thousand compared to $1,313 thousand in 2009. This increase was mainly attributed to a relative weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our general and administrative expenses are incurred in New Israeli Shekels).

General and administrative expenses in 2009 decreased by 8.0% to $1,313 thousand compared to $1,427 thousand in 2008. This decrease was mainly attributed to a relative strengthening of the US dollar against the New Israeli Shekel (since a significant portion of our general and administrative expenses are incurred in New Israeli Shekels).

Financial income, net in 2010 decreased by 32.1% to $617 thousand compared to $909 thousand in 2009. The decrease was primarily caused by the relative weakening of the US dollar against the New Israeli Shekel (a significant portion of our balance sheet assets and obligations are denominated in New Israeli Shekels), which created a net financial expense in US dollars from exchange rate differences, and the decrease in yields from investments in marketable securities. Thus, despite the increase in funds available for investment, there was a decrease in financial income in 2010.

Financial income, net in 2009 decreased by 23.5% to $909 thousand compared to $1,188 thousand in 2008. The decrease was primarily caused by the decrease in yields from investments in marketable securities. Thus, despite the effect of a relative strengthening of the US dollar against the New Israeli Shekel (a significant portion of our balance sheet assets and obligations are denominated in New Israeli Shekels), which creates a net financial income in US dollars from exchange rate differences, and an increase in funds available for investment, there was a decrease in financial income in 2009.

In 2010 we recorded current income tax expenses of $657 thousand and deferred income tax expenses of $156 thousand compared to current income tax expenses of $358 thousand and deferred income tax expenses of $19 thousand in 2009. In addition, in 2010 we recorded income tax benefit relating to former years (tax returns) of $12 thousand.

In 2009 we recorded current income tax expenses of $358 thousand and deferred income tax expenses of $19 thousand compared to current income tax expenses of $438 thousand and deferred income tax benefit of $314 thousand in 2008. In addition, in 2009 we recorded income tax benefit relating to former years (tax returns) of $72 thousand.

The net change in valuation allowance for the years ended December 31, 2008, 2009 and 2010 was an increase of $31 thousand, a decrease of $423 thousand, and a decrease of $17 thousand, respectively. In assessing the realizability of the deferred tax assets, our management has to consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences and/or loss carry-forward become deductible. In making this assessment, our management has to consider the projected future taxable income as well as tax planning strategies.

For the year ended December 31, 2008, we recorded valuation allowance in the amount of its non-current deferred tax assets due to the uncertainty of their realization. In assessing the need for a valuation allowance, our management considered our historical levels of income, the fact that we had a single product line, short lead time of customer's orders and flexible forecasting and expectation of future taxable income and ongoing tax planning strategies.

For the year ended December 31, 2009, our management re-evaluated the need for a valuation allowance, due to our cumulative profits in recent years and in particular completing profitable quarters in 2009 despite the major worldwide economic downturn which started at the end of 2008. In light of the projections for future taxable income over the periods in which the deferred tax are deductible, our management believed that it is more likely than not that we would realize the benefits of these deductible differences. In making these projections we have considered our currently stable work environment related to our existing line of products, which enables us to present current positive operating income and net income. Additionally, we have considered our planned new line of products.

Accordingly, the Company reversed a major part of the valuation allowance and recorded an income tax benefit of $423 thousands in 2009. In 2010 the Company's view remained unchanged. As of December 31, 2010 all of the valuation allowance refers to loss carry-forward related to Silicom Connectivity Solutions, Inc., which is our U.S. subsidiary that files tax returns in the United States.

Based upon projections for future taxable income over the periods in which the deferred tax assets are deductible, the Company believes it is more likely than not that it will realize the benefits of these deductible differences, net of existing valuation allowance. The amount of the deferred tax asset considered realizable, however, could be reduced in the future if the estimations of future taxable income during the carryforward period are reduced.

In 2010 we recorded net income of $5,715 thousand compared to net income of $2,819 thousand in 2009, a 102.7% increase. This increase was mainly due to our higher sales in 2010.

In 2009 we recorded net income of $2,819 thousand compared to net income of $4,645 thousand in 2008, a 39.3% decrease. This decrease was mainly due to the respective decrease in sales, and occurred despite a decrease in our operational expenses as described above.

Impact of Inflation and Currency Fluctuations on Results of Operations, Liabilities and Assets

Since the majority of our revenues are denominated and paid in U.S. dollars, we believe that inflation and fluctuations in the U.S. dollar exchange rate have no material effect on our revenue. Inflation in Israel and the Israeli currency as well as U.S. dollar exchange rate fluctuations, may however, have an effect on our expenses and, as a result, on our net income/loss. The cost of our Israeli operations, as expressed in U.S. dollars, is influenced by the extent to which any change in the rate of inflation in Israel is not offset (or is offset on a lagging basis) by a change in valuation of the NIS in relation to the U.S. dollar.

We do not presently engage in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate or interest rate fluctuations. However, we may in the future undertake such transactions, if management determines that it is necessary to offset such risks.

Liquidity and Capital Resources

As of December 31, 2010, we had working capital of $33,708 thousand and our current ratio (current assets to current liabilities) was 6.78. Cash and cash equivalents as of December 31, 2010 decreased by $596 thousand to $6,657 thousand, compared to $7,253 thousand as of December 31, 2009. Short-term bank deposits increased by $1,956 thousand to $9,209 thousand, compared to $7,253 thousand as of December 31, 2009. Short-term marketable securities decreased by $2,263 thousand to $8,162 thousand and long-term marketable securities increased by $3,465 thousand to $21,773. The net increase of $2,562 thousand in these four balance sheet items in 2010 was mainly due to net cash provided by operating activities.

Trade receivables increased to $6,762 thousand as of December 31, 2010, compared to $5,172 thousand as of December 31, 2009, mainly due to the increase in sales in the fourth quarter of 2010, as compared to sales in the fourth quarter of 2009. Other receivables increased to $555 thousand as of December 31, 2010, compared to $371 thousand as of December 31, 2009.

Trade payables increased to $3,753 thousand as of December 31, 2010, compared to $2,261 thousand as of December 31, 2009, mainly due to the increase in inventory in the forth quarter of 2010.

Other payables and accrued liabilities decreased to $2,074 thousand as of December 31, 2010, compared to $2,138 thousand as of December 31, 2009.

Cash provided by operating activities in 2010 amounted to $3,236 thousand compared to $3,835 thousand in 2009. The cash provided by operating activities in 2010 was the result of our positive operating income.

Inventories increased to $8,140 thousand as of December 31, 2010, compared to $4,677 thousand as of December 31, 2009, mainly due to the fact that as our sales grow and customers demand receipt of products within a number of weeks following the issuance of purchase orders, we are required to be ready to deliver our products in accordance with our customers' expectations.

Capital expenditures on property and equipment as of December 31, 2010 were $466 thousand, compared to $258 thousand as of December 31, 2009.

In January 2006, we completed an offering and sale of 10,000 units in Israel, composed of 800,000 of our ordinary shares and 400,000 warrants, pursuant to a prospectus filed with the Israeli Securities Authority and TASE. The sale of units resulted in net proceeds of approximately $5.6 million. As of January 31, 2008 (i.e. the expiration date of the warrants), 399,934 warrants were exercised, resulting in additional proceeds of approximately $3.5 million in the aggregate. See “Item 4. Information on the Company – History and Development of the Company.”

In May 2007, we conducted a private placement, pursuant to which we issued to certain “accredited investors” and “qualified institutional purchasers” 875,000 ordinary shares at a purchase price of $20.50 per share and warrants to purchase up to 218,750 ordinary shares at an exercise price of $28.25 per share. We issued to the placement agents warrants to purchase up to an aggregate of 10,937 ordinary shares on the same terms as the warrants issued to the investors. Net proceeds from the private placement were approximately $16.8 million, net of $1.2 million of issuance costs. The warrants issued to the investors and to the placement agents expired in July 2010. Prior to their expiration in July 2010, no such warrants were exercised into shares.

We have cash and cash equivalents that we believe are sufficient for our present requirements. Furthermore, our cash resources are sufficient to fund our operating needs for the next twelve months.

Research and development, patents and licenses, etc.

Because the market for our products is characterized by rapidly changing technology and evolving industry standards, our success depends upon our ability to select, develop, manufacture and market new and enhanced products in a timely manner to meet changing market needs. As such, we invest significant resources in research and new product development, enhancements to existing products, and the development of new networking and connectivity technologies, and we expect to continue to do so.

On April 8, 2010, we filed a patent application in the United States the "Server-Based Network Appliance", to protect our proprietary intellectual property with respect to SETAC products.

On November 15, 2010, we filed a provisional patent application in the United States, the "NIC with Ethernet-Managed Bypass", to protect our proprietary information with respect to Ethernet-managed network interface cards.

We cannot assure you that a patent will actually be issued or that the scope of any issued patent will adequately protect our intellectual property rights.

The Government of Israel encourages research and development projects oriented towards products for export or projects which will otherwise benefit the Israeli economy. In each of the three fiscal years from 1999 to 2001, we received grants from the OCS for the development of systems and products. We have received from the OCS approximately 30% of certain research and development expenditures for particular projects. Under the terms of Israeli Government participation, a royalty of 2% or up to 5% of the net sales of products developed from a project funded by the OCS must be paid, beginning with the commencement of sales of products developed with grant funds and ending when 100% or 150% of the grant is repaid. For projects approved after January 1, 1999, the amount of royalties payable is up to a dollar-linked amount equal to 100% of such grants plus interest at LIBOR. The terms of Israeli Government participation also place restrictions on the location of the manufacturing of products developed with government grants, which, in general, must be performed in Israel, and on the transfer to third parties of technologies developed through projects in which the government participates. See “Item 10. Additional Information - Taxation.” We received approximately 20% of certain research and development expenditures for a particular project in 2003 and approximately 30% of a particular project in 2004. We did not have any new grant programs with the OCS from 2005 to 2010. In August 2005, we received approval for a $54 thousand dollar grant from the Korea-Israel Industrial Research and Development Foundation, or Koril-RDF, in connection with the joint development of a certain product with a Korean company. Under the terms of this grant we are required to repay the amounts received at a rate of 2.5% per year of our gross sales of the product developed with the grant in each such year, until 100% of the grant (and any other sums received from Koril-RDF) are repaid. The annual payment for every year following the first sale of the product will not exceed certain percentages of the amounts received from Koril-RDF. As of January 2006 and to date, our research and development activities have been sponsored and funded by us, and we did not participate in any new encouragement programs or received any additional grants from the OCS or Koril- RDF.

We expect that we will continue to commit resources to research and development in the future. As of February 28, 2011, we employed 30 persons in research and development. In 2008, 2009 and 2010, our research and development expenses were $3,048, $2,716 and $3,280, respectively, constituting approximately 11.9%, 13.2% and 10.8%, respectively, of our sales. For additional information concerning commitments to pay royalties on sales of products developed from projects funded by the OCS, see Note 10A to our financial statements included elsewhere in this annual report and see “Item 10. Additional Information - Taxation.”

Trend Information

In late 2002, we leveraged our expertise and know-how in networking and operating systems to develop a line of high-end server networking cards (Server Adapters). In today's network-based environment, there is a growing demand for server-based systems. The markets for such systems are almost continuously growing. Furthermore, the security market is growing due to an increase in demand for security appliances, most of which are server based, and the WAN optimization market is growing due to an increase in demand for better WAN connection between branch offices and headquarters. These two markets are now the main markets in which our Server Adapters provide added value. We began investing in marketing and sales of this line to potential markets and customers during 2003 and received initial purchase orders from a number of sources. We continued to invest in the marketing of these products during 2004-2010. During 2004-2007, the number of purchase orders for these products significantly increased. In 2008 there was a slight decrease in purchase orders as compared with 2007, and in 2009 there was a further decrease in purchase orders as compared with 2008, which was mostly attributed to the generally lower demand for the products due to the global economic downturn. The sales cycles in the markets for our products are long, but once we establish a customer base, each such customer will represent an opportunity for sustained, long-term revenues. During the years 2002-2009, our business was based in its entirety on this product line, which generated all of our revenues, and, during this period, we expected that this product line would continue to be our principal line of business in the coming years, specifically with respect to the 10Gbps cards, higher port density cards, bypass cards and intelligent and programmable cards.

In 2009, despite the impact of the major worldwide economic downturn as discussed above, we have continued to be profitable and completed four profitable quarters despite the year's significant challenges. Furthermore, in the last two quarters of 2009, we have been able to restore a process of growth in our business, a trend which continued in 2010. In 2010, the number of purchase orders for our products significantly increased, and we reached our highest revenues to date. Many of our customers have renewed their purchases to their level of purchases prior to the economic crisis, and we made sales associated with new products and customers. In 2009 and 2010 we launched new products, such as our new product family, the patent-pending SETAC (Server To Appliance Converter), which received a positive reaction in the market, penetrated our existing customer base and facilitated cooperation with new customers including a significant cooperation at the end of 2010 with a pioneering developer and manufacturer of high-performance server platforms, and with a major vendor in the security industry, who will be incorporating SETAC products in their next-generation lines of security appliances to be launched in 2011, and a significant cooperation at the beginning of 2011 with a leading server manufacturer which will begin offering appliances integrating Silicom's SETAC products with of a popular model of its standard servers. We believe that as products such as SETAC will further prove themselves in commercial deployments, the demand for such products is expected to increase and, consequentially, may turn this product family into one of our growth drivers in future years.

However, although we expect our business and products to further develop in the coming years, there is no assurance that we will continue to generate significant sales in the areas in which we operate.

Off-Balance Sheet Arrangements

On July 22, 2002, our Audit Committee and the Board of Directors approved an Indemnification Agreement with our directors and officers. Our shareholders approved the terms of this agreement in a General and Extraordinary Meeting held on January 7, 2004. In the March 2005 amendment to the Israeli Companies Law-1999, the instances in which a company may indemnify its officers and directors were broadened. In December 2007 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment. Our shareholders approved the terms of this new Indemnification Agreement in January 2008. The Agreement provides that the directors and officers will be exempt from liability in certain circumstances. The Agreement also provides for the indemnification by the Company for certain obligations and expenses imposed on the officer in connection with an act performed in his or her capacity as an officer of the Company. This right to indemnification is limited, and does not cover, among other things, a breach of an officer’s duty of loyalty, a willful breach of an officer’s duty of care, or a reckless disregard for the circumstances or consequences of a breach of duty of care. The right to indemnification also does not cover acts that are taken intentionally to unlawfully realize personal gain. The maximum amount of our liability under these Indemnification Agreements is currently $3,000,000.

Tabular disclosure of contractual obligations

The following table shows our outstanding contractual obligations by category and by payments due as of December 31, 2010:

	Payments due by period				
Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating Leases	$ 784,000	$ 561,000	$ 223,000		
Purchase Obligations	$ 5,782,000	$ 5,782,000			
Total	$ 6,566,000	$ 6,343,000	$ 223,000		

The Company’s total outstanding contingencies in respect of royalty-bearing participations received or accrued, net of royalties paid or accrued before interest, amounted to approximately $2,960 thousand as of December 31, 2010 ($2,960 thousand as of December 31, 2009), of which $2,782 thousand are attributable to sales of our legacy products and $178 thousand are attributable to sales of our new line of products.

Item 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Senior Management

The following table and notes thereto set forth information regarding our officers, directors and senior management as of February 28, 2011.

Name	Age	Position with Company
Avi Eizenman	53	Active Chairman of the Board
Shaike Orbach	59	President, Chief Executive Officer, Director
Zohar Zisapel	62	Director
Einat Domb-Har	43	External Director
Ilan Erez	43	External Director
David Hendel	49	Vice-President Research and Development
Eran Gilad	43	Chief Financial Officer

Avi Eizenman co-founded the Company in 1987 and has served as its President and as a Director, since its inception. Mr. Eizenman also served as Chief Executive Officer from the Company's inception until April 1, 2001, and on such date, he resigned from his position as Chief Executive Officer and was appointed Active Chairman of the Board of Directors. Mr. Eizenman served as head of the ASIC department at Scitex Ltd. in 1986. From 1979 until 1985, Mr. Eizenman held various positions, including project manager, ASIC specialist and engineer, with the Electronic Research & Development Department of the Israeli Ministry of Defense. Mr. Eizenman holds a B.Sc. degree, with honors, in Electrical Engineering from the Technion, and an M.B.A. from Tel Aviv University.

Shaike Orbach has been President and Chief Executive Officer of the Company since April 2001. In December 2001, Mr. Orbach was named a Director, replacing Zohar Zisapel, who resigned from the Board of Directors. Prior to that, for a period of four and a half years, Mr. Orbach was President and CEO of Opgal Ltd., a high-tech subsidiary of Israel's Rafael and El-Op corporations. Previously, he was General Manager of Edusoft, an Israeli company the shares of which were traded on the NASDAQ National Market (now, the NASDAQ Global Market), and Managing Director of Tecsys Ltd. He holds a B.Sc degree in Mechanical Engineering from the Technion.

Zohar Zisapel is a co-founder of the Company. He served as a Director from the Company's inception and until 2001. Mr. Zisapel is also a founder and a director of RAD Data Communications Ltd., of which he served as CEO from January 1982 until January 1998 and has served as chairman since 1998. Mr. Zisapel serves as chairman of three other public companies – Ceragon Networks Ltd. (Ticker Symbol CRNT), RADVision Ltd. (Ticker Symbol RVSN) and RADCOM Ltd. (Ticker Symbol RDCM) – and as chairman or director of several private companies belonging to the RAD Group. The Company has certain dealings with members of the Rad Group (see "Item 7. Major Shareholders and Related Party Transactions" below). Since July 2008, Mr. Zisapel has been a director of Amdocs Limited (Ticker Symbol DOX). Mr. Zisapel received a B.Sc. and a M.Sc. in electrical engineering from the Technion, Israel Institute of Technology, and an M.B.A. from Tel Aviv University.

Einat Domb-Har has served as Chief Financial Officer of Olista Ltd., a company providing unique solutions for the cellular industry, since June 2006. From April 2004 to April 2006 Ms. Domb-Har served as the Chief Financial Officer of Stage One Venture Capital, which focuses on seed investment in the telecom industry. From 2000 to 2004 Ms. Domb-Har served as a controller of Pitango Venture Capital, Israel's largest pool of four venture capital funds. From 1994 to 1999 Ms. Domb-Har served as a senior manager at Kost, Forer and Gabbay, CPA, a member of Ernst & Young International. Ms. Domb-Har is an Israeli Certified Public Accountant and holds a BA in Economics and Accounting from Tel Aviv University. She also holds an M.B.A. from the Israeli extension of Bradford University.

Ilan Erez has served as Chief Financial Officer of Cimatron Ltd. (Ticker Symbol CIMT) engaged in the design and sale of CAD/CAM software for the tool-making and discrete manufacturing industries, since July 2005. From 1998 to 2005 Mr. Erez served as the Chief Financial Officer of the Company. He also served as VP Operations of the Company from May 2001 to 2005. From 1996 to 1998 Mr. Erez served as Controller and assistant to the Chief Executive Officer at Bio-Dar Ltd. From 1994 to 1996 Mr. Erez served as an auditor at Kesselman & Kesselman, a member of Price Waterhouse Coopers. Mr. Erez is a Certified Public Accountant in Israel and holds a B.A in Accounting and Economics from the Hebrew University and an LL.M. in Business Law from Bar-Ilan University.

David Hendel has been Vice-President, Research and Development of the Company since 1995. From 1991 to 1995, he served as a Senior Hardware Engineer of the Company. Mr. Hendel previously served as an engineer in the Intelligence Corps of the Israeli Defense Forces. He holds a B.Sc. degree in Electrical Engineering from Ben-Gurion University.

Eran Gilad has been the Chief Financial Officer of the Company since May 2005. From 2002 to 2004 Mr. Gilad served as VP of Finance & Operation at Frontline PCB Solutions Ltd. From 2000 until 2002 Mr. Gilad held senior financial and operational positions at Lynx Photonic Networks Inc. From 1996 until 2000 Mr. Gilad held senior financial positions at Technomatix Technologies Ltd. He is a Certified Public Accountant in Israel and holds an M.A in Economics from Tel-Aviv University and a B.A in Accounting and Economics from Tel-Aviv University.

Compensation

The aggregate direct remuneration paid to all persons as a group who served in the capacity of director or executive officer during the year ended December 31, 2010 was $1,118 thousand. The aggregate amount accrued to provide for severance payments to all persons as a group who served in the capacity of director or executive officer as of the year ended December 31, 2010 was $946 thousand. The severance terms of the Company's Chief Executive Officer and Chairman of the Board, as approved by the audit committee, board of directors and shareholders of the Company, may entitle them, in certain circumstances, to additional payments. We did not pay cash compensation to Yehuda Zisapel and do not pay cash compensation to Zohar Zisapel for serving on our board of directors. We do pay cash compensation to Avi Eizenman who is an active Chairman of the Board, to Shaike Orbach, who is the President and Chief Executive Officer, and to Ms. Einat Domb-Har and Mr. Ilan Erez who are external directors and receive compensation in accordance with the regulations promulgated under the Israeli Companies Law-1999. All our officers work full time for us. Certain of the compensation previously paid to our directors was paid in the form of options under the Silicom Directors Share Incentive Option Plan (1994) and certain of such compensation is paid in the form of options under the Share Option Plan (2004) described below. The Directors Share Incentive Option Plan (1994) was adopted by the board of directors in August 1994, in order to grant options to members of the board of directors who served on the board of directors for at least three fiscal quarters. The Director Share Incentive Option Plan was administered by the board of directors, which designated the optionees, dates of grant and the exercise price of options. Under the Director Share Incentive Option Plan, 500,000 of our ordinary shares were reserved for issuance. The options granted under the Director Share Incentive Option Plan expire at the end of ten years from their date of grant and are non-assignable except by the laws of descent. The grantee is responsible for all personal tax consequences of the grant and the exercise thereof. We believe that we will bear no tax consequences in connection with such grant or exercise. The Director Share Incentive Option Plan was cancelled in July 2004 with respect to any share capital previously reserved and not yet allocated as well as any share capital that becomes unallocated from time to time as outstanding options expire or are forfeited. As of February 28, 2011, there are no outstanding options under the Director Share Incentive Plan (1994).

On October 24, 2000, the board of directors adopted the Silicom Ltd. US Share Option Plan (2000). This Plan is intended to constitute a means of providing additional incentive to officers, consultants and certain other present and future employees and directors of the Company and its subsidiaries. Pursuant to the Plan, the Company may grant both Incentive Stock Options (as such term is defined in Section 422 of the Internal Revenue Code of 1986, as amended; "ISOs") and Nonqualified Stock Options (“NSOs”), provided, however, that only our employees or employees of our subsidiaries can receive ISOs. The Plan is administered by the board of directors, which has full authority to grant options under the Plan. Under the terms of the Plan, up to a maximum of 200,000 of our ordinary shares are reserved for issuance, subject to certain adjustments. The exercise price of the options granted under the Plan shall be not less than 100 percent (or, in the case of a grant of ISO's to a holder of more than 10% of the Company's outstanding shares, 110 percent) of the fair market value (as defined in the Plan) of the ordinary shares subject to the option on the date the option is granted. The vesting period of the options is subject to the discretion of the Board. The term of ISOs shall not exceed 10 years from the date on which they are granted (or 5 years, in the case of optionees who hold more than 10% of our outstanding shares). In total, as of February 28, 2011, we have granted 22,600 options pursuant to the US Share Option Plan (2000) to employees of our US subsidiary – Silicom Connectivity Solutions, Inc., of which 11,300 were returned to the Company due to certain employees who left their positions not exercising their options and 2,500 expired without exercise due to the expiration of their term.

On December 30, 2004, our shareholders adopted our Share Option Plan (2004). Under the original terms of the Share Option Plan (2004) up to a maximum of 282,750 of our ordinary shares are reserved for issuance, subject to certain adjustments, upon the exercise of options granted to employees, directors, officers, consultants and service providers. In December 2007, the Board of Directors increased the number of our ordinary shares available for issuance under the Share Option Plan (2004) by 300,000. The Share Option Plan (2004) is administered by the board of directors, which designates the optionees, dates of grant, vesting periods and the exercise price of options. The options are non-assignable except by the laws of descent. Certain tax advantages apply to certain of our directors, officers and employees with respect to options granted to them under the Share Option Plan (2004). As of February 28, 2011, we have granted a total of 791,000 options under the Share Option Plan (2004), of which (i) 160,000 options were granted to Mr. Avi Eizenman, such that (a) 30,000 at an exercise price of $2.53 and at a termination date of December 30, 2014; (b) 40,000 expired in July 2008, (c) 40,000 at an exercise price of $3.82 and at a termination date of the earlier to occur of October 15, 2016 or the closing price of our shares falling below $1.91 and (d) 50,000 at an exercise price of $18.82 and at a termination date of the earlier to occur of December 21, 2018 or the closing price of our shares falling below $9.41, (ii) 30,000 options were granted to Mr. Yehuda Zisapel, at an exercise price of $2.53 and at a termination date of December 30, 2014, (iii) 160,000 options were granted to Mr. Shaike Orbach, such that (a)30,000 at an exercise price of $2.53 and at a termination date of December 30, 2014, (b) 40,000 expired in July 2008,(c) 40,000 at an exercise price of $3.82 and at a termination date of the earlier to occur of October 15, 2016 or the closing price of our shares falling below $1.91, and (d) 50,000 at an exercise price of $18.82 and at a termination date of the earlier to occur of December 21, 2018 or the closing price of our shares falling below $9.41 (iv) 30,000 options were granted to Ms. Einat Domb-Har at an exercise price of $2.53 and at a termination date of December 30, 2014 ; and (v) 30,000 options were granted to Mr. Ilan Kalmanovich, our former external director, at an exercise price of $2.53 and at a termination date of December 30, 2014. 20,500 of the options granted under the Share Option Plan (2004) were returned to the company due to certain employees who left their positions not exercising their options and 197,500 of the options granted under the Share Option Plan (2004) expired without exercise due to the expiration of their term.

In addition to the Plans described above, the oldest of the Company's share option plans was adopted in December 1993, and amended in 1997. Pursuant to this plan, 300,000 ordinary shares were reserved for issuance upon the exercise of options granted to employees and consultants of the Company. This reserve was increased by the board of directors to 500,000. The Share Option Plan was administered by the board of directors, which designated the optionees, dates of grant, vesting periods and the exercise price of options. The options granted under this plan expire after 10 years from their date of grant and are non-assignable except by the laws of descent. The grantee is responsible for all personal tax consequences of the grant and the exercise thereof. The 1993 share option plan was cancelled in July 2004 with respect to any share capital previously reserved and not yet allocated as well as any share capital that becomes unallocated from time to time as outstanding options expire or are forfeited.

Board Practices

Each of Yehuda Zisapel, Avi Eizenman and Shaike Orbach was elected to the board of directors most recently on April 14, 2010 to serve until the next Annual Shareholders' Meeting. Messrs. Yehuda Zisapel and Avi Eizenman are both Founders of the Company, and have served as Directors since our inception in 1987. On July 15, 2010, Yehuda Zisapel resigned from serving as director on the board of directors of the Company, and, on September 2, 2010, Zohar Zisapel was elected to the board of directors to serve until the next Annual Shareholders' Meeting. Mr. Zohar Zisapel is also a founder of the Company. On June 30, 2004 Ms. Einat Domb-Har and Mr. Ilan Kalmanovich were elected to the board of directors of the Company to hold office as external directors for a period of three years in accordance with Section 245(a) of the Companies Law – 1999. On September 23, 2007, the appointments of each of Ms. Einat Domb-Har and Mr. Ilan Kalmanovich as external directors were extended for additional three-year terms. On July 1, 2010, the terms of service of Mr. Ilan Kalmanovich and Ms. Einat Domb-Har as external directors in the Company expired. On September 2, 2010, the appointment of Ms. Einat Domb-Har as external director was extended for an additional three-year term, and Mr. Ilan Erez was elected to hold office as external director for a period of three years.

None of the members of the board of directors is entitled to receive any severance or similar benefits upon termination of his or her service with the board of directors, except for Avi Eizenman, who also functions as the active Chairman of the board and Shaike Orbach, who also functions as President and Chief Executive Officer (See “Item 6. Directors and Senior Management – Compensation” above).

In December 2007 our Audit Committee and Board of Directors approved severance arrangements for each of Mr. Avi Eizenman and Mr. Shaike Orbach, which provide for extended notice provisions and severance payments in the event of termination. The arrangements were approved by our shareholders in January 2008, and include the following main terms and conditions (identical with respect to each of Mr. Avi Eizenman and Mr. Shaike Orbach):

Notice of Termination

The termination of the executive’s employment, by him or the company, for any reason other than cause (which is generally defined as willful conduct or omission materially injurious to the company), death or disability, shall require 12 months advance written notice. If, however, following a change in control transaction, either: (i) he shall give notice of termination of his employment for good reason (which is generally defined as an adverse change to the status, responsibilities, salary or other material terms of his employment); or (ii) we shall give notice of termination of his employment for any reason other than cause or disability, 18 months advance written notice shall be required. A change in control transaction includes transactions such as sale of all or substantially all of the company’s shares or assets, or a merger, acquisition, or other reorganization in which control of our company changes following such transaction.

Severance Payments

If the executive's employment shall be terminated for any reason other than cause, he shall be entitled to receive his last full monthly salary multiplied by the number of years (or portions thereof) that he was employed by us (i.e. the severance amount he would be entitled to receive under the Israeli law, had we terminated his employment for any reason other than cause) (the "Severance Law Amount"). If, however, his employment shall be terminated: (i) by the company for any reason other than cause or disability; or (ii) by him for a good reason following a change in control, he shall be entitled to receive one and half times the Severance Law Amount. If the executive's employment under the arrangement is terminated by reason of death or disability, then, in addition to the above, he shall be entitled to receive a lump sum severance payment equal to his last full monthly salary multiplied by twelve 12 months.

Board of Directors

Our Articles of Association provide for a board of directors of not less than two nor more than eight members. Each director (except external directors) is elected to serve until the next annual general meeting of shareholders and until his or her successor has been elected. Officers serve at the discretion of the board of directors. The Articles of Association of the Company provide that any director may, subject to the provisions of the Israeli Companies Law-1999 and the approval by the Board of Directors, appoint another person to serve as a substitute director and may cancel such appointment. Under the Israeli Companies Law-1999, a person who is already serving as a director will not be permitted to act as a substitute director. Additionally, the Israeli Companies Law-1999 prohibits a person from serving as a substitute director for more than one director. Appointment of a substitute director for a member of a board committee is only permitted if the substitute is a member of the board of directors and does not already serve as a member of such committee. If the committee member being substituted is an external director, the substitute may only be another external director who possesses the same expertise as the external director being substituted. The term of appointment of a substitute director may be for one meeting of the board of directors or for a specified period or until notice is given of the cancellation of the appointment. To our knowledge, no director currently intends to appoint any other person as a substitute director, except if the director is unable to attend a meeting of the board of directors.

On December 5, 2010, our board of directors has established a compensation committee, composed of at least two directors who shall initially be Mr. Zohar Zisapel, as chairman, and Mr. Avi Eizenman. The Committee does not have the authority to approve resolutions and take action in lieu of the board of directors, and its sole function is to recommend to the board of directors with respect to the following matters and any other matters as the board of directors shall decide from time to time:

- goals and objectives relating to the compensation of the Chief Executive Officer and Active Chairman of the Board of Directors, evaluation of their performance in light of such goals and objectives and determination and approval of their compensation based on such evaluation;
- compensation of other directors;
- indemnification and insurance of directors and executive officers;
- employee stock option plans; and
- this committee's performance.

External Directors; Audit Committee

Under the Israeli Companies Law-1999, companies registered under the laws of Israel the shares of which have been offered to the public in or outside of Israel are required to appoint no less than two external directors. No person may be appointed as an external director if such person or the person's relative, partner, employer or any entity under the person's control, has or had, on or within the two years preceding the date of the person's appointment to serve as external director, any affiliation with the company or any entity controlling, controlled by or under common control with the company. The term "affiliation" includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder.

A person shall be qualified to serve as an external director only if he or she possesses "expertise in finance and accounting" or "professional qualifications". At least one external director must posses expertise in finance and accounting.

A director can satisfy the requirements of having "expertise in finance and accounting" if due to his or her education, experience and qualifications he or she has acquired expertise and understanding in business and accounting matters and financial statements, in a manner that allows him or her to understand, in depth, the company's financial statements and to spur a discussion regarding the manner in which the financial data is presented.

A public company's board of directors must evaluate the proposed external director's expertise in finance and accounting, by considering, among other things, such candidate's education, experience and knowledge in the following: (i) accounting and auditing issues typical to the field in which the company operates and to companies of a size and complexity similar to such company; (ii) the company's independent public accountant's duties and obligations; (iii) preparation of the company's consolidated financial statements and their approval in accordance with the Companies Law and the Israeli Securities Law - 1961.

A director is deemed to be “professionally qualified” if he or she meets any of the following criteria: (i) has an academic degree in any of the following professions: economics, business administration, accounting, law or public administration; (ii) has a different academic degree or has completed higher education in a field that is the company’s main field of operations, or a field relevant to his or her position; or (iii) has at least five years experience in any two of the following: (A) a senior position in the business management of a corporation with a significant extent of business, (B) a senior public position or a senior position in public service, or (C) a senior position in the company's main field of operations. As with a candidate’s expertise in finance and accounting, the board of directors here too must evaluate the proposed external director's "professional qualification" in accordance with the criteria set forth above.

The declaration required by law to be signed by a candidate to serve as an external director must include a statement by such candidate concerning his or her education and experience, if relevant, in order that the board of directors may properly evaluate whether such candidate meets the requirements of having "expertise in finance and accounting" or being "professionally qualified" as set forth in the regulations. Additionally, the candidate should submit documents and certificates that support the statements set forth in the declaration.

No person may serve as an external director if the person’s position or other business activities create, or may create, a conflict of interest with the person’s responsibilities as an external director or may otherwise interfere with the person’s ability to serve as an external director. If, at the time external directors are to be appointed, all current members of the board of directors are of the same gender, then at least one external director must be of the other gender.

External directors are to be elected by a majority vote at a shareholders’ meeting, provided that either:

- the majority of shares voted at the meeting, including at least one-third of the shares held by non-controlling shareholders voted at the meeting, vote in favor of election of the director; or
- the total number of shares held by non-controlling shareholders voted against the election of the director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an external director is three years and may be extended for additional terms of three years. External directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment, violate their duty of loyalty to the company or are found by a court to be unable to perform their duties on a full time basis. External directors may also be removed by an Israeli court if they are found guilty of bribery, fraud, administrative offenses in a company or use of inside information. Each committee of a company’s board of directors must include at least one external director. See “Item 10. Additional Information- Companies Law Amendment” below for a discussion of a recent amendment to the Israeli Companies Law-1999 which, once it enters into effect, may impact our company’s corporate governance practices as discussed herein.

An external director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law-1999 and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an external director. Ms. Einat Domb-Har and Mr. Ilan Kalmanovich were elected to the board of directors as external directors on June 30, 2004 and were subsequently re-elected on September 23, 2007. On September 2, 2010, Ms. Einat Domb-Har was re-elected and Mr. Ilan Erez was elected to the board of directors as external directors for a term of three years.

Audit Committee

The Israeli Companies Law-1999 requires public companies to appoint an audit committee. The responsibilities of the audit committee include identifying irregularities in the management of our business and approving related party transactions as required by law. An audit committee must consist of at least three directors, including all the external directors of the company. The chairman of the board of directors, any director employed by or otherwise providing services to the company, and a controlling shareholder or any relative of a controlling shareholder, may not be a member of the audit committee. Currently, Ms. Einat Domb-Har, Mr. Ilan Erez and Mr. Zohar Zisapel serve as members of our audit committee. See "Item 10. Additional Information- Companies Law Amendment" below for a discussion of a recent amendment to the Israeli Companies Law-1999 which, once it enters into effect, may impact our company's corporate governance practices as discussed herein.

As of December 31, 2010, pursuant to Companies Regulations (Instructions and Conditions to the Approval Procedures of Financial Statements) - 2010 ("Regulations for Approval of Financials"), our audit committee also serves as a special committee for the review of financial statements (the "Financial Statements Committee"). The function of the Financial Statements Committee is to review our financial statements and make recommendations on certain topics to the board of directors, as set forth in the Regulations for Approval of Financials. The board of directors, in turn, considers the recommendations of the Financial Statements Committee while it approves our financial statements.

Internal Auditor

Under the Israeli Companies Law-1999, the board of directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether our actions comply with the law and orderly business procedure. Under the Israeli Companies Law-1999, the internal auditor may be an employee of the company but not an office holder (as defined in Item 10 below), or an affiliate, or a relative of an office holder or affiliate, and he or she may not be our independent accountant or its representative. Our board of directors appointed Fahn Kaneh Control Management Ltd. to be our internal auditor on April 26, 2005, according to the recommendation of the audit committee.

Employees

The number of employees over the last three financial years is set forth in the table below.

As of December 31	2008	2009	2010
Total Employees	74	76	85
Marketing, Sales, Customer Services	11	10	10
Research & Development	23	25	30
Manufacturing	32	33	37
Corporate Operations and Administration	8	8	8

As of February 28, 2011, we had 85 employees, including 11 in marketing, sales and customer services, 30 in research and development, 36 in manufacturing, and 8 in corporate operations and administration. All such employees, except for 2 employees in the United States, are based in Israel. We consider our relations with our employees excellent and have never experienced a labor dispute, strike or work stoppage. None of our employees is represented by a labor union. We do not employ a significant number of temporary employees, but we do use temporary employees from time to time, as necessary.

Certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations including the Industrialists' Associations are applicable to our Israeli employees by order of the Israeli Ministry of Labor. The laws principally concern the length of the work day, contributions to a pension fund, recuperation pay, travel expenses payment and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

Israeli law generally requires severance pay, which may be funded by managers' insurance and/or a pension fund described below, upon the retirement or death of an employee or termination of employment without cause (as defined in the law). The payments to the managers’ insurance and/or pension fund in respect of severance pay amount to approximately 8.33% of an employee’s wages, in the aggregate. Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Such amounts also include payments for national health insurance. The payments to the National Insurance Institute are equal to approximately 16% of an employee’s wages, of which the employee contributes approximately 62.5% and the employer contributes approximately 37.5%.

A general practice followed by the Company, is the contribution of funds on behalf of most of its employees either to a fund known as managers' insurance or to a pension fund, or to a combination of both. Such practice was further reinforced by the Company in July 1, 2008, when the Company entered into agreements with a majority of its employees in order to implement Section 14 to the Severance Pay Law, according to which the payment of monthly deposits by the Company into managers' insurance and/or pension fund are in respect of severance obligation to such employees. See Note 9 of our consolidated financial statements. These funds provide a combination of savings plan, insurance and severance pay benefits to the employee, giving the employee a lump sum payment upon retirement and securing the severance pay or part of it, if legally entitled, upon termination of employment. To the funds, each employee contributes an aggregate amount equal to between 5% and 5.5% of his base salary, and we contribute, in the aggregate, including the 8.33% abovementioned which are contributed as severance pay, between 13.3% and 15.8% of the employee's base salary.

Share Ownership

The following table sets forth, as of February 28, 2011, the number of Shares owned by officers, directors and senior management of the Company:

Name and Address	Number of Shares and Options Owned1	Percent of Outstanding Shares	
Zohar Zisapel2	1,511,722	21.94	%
Avi Eizenmann	237,022	3.42	%
Shaike Orbach	*	*	
Einat Domb Har	*	*	
Ilan Kalmanovich	*	*	
David Hendel	*	*	
Eran Gilad	*	*	
All directors and officers as a group	1,748,744	25.20	%

* Denotes ownership of less than 1% of the outstanding shares.

1 The table above includes the number of shares and options that are exercisable within 60 days of February 28, 2011. Ordinary shares subject to these options are deemed beneficially owned for the purpose of computing the ownership percentage of the person or group holding these options, but are not deemed outstanding for purposes of computing the ownership percentage of any other person. To our knowledge, the persons and entities named in the table have sole voting and dispositive power with respect to all shares shown as beneficially owned by them.

2 Based on Schedule 13D/A filed on March 5, 2009.

See also "Item 6. Directors and Senior Management – Compensation."

Item 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

Major Shareholders

The shareholders of the Company who beneficially own over 5% or more of each class of shares, as well as the number of shares owned and the percentage of outstanding shares owned by each, and additional information, is set forth below. The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares.

Name of Shareholder	Number of Shares and Options Owned3	Percentage of Outstanding Shares		Any Significant Change in Past 3 Years
Zohar Zisapel4	1,511,722	21.94	%	+837,999

3 The table above includes the number of shares and options that are exercisable within 60 days of February 28, 2011. Ordinary shares subject to these options are deemed beneficially owned for the purpose of computing the ownership percentage of the person or group holding these options, but are not deemed outstanding for purposes of computing the ownership percentage of any other person. To our knowledge, the persons and entities named in the table have sole voting and dispositive power with respect to all shares shown as beneficially owned by them.

4 Based on Schedule 13D/A filed on March 5, 2009.

As of February 28, 2011, there were approximately 13 record holders of ordinary shares, including approximately 10 record holders in the United States. Collectively, these 13 record holders held approximately 16% of the outstanding ordinary shares.

Related Party Transactions

Messrs. Yehuda and Zohar Zisapel are brothers and are our founders. On July 15, 2010 Mr. Yehuda Zisapel resigned from serving as director on our board of directors, and on September 2, 2010, Mr. Zohar Zisapel was elected to serve as a director on our board. Messrs. Yehuda and Zohar Zisapel are also founders, directors and principal shareholders of several other corporations within the "Rad Group", as described in "Item 6. Directors, Senior Management and Employees".

There are other members of the Rad Group that are actively engaged in designing, manufacturing, marketing and supporting data communications products, none of which are currently the same as our products. Certain products of members of the Rad Group are complementary to, and may be used in connection with, our products. We and other members of the Rad Group also market certain of our products through the same distribution channels. Such products may, to a limited extent, compete with one another for the distributors' time and efforts.

The Rad Group provides us with certain services, and is reimbursed by us for the costs of providing such services. During 2010, we purchased from the Rad Group internet services for an amount of up to $35,000, testing services for our products for an amount of up to $36,000 and car leasing services for an amount of up to $6,000. We also sub-lease office space in Paramus, New Jersey, for an amount of up to $10,000 (monthly rent payments of approximately $800) from Radcom Equipmet, Inc., an affiliated company of the Rad Group. We began to sub-lease this space in February 2004; the sub-lease was in effect until January 31, 2006 and was renewed for additional one-year periods through January 31, 2011. On January 31, 2011, we extended the sub-lease for an additional one-year period until January 31, 2,012.

During 2010, we sold external bypass switches and Server Adapters to members of the Rad Group for an amount of up to $290,000.

The material terms of the arrangements with the Rad Group, described in the preceding paragraphs, occur within the Company's ordinary course of business, and on market terms. We believe that such arrangements are neither material to the Company nor unusual in their nature or conditions. We further believe that the terms of the transactions in which we have engaged and are currently engaged with other members of the Rad Group are generally no less favorable to us than terms which might be available to us from unaffiliated third parties.

In January 2006 our board of directors approved a resolution under which sales to or purchases from any members of the Rad Group must meet certain criteria or be specifically approved by the audit committee, board of directors and shareholders, as applicable in accordance with Israeli law. These criteria included a stipulation that transactions between us and members of the Rad Group relate to standard equipment, services and products purchased or sold by us and the Rad Group, as applicable, and that such transactions occur within our ordinary course of business. The January 2006 resolution determined that transactions with members of the Rad Group must be entered into at least on market terms and at a value lower than 0.5% of our annual turnover per transaction and not more than 1% of our annual turnover in the aggregate for all such transactions in a financial year. Further, all future related party transactions and arrangements (or modifications of existing ones) with members of the Rad Group, transactions in which office holders of the Company have a personal interest, or transactions which raise issues of such office holders' fiduciary duties, could require audit committee, board of directors and shareholder approval under the Israeli Companies Law-1999.

In January 2011, recognizing that sales to or purchases from the Rad Group may in the aggregate exceed 1% of our annual turnover in such year (without constituting extraordinary transactions as defined in the Israeli Companies Law), our board of directors revised its January 2006 resolution in respect of related party transactions.

In its new resolution, on January 23, 2011, the board of directors approved sales to or purchases from the Rad Group, from time to time, of standard equipment, services and products, which are (i) within our ordinary course of business and (ii) at least at market terms and at a value lower than 0.5% of our annual turnover per transaction and 2.5% of our annual turnover for all such transactions in a financial year, aggregated together. Our management is required to examine on a quarterly basis whether transactions with the Rad Group comply with such criteria. Transactions which do not meet the criteria will require specific approvals in the applicable manner prescribed by Israeli law

Our board of directors further determined that our transactions with the Rad Group during 2010, which constituted 1.2% of our annual turnover, were (i) within our ordinary course of business; (ii) at least at market terms and at a value lower than 0.5% of our annual turnover per transaction and (iii) did not have any material effect on our profitability, assets or obligations.

In addition to being a founder, director and principal shareholder of each member of the Rad Group, Yehuda Zisapel is the founder and principal shareholder of Bynet and its subsidiaries. Bynet acts as a distributor in Israel for us and for other members of the Rad Group and also acts as a distributor in Israel for numerous unaffiliated manufacturers of data communications and other equipment. We believe that the terms of our relationship with Bynet are generally no less favorable to us than terms which might be available to us from unaffiliated third parties.

Except as indicated above, we do not directly currently compete with other members of the Rad Group and do not currently contemplate engaging in competition with any other member of the Rad Group in the future. However, opportunities to develop, manufacture or sell new products (or otherwise enter new fields) may arise in the future, which opportunities might be pursued by us or by one or more other members of the Rad Group to the exclusion of (or in competition with) other members of the Rad Group (including us). In the event that any such opportunity arises, the directors then in office will determine whether or not we should seek to pursue it. Any such determination will be based upon such factors as the directors then deem relevant. However, in making any such determination, the directors will be bound by their fiduciary duties to the Company (and to any other corporation or other person to whom they then owe a fiduciary duty).

On July 22, 2002, our audit committee and the Board of Directors approved an Indemnification Agreement with our directors and officers. Our shareholders approved the terms of this agreement in a General and Extraordinary Meeting held on January 7, 2004. In the March 2005 amendment to the Israeli Companies Law-1999, the instances in which a company may indemnify its officers and directors were broadened. In December 2007 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment. Our shareholders approved the terms of this new Indemnification Agreement in January 2008. The Agreement provides that our directors and officers will be exempt from liability in certain circumstances. The Agreement also provides for the indemnification by the Company for certain obligations and expenses imposed on the officer in connection with act performed in his or her capacity as an officer of the Company. This right to indemnification is limited, and does not cover, among other things, a breach of an officer's duty of loyalty, a willful breach of an officer's duty of care, or a reckless disregard for the circumstances or consequences of a breach of a duty of care. The right to indemnification also does not cover acts that are taken intentionally to unlawfully realize personal gain. The maximum amount of our liability under these Indemnification Agreements is currently $3,000,000.

We have maintained liability insurance for our directors and officers. On September 23, 2007 our shareholders approved the procurement of a policy, which provides for coverage of up to $4,000,000. All of our directors are parties to our Indemnification Agreements and are covered by our directors and officers insurance policy.

See "Item 10. Additional Information- Companies Law Amendment" below for a discussion of a recent amendment to the Israeli Companies Law-1999 which, once it enters into effect, may impact our company's corporate governance practices as discussed herein.

See also "Item 6. Directors and Senior Management – Compensation."

Item 8. FINANCIAL INFORMATION

Our consolidated financial statements and other financial information are included herein on pages F-1 through F-37.

Legal Proceedings

We are not a party to any material litigation and we are not aware of any pending or threatened litigation that would have a material adverse effect on us or our business.

Item 9. THE OFFER AND LISTING

Markets and Share Price History

The primary trading market for our ordinary shares is the NASDAQ Global Market (previously NASDAQ National Market), where our shares have been listed and traded under the symbol SILC (previously SILCF) since February 11, 2008. Prior thereto, our shares were listed and traded on the NASDAQ Capital Market (previously known as the NASDAQ Small-Cap).

The table below sets forth the high and low reported sales prices in dollars of our ordinary shares, as reported by NASDAQ during the indicated periods:

PERIOD	HIGH	LOW
LAST 6 CALENDAR MONTHS		
February 2011	21.85	16.79
January 2011	21.00	17.18
December 2010	19.54	15.75
November 2010	17.78	14.53
October 2010	16.50	13.61
September 2010	14.60	12.09
FINANCIAL QUARTERS DURING THE PAST TWO YEARS		
Fourth Quarter 2010	19.54	13.61
Third Quarter 2010	14.60	8.02
Second Quarter 2010	10.79	8.07
First Quarter 2010	11.49	8.50
Fourth Quarter 2009	10.20	7.47
Third Quarter 2009	9.55	6.22
Second Quarter 2009	8.00	6.07
First Quarter 2009	6.90	4.11
FIVE MOST RECENT FULL FINANCIAL YEARS		
2010	19.54	8.02
2009	10.20	4.11
2008	16.75	2.87
2007	28.24	8.40
2006	12.46	3.75

On December 27, 2005, our shares commenced trading on the Tel Aviv Stock Exchange in Israel under the symbol “SILC” (in Hebrew letters). The following table sets forth, for the periods indicated, the high and low reported sales prices, in NIS, of the ordinary shares on the Tel Aviv Stock Exchange:

PERIOD	HIGH	LOW
LAST SIX CALENDAR MONTHS		
February 2011	80.64	63.50
January 2011	75.50	63.02
December 2010	71.20	59.20
November 2010	63.85	52.52
October 2010	61.40	50.01
September 2010	54.97	44.76
FINANCIAL QUARTERS DURING THE PAST TWO YEARS		
Fourth Quarter 2010	71.20	50.01

Third Quarter 2010	54.97	30.31
Second Quarter 2010	40.14	31.81
First Quarter 2010	43.63	30.40
Fourth Quarter 2009	44.44	25.51
Third Quarter 2009	36.00	24.52
Second Quarter 2009	34.55	25.25
First Quarter 2009	30.00	16.20
FIVE MOST RECENT FULL FINANCIAL YEARS		
2010	71.20	30.31
2009	44.44	16.20
2008	59.80	13.05
2007	111.70	36.31
2006	56.59	20.16

Item 10. ADDITIONAL INFORMATION

Memorandum and Articles of Association

Articles of Association

Our shareholders approved our Amended and Restated Articles of Association ("Articles") on January 24, 2008. The objective stated in the Articles is to carry on any business and perform any act which is not prohibited by law.

We have currently outstanding only one class of shares, our Ordinary Shares, having a nominal value of NIS 0.01 per share. Holders of Ordinary Shares have one vote per share, and are entitled to participate equally in the payment of dividends and share distributions and, in the event of a liquidation of the Company, in the distribution of assets after satisfaction of liabilities to creditors. No preferred shares are currently authorized.

Our Articles require that we hold our annual general meeting of shareholders each year no later than 15 months from the last annual meeting, at a time and place, either within or without the State of Israel, determined by the board of directors, upon 21 days' prior notice to our shareholders or 35 days' prior notice to the extent required under the regulations to the Israeli Companies Law-1999 the "Companies Law"). In general, no business may be commenced at a general meeting until a quorum of two or more shareholders holding at least 33 1/3% of the voting rights is present in person or by proxy. Shareholders may vote in person or by proxy.

A simple majority is required to amend the articles of association of a company.

Pursuant to the Israeli Companies Law, resolutions regarding the following matters must be passed at a general meeting of shareholders:

- appointment or termination of our auditors;
- appointment and dismissal of directors;
- approval of interested party acts and transactions requiring general meeting approval as provided in sections 255 and 268 to 275 of the Israeli Companies Law;
- a merger as provided in section 320(a) of the Israeli Companies Law;
- the exercise of the powers of the board of directors, if the board of directors is unable to exercise its powers and the exercise of any of its powers is vital for our proper management, as provided in section 52(a) of the Israeli Companies Law.

An extraordinary general meeting may be convened by demand of two directors or by written request of one or more shareholders holding at least 5% of our issued share capital and 1% of the voting rights or one or more shareholders holding at least 5% of the voting rights. Shareholders requesting a special meeting must include in their request all relevant information, including the reason that such subject is proposed to be brought before the special meeting.

The Israeli Companies Law-1999

We are subject to the provisions of the Israeli Companies Law, which became effective on February 1, 2000. The Israeli Companies Law codifies the fiduciary duties that “office holders,” including directors and executive officers, owe to a company. An office holder, as defined in the Israeli Companies Law, is a director, general manager, chief business manager, deputy general manager, vice general manager, executive Vice-President, Vice-President, another manager directly subordinate to the managing director or any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title. Each person listed in the table in “Item 6. Directors, Senior Management and Employees” above is an office holder. See “Item 10. Additional Information- Companies Law Amendment” below for a discussion of a recent amendment to the Israeli Companies Law which, once it enters into effect, may impact our company’s corporate governance practices as discussed herein.

The Israeli Companies Law requires that an office holder of a company promptly disclose, no later than the first board meeting in which such transaction is discussed, any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. In addition, if the transaction is an extraordinary transaction, the office holder must also disclose any personal interest held by the office holder’s relative, or by any corporation in which the office holder is a 5% or greater shareholder, holder of 5% or more of the voting power, director or general manager or in which he or she has the right to appoint at least one director or the general manager. An extraordinary transaction is defined as a transaction not in the ordinary course of business, not on market terms, or that is likely to have a material impact on the company’s profitability, assets or liabilities.

In the case of a transaction that is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, only board approval is required unless the articles of association of the company provide otherwise. The transaction must not be adverse to the company's interests. If the transaction is an extraordinary transaction, then, in addition to any approval required by the articles of association, it must also be approved by the audit committee and by the board of directors, and, under specified circumstances, by a meeting of the shareholders, as well.

Subject to certain exceptions provided for in the regulations to the Israeli Companies Law, agreements regarding directors' terms of compensation require the approval of the audit committee, board of directors and the shareholders of the company. In all matters in which a director has a personal interest, including matters of his or her terms of compensation, he or she shall not be permitted to vote on the matter or be present in the meeting in which the matter is considered. However, if a majority of the audit committee or of the board of directors has a personal interest in the matter then:

- all of the directors are permitted to vote on the matter and attend the meeting in which the matter is considered; and
- the matter requires approval of the shareholders at a general meeting.

According to the Israeli Companies Law, the disclosure requirements discussed above also apply to a controlling shareholder of a public company. Such requirements also apply to certain shareholders of a public company, with respect to private placements that will increase their relative holdings in the company. The term "controlling shareholder" is defined as a shareholder who has the ability to direct the activities of a company, other than if this power derives solely from the shareholder's position on the board of directors or any other position with the company, and the definition for these purposes also includes shareholders that hold 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. In general, extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and agreements relating to employment and compensation terms of a controlling shareholder, require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval must either include at least one-third of the shares held by disinterested shareholders who actively participate in the voting process (without taking abstaining votes into account), or, alternatively, the total shareholdings of the disinterested shareholders who vote against the transaction must not represent more than one percent of the voting rights in the company.

Private placements in a public company require approval by a company's board of directors and shareholders in the following cases:

- A private placement that meets all of the following conditions:

µ The private placement will increase the relative holdings of a shareholder that holds five percent or more of the company's outstanding share capital, assuming the exercise of all of the securities convertible into shares held by that person, or that will cause any person to become, as a result of the issuance, a holder of more than five percent of the company's outstanding share capital.

µ 20 percent or more of the voting rights in the company prior to such issuance are being offered.

µ All or part of the consideration for the offering is not cash or registered securities, or the private placement is not being offered at market terms.

- A private placement which results in anyone becoming a controlling shareholder of the public company.

In addition, under the Companies Law, certain transactions or a series of transactions are considered to be one private placement.

Any placement of securities that does not fit the above description may be issued at the discretion of the board of directors.

Under the Israeli Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders when exercising his or her rights and refrain from abusing his power in the company, including, among other things, voting in the general meeting of shareholders on the following matters:

- any amendment to the articles of association;
- an increase of the company's authorized share capital;
- a merger; or
- approval of interested party acts and transactions that require general meeting approval as provided in sections 255 and 268 to 275 of the Israeli Companies Law.

In addition, any controlling shareholder, any shareholder who knows that it possesses power to determine the outcome of a shareholder vote and any shareholder who has the power to appoint or prevent the appointment of an office holder in the company is under a duty to act with fairness towards the company. The breach of such duty is governed by Israeli contract laws. The Israeli Companies Law does not describe the substance of this duty. The Israeli Companies Law requires that specified types of transactions, actions and arrangements be approved as provided for in a company's articles of association and in some circumstances by the audit committee, by the board of directors and by the general meeting of the shareholders. In general, the vote required by the audit committee and the board of directors for approval of these matters, in each case, is a majority of the disinterested directors participating in a duly convened meeting. See "Item 10. Additional Information- Companies Law Amendment" below for a discussion of a recent amendment to the Israeli Companies Law which, once it enters into effect, may impact our company's corporate governance practices as discussed herein.

Companies Law Amendment

Recently, the Israeli legislature, the Knesset, approved a new amendment to the Israeli Companies Law (the "Companies Law Amendment") that will come into effect within the next few months. The main purpose of the Companies Law Amendment is to revise and enhance existing provisions governing corporate governance practices of Israeli companies.

The main revisions contemplated under the Companies Law Amendment are, among others, as follows:

- Audit Committee. A majority of the Audit Committee must be comprised of "independent directors" (which is defined as directors with the qualifications of External Directors that did not serve as directors in the company for over 9 years); any person regularly engaged by or rendering services to a controlling shareholder may not serve on the Audit Committee; the Audit Committee is authorized to classify a transaction as extraordinary or significant.
- External Directors.The initial three-year term of service of External Directors can be extended, at the election of the company subject to certain conditions, by two additional three-year terms; External Directors will be elected by a majority vote at a shareholders' meeting, provided that either the majority of shares voted at the meeting, including at least one- half (instead of one-third, as under the current law) of the shares held by non-controlling shareholders voted at the meeting, vote in favor; or the total number of shares held by non-controlling shareholders voted against does not exceed two percent (instead of one percent, as under current law) of the aggregate voting rights in the company.
- Extraordinary Transactions. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and agreements relating to employment and compensation of a controlling shareholder, require shareholders' approval that shall either include at least one- half (instead of one-third, as under current law) of the shares held by disinterested shareholders participating in the vote, or, alternatively, the total shareholdings of disinterested shareholders voting against the transaction must not represent more than two percent (instead of one percent, as under current law) of the voting rights; agreements relating to engagement or provision of services for a period exceeding three years, must generally be approved once every three years.
- Code of Corporate Conduct. A code of recommended corporate governance practices has been attached to the Companies Law Amendment; we are currently determining the applicability of such code to our company.
- Fines.The Israeli Securities Authority shall be authorized to impose fines on any person or company performing an action specifically designated as a breach under the Companies Law Amendment.

Although we expect to be in compliance with the Companies Law, there is no assurance that we will not be required to adjust our current corporate governance practices, as discussed in this annual report, pursuant to the provisions of this amendment.

The Israeli Securities Law- 1968 and the Securities Law Amendment

On February 27, 2011, an amendment to the Israeli Securities Law- 1968 (the “Israeli Securities Law”) came into effect (the “Securities Law Amendment”), which applies to Israeli public companies, including companies the securities of which are also listed on NASDAQ Global Market. The main purpose of the Securities Law Amendment is creating an administrative enforcement procedure to be used by the Israeli Securities Authority ("ISA") to enhance the efficacy of enforcement in the securities market in Israel. The new administrative enforcement procedure may be applied to any company or person (including director, officer or shareholder of a company) performing any of the actions specifically designated as breaches of law under the Securities Law Amendment.

Furthermore, the Securities Law Amendment requires that the chief executive officer of a company supervise and take all reasonable measures to prevent the company or any of its employees from breaching the Israeli Securities Law. The chief executive officers is presumed to have fulfilled such supervisory duty if the company adopts internal enforcement procedures designed to prevent such breaches, appoints a representative to supervise the implementation of such procedures and takes measures to correct the breach and prevent its reoccurrence.

Under the Securities Law Amendment, a company cannot obtain insurance against or indemnify a third party (including its officers and/or employees) for any administrative procedure and/or monetary fine (other than for payment of damages to an injured party). The Securities Law Amendment permits insurance and/or indemnification for expenses related to an administrative procedure, such as reasonable legal fees, provided that it is permitted under the company's articles of association.

We are currently examining the implications of the Securities Law Amendment; however, its effect and consequences, as well as our scope of exposure, are yet to be determined in practice. There is no assurance that we will not be required to take certain actions in order to enhance our compliance with the provisions of the Amendment, such as adopting and implementing an internal enforcement plan to reduce our exposure to potential breaches of the Israeli Securities Law, or amending our articles of association to permit insurance and/or indemnification as contemplated by this amendment.

NASD Marketplace Rules and Home Country Practices

In accordance with Israeli law and practice and subject to the exemption set forth in Rule 4350(a)(1) of the NASD Marketplace Rules, we follow the provisions of the Israeli Companies Law – 1999, rather than the requirements of Rule 4350 of the Market Place Rules with respect to the following requirements:

- Distribution of annual and quarterly reports to shareholders – Under Israeli law we are not required to distribute annual and quarterly reports directly to shareholders and the generally accepted business practice in Israel is not to distribute such reports to shareholders. We do however make our audited financial statements available to our shareholders prior to our annual general meeting and file our quarterly and annual financial results with the Securities Exchange Commission on Form 6-K.

- Independence, Nomination and Compensation of Directors – A majority of our board of directors is not comprised of independent directors as defined in Rule 4200 of the NASD Marketplace Rules. Our board of directors contains two external directors in accordance with the provisions contained in Sections 239-249 of the Israeli Companies Law – 1999. Israeli law does not require, nor do our external directors conduct, regularly scheduled meetings at which only they are present. In addition, with the exception of our external directors, our directors are elected for terms of one year or until the following annual meeting, by a general meeting of our shareholders. The nominations for director which are presented to our shareholders are generally made by our directors. Israeli law does not require the adoption of and our board has not adopted a formal written charter or board resolution addressing the nomination process and related matters. Compensation of our directors and other officers is determined in accordance with Israeli law.

- Audit Committee– Our audit committee does not meet with all the requirements of Rules 4350(d)(2)(A)(i), 4350(d)(2)(A)(iii) and 4350(d)(2)(A)(iv) of the NASD Marketplace Rules. We are of the opinion that the members of our audit committee comply with the requirements of Rule 10A-3(b) of the general rules and regulations promulgated under the Securities Act of 1933 and all requirements under Israeli law. Our audit committee has not adopted a formal written audit committee charter specifying the items enumerated in Rule 4350(d)(1) of the NASD Marketplace Rules.

- Quorum – Under Israeli law a company is entitled to determine in its articles of association the number of shareholders and percentage of holdings required for a quorum at a shareholders meeting. Our Articles of Association provide that a quorum of two or more shareholders, present in person or by proxy, holding shares conferring in the aggregate more than thirty three and a third (33 1/3 %) percent of the voting power of the Company is required for commencement of business at a general meeting.

- Approval of Related Party Transactions – All related party transactions are approved in accordance with the requirements and procedures for approval of interested party acts and transactions, set forth in sections 268 to 275 of the Israeli Companies Law-1999.

- Shareholder Approval – We seek shareholder approval for all corporate action requiring such approval, in accordance with the requirements of the Israeli Companies Law – 1999.

See "Item 10. Additional Information- Companies Law Amendment" above for a discussion of a recent amendment to the Israeli Companies Law which, once it enters into effect, may impact our company's corporate governance practices as discussed herein.

Material Contracts

All of our contracts over the past two years have been entered into in the ordinary course of business, except for our real property leases. Information regarding our real property leases is provided in "Item 4. Information on the Company – Property, Plant and Equipment" and "Item 19. Exhibits".

Exchange Controls

Under current Israeli regulations, any dividends or other distributions paid in respect of our ordinary shares purchased by nonresidents of Israel with certain non-Israeli currencies (including dollars) and any amounts payable upon the dissolution, liquidation or winding up of our affairs, as well as the proceeds of any sale in Israel of our securities to an Israeli resident, will be freely repatriable in such non-Israeli currencies at the rate of exchange prevailing at the time of conversion pursuant to the general permit issued under the Israeli Currency Law, 1978, provided that Israeli income tax has been paid on (or withheld from) such payments. Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, U.S. shareholders will be subject to any such currency fluctuation during the period from when such dividend is declared through the date payment is made in U.S. dollars.

Investments outside Israel by the Company no longer require specific approval from the Controller of Foreign Currency at the Bank of Israel.

Taxation

The following is a summary of some of the current tax law applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of specified Israeli tax consequences to our shareholders and government programs from which we benefit. To the extent that the discussion is based on tax legislation (including the legislation passed as part of the recent tax reform in Israel) that has not been subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will be accepted by the tax authorities in question.

The discussion is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations.

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

General Corporate Tax

Israeli companies are subject to corporate tax at the rate of 25% in the 2010 tax year and 24% in the 2011 tax year. The corporate tax rate has been scheduled to further decline in the amendment to the Income Tax Ordinance (Amendment No. 171 dated July 23, 2009) to 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter. However, the effective tax rate payable by a company which derives income from an Approved Enterprise (as further discussed below) may be considerably less.

Law for the Encouragement of Capital Investments, 1959

Certain of our facilities have been granted "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended (the "Investment Law"). The Investment Law provides that a capital investment in eligible facilities may, upon application to the Israel Investment Center of the Ministry of Industry and Trade of the State of Israel (referred to as the Investment Center), be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources and its physical characteristics, for example, the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific Approved Enterprise.

An amendment to the Investment Law which came into effect as of April 1, 2005 (the "First Amendment") has significantly changed the provisions of the Investment Law. The First Amendment determined criteria for the approval of a facility as an Approved Enterprise, such as provisions generally requiring that at least 25% of the income of an Approved Enterprise will be derived from exports. Additionally, as explained below, the First Amendment sets forth major changes in the manner in which tax benefits were awarded under the Investment Law whereby companies were no longer require Investment Center approval (and Approved Enterprise status) in order to qualify for tax benefits. However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investment Law as in effect on the date of such approval. Therefore the tax benefits granted to our Approved Enterprises under the Investment Law will generally not be subject to the provisions of the First Amendment. Many of the requirements under the Investment Law following the First Amendment were amended again in a second amendment to the Investment Law (the "Second Amendment"), as will be described below.

Tax Benefits Prior to the First Amendment

In general, taxable income of a company derived from an Approved Enterprise was subject to tax exemption and/or reduced corporate tax than the rates stated above (this will also apply to Approved Enterprises approved after the First Amendment, as explained below). The reduced corporate tax rate applies for a period of time termed the "benefit period". The benefit period was a period of seven years commencing with the year in which the Approved Enterprise first generates taxable income. In any event, the benefit period was limited to 12 years from the commencement of production or operation, or 14 years from the year in which the approval was received, whichever is earlier. Under certain circumstances (as further detailed below), the benefit period may have been extended to a maximum of ten years from the commencement of the benefit period. In the event that a company was operating under more than one approval or that only part of its capital investments were approved (a "Mixed Enterprise"), its effective corporate tax rate was the result of a weighted combination of the various applicable rates.

A company which qualifies as a "Foreign Investors' Company" was entitled to an extended benefit period and to further reductions in the tax rate normally applicable to Approved Enterprises. Subject to certain conditions, a "Foreign Investors' Company" was defined as a company which has more than 25% of its combined shareholders' investment in share capital (in terms of rights to profits, voting and the appointment of directors) and in long term shareholders' loans, as defined in the Investment Law, made by persons who are not residents of Israel. The percentage owned by nonresidents of Israel for any tax year will be determined by the lowest percentage in any of the above rights held by nonresidents during that year. Foreign Investors' Company paid Company Tax at reduced rates for an extended ten-year (rather than the otherwise applicable seven-year) period as detailed below:

Level of Foreign Investment	Company Tax Rate		Benefit period (years)
Over 0% but less than 25%	25	%	7
Over 25% but less than 49%	25	%	10
49% or more but less than 74%	20	%	10
74% or more but less than 90%	15	%	10
90% or more	10	%	10

There can be no assurance that the above-mentioned shareholding proportion will be reached for each subsequent year.

Prior to the First Amendment, a company owning an Approved Enterprise approved after April 1, 1986 (or prior thereto provided no government grants or loans had previously been granted regarding such enterprise) was entitled to elect (as we have) to forego certain Government grants extended to Approved Enterprises in return for an "alternative route" of tax benefits (the "Alternative Route"). Under the Alternative Route, a company's undistributed income derived from an Approved Enterprise was exempt from corporate tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the Approved Enterprise within Israel, and such company was eligible for the reduced tax rates under the Investment Law for the remainder of the benefit period as mentioned above.

Our production facilities have been granted “Approved Enterprise” status under the Alternative Route according to the Investment Law. The initial Approved Enterprise status was granted in 1988 (“Initial Approved Enterprise”). An extension program was granted Approved Enterprise status in 1995 (the “Extended Approved Enterprise”). Income derived from our Approved Enterprises is tax exempt during six years of the seven year tax benefit period and is subject to a reduced tax rate of 25% in the seventh year. The seven year period of benefits commences in the year the Approved Enterprise first earns taxable income but is limited to twelve years from commencement of production or fourteen years from date of approval, whichever is earlier. The period of tax benefits, relating to our Initial Approved Enterprise, commenced in 1991 and expired in 1997. The period of tax benefits relating to our Extended Approved Enterprise commenced in 1997 and expired in 2006, as explained below.

In June 1995, we reached an agreement with the tax authorities regarding our entitlement to benefits under the Investment Law. The agreement, effective from tax year 1994 and thereafter, relates to the method of determination of taxable income from our research and development activities. Pursuant to the agreement, for the purpose of determining our tax liability, our income will be allocated to our manufacturing plant and to our research and development center, according to a formula based on the net costs plus royalties of the research and development center and our profitability. Income allocated to the expansion of the manufacturing plant will benefit from a ten-year tax exemption, while income allocated to the research and development center will benefit from a two-year exemption, and for a five-year period immediately following will be taxed at a 25% rate.

Our income to be attributed to our Extended Approved Enterprise in any year will be computed as a ratio of the increase in our sales turnover, if any, in that year to our turnover in the year before the Extended Approved Enterprise commenced its tax benefits entitlement. The tax authorities have reserved their right to reconsider our claim to such tax benefits in future years.

The entitlement to the above benefits is conditional upon our fulfillment of the conditions stipulated by the law, regulations published thereunder and the instruments of approval for the specific investments in the Approved Enterprise. In the event of failure to comply with these conditions, the benefits may be canceled and we may be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences, interest and penalties. Should we derive income from sources other than the Approved Enterprise during the relevant periods of benefits, such income will be taxable at regular corporate tax rates stated above.

A company that elected the Alternative Route prior to the First Amendment and that subsequently paid a dividend out of income derived from the Approved Enterprise(s) during the tax exemption period will be subject to Company Tax in the year the dividend is distributed in respect of the amount distributed (including the corporate tax thereon), at the rate that would have been applicable had the company not elected the Alternative Route (10%-25%, depending on the level of foreign investment in the company, as explained above). In addition, the dividend recipient is taxed at the reduced rate applicable to dividends from Approved Enterprises (15%), if the dividend is distributed during the tax exemption period or within a specified period thereafter (in the event, however, that the company qualified as a Foreign Investors' Company, there was no such time limitation).

Subject to certain provisions concerning income subject to the Alternative Route, all dividends are considered to be attributable to the entire enterprise and the effective tax rate is the result of a weighted combination of the various applicable tax rates. Under the Investment Law, a company that has elected the alternative package of benefits was not required to distribute exempt retained profits, and may generally decide from which year’s profits to declare dividends.

The Investment Law also provided that an Approved Enterprise was entitled to accelerated depreciation on its property and equipment that were included in an approved investment program. We have not utilized this benefit.

Grants and certain other incentives received by a company in accordance with the Investment Law remained subject to final ratification by the Israel Investment Center and final determination by the Israel Tax Authority. Such ratification and determination were conditional upon fulfillment of all of the terms of the approved program.

Tax Benefits under the First Amendment

As a result of the First Amendment, a company was no longer required to acquire Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Route and therefore such companies did not need to apply to the Investment Center for this purpose. However, the Investment Center continued granting Approved Enterprise status to companies seeking Governmental grants. A company could have claimed the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set forth in the First Amendment (a “Benefited Enterprise”). Companies were also entitled to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the First Amendment. The First Amendment included provisions intended to ensure that a company will not enjoy both government grants and tax benefits for the same investment program.

Tax benefits were available under the First Amendment to production facilities and other eligible facilities, which were generally required to derive more than 25% of their business income from exports. In order to receive the tax benefits, the First Amendment stated that the company must make an investment in the Benefited Enterprise exceeding a minimum amount specified in the Investment Law. Such investment could have been made over a period of no more than three years, such period concluding at the end of the year in which the company requested to have the tax benefits apply to its Benefited Enterprise (the “Year of Election”). Where the company requested to have the tax benefits apply to an expansion of existing facilities, only the expansion was considered a Benefited Enterprise and the company’s effective tax rate was the result of a weighted combination of the applicable rates. In the case of an expansion of existing facilities, the minimum investment required in order to qualify as a Benefited Enterprise was determined as a certain percentage of the company’s production assets before the expansion and in any case was not less than NIS 300,000.

The tax benefits which were available under the First Amendment to qualifying income of a Benefited Enterprise were determined by the geographic location of the Benefited Enterprise in Israel. The Investment Law divides the country into three zones – A, B and C, so that a Benefited Enterprise operating in Zone A (which generally includes areas remote from the center of Israel) received the greatest benefits and Benefited Enterprises in Zone C received the least benefits.

The First Amendment provided that a company producing income from a Benefited Enterprise in Zone A could have elected either that (i) the undistributed income derived from the Benefited Enterprise will be fully tax exempt for the entire benefit period described below ("tax exemption"), in which case the ordinary provisions described below concerning the taxation of the company and shareholder for distribution of dividends will apply; or (ii) that the income from its Benefited Enterprise will be subject to corporate tax at a rate of a 11.5%, in which case dividends paid out of such income to a foreign resident will be taxed at a rate of 4% and to an Israeli resident will be taxed at a rate of 15%, and the company will not be subject to additional tax upon dividend distribution. Further benefits were available in the event of certain large investments by multinational companies. Benefited Enterprises located in Zones B and C was exempt from tax for six and two years, respectively, and subject to tax at a rate of 10%-25% for the remainder of the benefit period, depending on the extent of foreign investment in the Company, as described above.

Dividends paid out of income derived by a Benefited Enterprise, or out of dividends received from a company whose income was derived from a Benefited Enterprise, were generally subject to withholding tax at the rate of 15% or less under certain anti double-taxation treaties, such tax being deductible at source. The reduced withholding tax rate of 15% was limited to dividends and distributions out of income derived during the benefit period and actually paid at any time up to 12 years thereafter. A company qualified for tax benefits under the First Amendment which paid a dividend out of income derived by its Benefited Enterprise during the tax exemption period will be subject to corporate tax in respect of the gross amount of the dividend. The rate of the tax was the rate which would have been applicable had the company not been tax exempt. Such tax rate was lower in the case of a qualified "Foreign Investors' Company".

The period for which tax benefits were available under the First Amendment was also determined by the geographical location of the Benefited Enterprise in Israel. The benefit period for Benefited Enterprises in Zone A ended on the earlier of (i) a period of ten years from the tax year in which the company first derived taxable income from the Benefited Enterprise (the "Commencement Year"); or (ii) twelve years (or in certain cases fourteen years) from the first day of the Year of Election. The benefit period for Benefited Enterprises in Zones B and C was extended until the earlier of (i) seven years from the Commencement Year or (ii) 12 years from the first day of the Year of Election. This period could have been extended for Benefited Enterprises owned by a "Foreign Investors' Company" during all or part of the benefit period.

Additionally, the First Amendment sets forth a minimal amount of foreign investment required for a company to be regarded a Foreign Investors' Company.

We have selected the 2004 tax year, the 2006 tax year and the 2009 tax year to be our Year of Election, from which the period of benefits under the Investment Law commenced.

There can be no assurance that we will attain approval for additional tax benefits under the Amendment, or receive approval for Approved Enterprises in the future.

The Second Amendment to the Investment Law

Recently the Israeli legislature, the Knesset, approved significant changes to the Investment Law, which revamped the tax incentive regime in Israel and are effective as of January 1, 2011. The main changes enacted under the Second Amendment are, inter alia, as follows:

- Replacement of all future tax incentives under the existing law as amended by the First Amendment; as a result, commencing 2011, industrial companies that meet the conditions set out by the Second Amendment will no longer be entitled to the existing tax incentives provided under the First Amendment, such as the exemption from tax on undistributed profits and a reduced tax rate thereafter but rather to the tax incentives under the Second Amendment.
- Under the transition provisions, any tax benefits obtained prior to 2011 shall continue to apply until expired, unless the company elects to apply the provisions of the Second Amendment to its income.
- The Second Amendment provides that industrial companies meeting the criteria set out by the Investment Law will be eligible for flat tax rates of 10% or 15% for the years 2011 through 2012, 7% or 12.5% for years 2013 through 2014 and 6% or 12% for years 2015 onwards, with the actual tax rates determined by the location of the enterprise. Under the Second Amendment, the tax incentives offered by the Investment Law are no longer dependant neither on minimum qualified investments nor on foreign ownership.
- The Second Amendment allows a company to enjoy both government grants and tax benefits concurrently. Governmental grants will not necessarily be dependent on the extent of enterprise's investment in assets and/or equipment. Commencing 2011, the approval of "Preferred Enterprise" status by either the Israeli Tax Authorities or the Investment Center will be accepted by the other. Therefore a Preferred Enterprise will be eligible to receive both tax incentives and government grants, under certain conditions.

Chapter B1 of the Investment Law determines that the "Preferred Income" of a "Preferred Enterprise" will be subject to corporate income tax rate of 10% if located in a preferred zone or 15% if not located in a preferred zone in years 2011-2012, a rate of 7% or 12.5%, for years 2013-2014 and a rate of 6% or 12% from 2015 and onwards.

"Preferred Income" is defined by the Second Amendment as income from the sale of products of the Preferred Enterprise (including components that were produced by other enterprises); income from the sale of semiconductors by other non related enterprises which use the Preferred Enterprise's self-developed know-how; income for providing a right to use the Preferred Enterprise's know how or software; royalties from the use of the know-how or software which was confirmed by the Head of Investment Center to be related to the production activity of the Preferred Enterprise and services with respect to the aforementioned sales. In addition, the definition of "Preferred Income" also includes income from the provision of industrial R&D services to foreign residents to the extent that the services were approved by the Head of Research for the Industrial Development and Administration.

A "Preferred Enterprise" is defined under the Second Amendment as an Industrial Enterprise (including, inter alia, an enterprise which develops software, an enterprise which provides approved R&D services to foreign residents and an enterprise which the Chief Scientist confirmed is carrying out R&D in the field of alternative energy), which generally more than 25% of its business income is from export. As mentioned above, the new tax incentives no longer depend on minimum qualified investments nor on foreign ownership.

Chapter B2 of the Investment Law determines the conditions and limitations applying to the tax benefits offered to a "Special Preferred Enterprise". Chapter B2 determines that a "Special Preferred Enterprise" will be able to enjoy corporate income tax rate in a rate of 5% if located in a preferred zone and 8% if not located in a preferred zone.

A "Special Preferred Enterprise" is defined following the Second Amendment as a Preferred Enterprise which meets one of the following conditions: (a) its Preferred Income is equal to or exceeds NIS 1.5 billion; (b) the total income of the company which owns the Preferred Enterprise or which operates in the same field of the Preferred Enterprise and which consolidates in its financial reports the company that owns the Preferred Enterprise equals or exceeds NIS 20 billions; or (c) its business plan was approved by the authorities as significantly benefitting the Israeli economy, either by an investment of at least NIS 400 - 800 million in assets; 100 -150 million NIS in R&D or the employment of at least 250 to 500 new employees, for preferred zones and regular zones, respectively.

With respect to the distribution of dividends, the Investment Law provides that distribution of dividends out of earnings that are subject to the new tax incentives is subject to a 15% withholding tax. Nevertheless, under the transition rules, dividend distributed by companies that elected to convert to the new law until 30 June 2015 (in respect to their existing programs) will not be subject to tax provided that: (a) the distribution is of nonexempt earnings derived by the company under the previous law; and (b) the distribution is made to an Israeli company.

The Company is currently examining the implications of the Second Amendment to the Investment Law. There can be no assurance that we will comply with the conditions of the Investment Law in the future or that we will be entitled to any additional benefits under the amended Investment Law under the First Amendment and/or the Second Amendment and whether the influence of the expected changes will be beneficial to the Company or not.

Law for the Encouragement of Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development (the “Research Law”), research and development programs approved by the Research Committee (the “Research Committee”) of the Office of the Chief Scientist (“OCS”) are eligible for grants or loans if they meet certain criteria, in return for the payment of royalties from the sale of the product developed in accordance with the program and subject to other restrictions. Once a project is approved, the OCS will award grants of up to 50% of the project’s expenditures in return for royalties, usually at the rate of 3% to 6% of sales of products developed with such grants. For projects approved after January 1, 1999, the amount of royalties payable is up to a dollar-linked amount equal to 100% of such grants plus interest at LIBOR. There is no further liability for payment.

The terms of these grants prohibit the manufacture outside of Israel of the product developed in accordance with the program without the prior consent of the Research Committee of the OCS. Such approval, if granted, is generally subject to an increase in the total amount to be repaid to the OCS to between 120% and 300% of the amount granted, depending on the extent of the manufacturing to be conducted outside of Israel.

The Research Law also provides that know-how from the research and development, which is used to produce the product, may not be transferred to Israeli third parties without the approval of the Research Committee. Until 2005, the Research Law stated that such know-how may not be transferred to non-Israeli third parties at all. An amendment to the Research Law has set forth certain exceptions to this rule; however, the practical implications of such exceptions are quite limited. The Research Law has stressed, that it is not just transfer of know-how that is prohibited, but also transfer of any rights in such know-how. Such restriction does not apply to exports from Israel of final products developed with such technologies. Approval of the transfer may be granted only if the transferee undertakes to abide by all of the provisions of the Research Law and regulations promulgated thereunder, including the restrictions on the transfer of know-how and the obligation to pay royalties. There can be no assurance that such consent, if requested, will be granted or, if granted, that such consent will be on reasonable commercial terms.

Tax Benefits for Research and Development

Israeli tax law allows, under certain conditions, a tax deduction in the year incurred for expenditures (including capital expenditures) in scientific research and development projects, if the expenditures are approved by the relevant Israeli Government Ministry (determined by the field of research) and the research and development is for the promotion of the enterprise and is carried out by or on behalf of the company seeking such deduction. Such expenditures not so approved are required to be deducted over a three-year period. Though we received such approvals for the years 2006, 2007 and 2008 and could deduct the tax in the year the expenditures were incurred, we chose to deduct the tax over a three-year period.

Law for the Encouragement of Industry (Taxes), 1969

Under the Law for the Encouragement of Industry (Taxes), 1969 (the "Industry Encouragement Law"), Industrial Companies (as defined below) are entitled to the following tax benefits:

(a) Amortization of purchases of know-how and patents over eight years for tax purposes.

(b) Amortization of expenses incurred in connection with certain public securities issuances over a three-year period.

(c) Accelerated depreciation rates on equipment and buildings.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. Under the Industry Encouragement Law, an "Industrial Company" is defined as a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, capital gains, dividends, interest and linkage differences, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is defined as an enterprise whose major activity in a given tax year is industrial production activity.

We believe that we currently qualify as an Industrial Company within the definition of the Industry Encouragement Law. No assurance can be given that we will continue to qualify as an Industrial Company or that the benefits described above will be available in the future.

Calculation of Results for Tax Purposes

The Israeli Income Tax Regulations (Rules for Maintaining Accounting Records of Foreign Investors' Companies and Certain Partnerships and Determining Their Taxable Income) - 1986 provide that as a Foreign Investors' Company (as defined in the Investment Law described above) is eligible to calculate its taxable income in accordance with these regulations, and therefore, if we elect to follow such regulations, our taxable income or loss is to be calculated in dollars. We have elected to apply these regulations and accordingly our taxable income or loss is calculated in dollars in the manner set forth in such regulations.

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