MASIMO CORP
Form S-1/A
August 07, 2007
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As filed with the Securities and Exchange Commission on August 7, 2007

Registration No. 333-142171

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 7

TO

FORM S-1

REGISTRATION STATEMENT

Under

The Securities Act of 1933

MASIMO CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	**3845**	**33-0368882**
(State or other jurisdiction of incorporation or organization)	**(Primary Standard Industrial Classification Code Number)**	**(I.R.S. Employer Identification Number)**

40 Parker

Irvine, California 92618

(949) 297-7000

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

Joe E. Kiani

Chief Executive Officer

40 Parker

Irvine, California 92618

(949) 297-7000

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

John F. Della Grotta

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650 Town Centre Drive, 20th Floor

Costa Mesa, CA 92626

Approximate date of commencement of proposed sale to the public:

As soon as practicable after the effectiveness of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act, check the following box: ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective Registration Statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

Calculation of Registration Fee

Title of each Class of	Amount	Proposed Maximum	Amount of

Securities to be Registered	to be Registered(1)	Proposed Maximum Aggregate Offering Price Per Share(2)	Aggregate Offering Price(2)	Registration Fee(3)
Common Stock, $0.001 par value	13,704,120	$18.00	$246,674,158.20	$7,573.00

(1) Includes 1,787,494 shares that the underwriters have the option to purchase solely to cover over-allotments, if any.
(2) Estimated solely for purposes of calculating the amount of the registration fee pursuant to Rule 457(a) under the Securities Act of 1933, as amended.
(3) Previously paid.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment that specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. We and the selling stockholders may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Subject to completion, dated August 7, 2007

11,916,626 Shares

MASIMO CORPORATION

Common Stock

$ per share

- Masimo Corporation and the selling stockholders are offering 11,916,626 shares of common stock, of which the selling stockholders are offering 10,416,626 shares.
- The initial public offering price of our common stock is expected to be between $16.00 and $18.00 per share.
- This is our initial public offering and no public market currently exists for our shares.

Proposed trading symbol:
NASDAQ Global Market MASI

This investment involves risks. See Risk Factors beginning on page 10.

	Per Share	Total
Initial public offering price	$	$
Underwriting discount	$	$
Proceeds, before expenses, to Masimo Corporation	$	$
Proceeds, before expenses, to selling stockholders	$	$

We have granted the underwriters a 30-day option to purchase up to 1,787,494 additional shares of our common stock at the initial public offering price, less the underwriting discount, to cover over-allotments, if any. We will not receive any proceeds from the sale of common stock by the selling stockholders.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

Piper Jaffray **Deutsche Bank Securities** **Citi**

Cowen and Company **Thomas Weisel Partners LLC**

The date of this prospectus is , 2007

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We have not authorized anyone to provide you with information different from that contained in this prospectus and any free writing prospectus authorized by us. We and the selling stockholders are offering the securities for sale in those jurisdictions in the United States, Europe and elsewhere where it is lawful to make such offers. The distribution or possession of this prospectus or any free writing prospectus in or from certain jurisdictions may be restricted by law. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted or where the person making the offer or sale is not qualified to do so or to any person to whom it is not permitted to make such offer or sale. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of our common stock. Our business, financial condition, results of operations and prospects may have changed since that date.

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SUMMARY

This summary highlights selected information contained elsewhere in this prospectus. This summary provides an overview of selected information and does not contain all of the information you should consider before investing in our common stock. You should read carefully the entire prospectus, including Risk Factors and the financial statements and related notes, before making an investment decision. Unless the context indicates otherwise, the references in this prospectus to Masimo, we, us and our refer to Masimo Corporation, together with its subsidiaries.

Our Business

We are a global medical technology company that develops, manufactures and markets non-invasive patient monitoring products that improve patient care. We invented Masimo Signal Extraction Technology, or Masimo SET, which provides the capabilities of Read-Through Motion and Low Perfusion pulse oximetry to address the primary limitations of conventional pulse oximetry. Pulse oximetry is the non-invasive measurement of the oxygen saturation level of arterial blood, or the blood that delivers oxygen to the body s tissues, and pulse rate. Our Masimo SET platform has significantly addressed many of the previous technology limitations. The benefits of Masimo SET have been validated in over 100 independent clinical and laboratory studies. During 2006, we generated product revenue of $155.1 million and we increased our product revenue at a compound annual growth rate, or CAGR, of approximately 41.6% for the four years ended December 31, 2006. We were profitable in 2005 and 2006, but prior to 2005, we had a history of net losses.

We develop, manufacture and market a family of patient monitoring solutions which incorporate a monitor or circuit board and consumables, including both proprietary single-patient use and reusable sensors and cables. In addition, we offer a remote-alarm/monitoring solution, software and other accessories. We sell our solutions and related products to end-users through our direct sales force and certain distributors, and certain of our products to original equipment manufacturer, or OEM, partners, for incorporation into their products. We estimate that our worldwide installed base of pulse oximeters and OEM monitors that incorporate Masimo SET was approximately 399,000 units as of March 31, 2007. Based on industry reports, we estimate that the worldwide pulse oximetry market is over $900 million, the largest component of which is the sale of consumables.

We believe that the reliability and accuracy of our Masimo SET platform, along with our remote-alarm and monitoring solutions, will facilitate the expansion of our pulse oximetry products into areas beyond critical care settings, including the general care areas of the hospital. Additionally, we have recently developed products that non-invasively monitor parameters beyond arterial blood oxygen saturation level and pulse rate. In 2005, we launched our Masimo Rainbow SET platform utilizing licensed Rainbow technology, which we believe includes the first and only devices cleared by the U.S. Food and Drug Administration, or FDA, to non-invasively measure carboxyhemoglobin, or carbon monoxide levels in the blood, and methemoglobin saturation levels in the blood. We believe that the use of products incorporating Rainbow technology will become widely adopted for the non-invasive monitoring of these parameters. In addition, we believe that we will develop and introduce new products to monitor additional parameters in the future based on our proprietary technology platforms.

The Masimo Solution

Our innovative and proprietary technologies and products are designed to overcome the primary limitations of pulse oximetry, which involve maintaining accuracy in the presence of motion artifact, or patient movement, and low perfusion, or low arterial blood flow. We overcame these limitations through our read-through motion and low perfusion pulse oximetry technology. Our Masimo SET platform,

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which became available to hospitals in the United States in 1998, is the basis of our pulse oximetry products, and we believe it represented the first significant technological advancement in pulse oximetry since its introduction in the early 1980s. Our products have gained significant acceptance in the market due to their ability to provide clinicians with reliable, continuous, real-time information even in the presence of both motion artifact and low perfusion.

To complement our Masimo SET platform, we have developed a wide range of proprietary single-patient use and reusable sensors, cables and other accessories designed specifically to work with Masimo SET software and hardware. Although our technology platforms operate solely with our proprietary sensor lines, our sensors have the capability to work with certain competitive pulse oximetry monitors through the use of our adapter cables. Our proprietary Low Noise Optical Probe, or LNOP, neonatal sensors have been clinically proven to exhibit greater durability compared to competitive products.

In 2005, we introduced our Masimo Rainbow SET platform, leveraging Masimo Signal Extraction Technology and incorporating licensed Rainbow technology to enable reliable, real-time monitoring of additional parameters beyond arterial blood oxygen saturation and pulse rate. The Masimo Rainbow SET platform has the unique ability to distinguish oxygenated hemoglobins, or hemoglobins carrying oxygen, from certain dyshemoglobins, or hemoglobins incapable of transporting oxygen, and allows for the rapid, non-invasive monitoring of carboxyhemoglobin and methemoglobin, which we refer to as Pulse CO-Oximetry. High levels of carboxyhemoglobin are indicative of carbon monoxide poisoning, which requires quick treatment to prevent long-term organ damage or death. Methemoglobin is another form of hemoglobin that is unable to carry oxygen to tissues throughout the body, and elevated levels can cause cyanosis, or bluish discoloration of the skin. This condition can also cause organ damage and, in extreme cases, death. Along with the release of our Masimo Rainbow SET Pulse CO-Oximetry products, we have developed specialized sensors that have the ability to monitor multiple parameters with a single sensor. We believe that the use of Masimo Rainbow SET Pulse CO-Oximetry products will become widely adopted for the non-invasive monitoring of these parameters.

Benefits of Our Products and Technology

We believe that our technology and products offer several key benefits, including:

Accurate, Real-Time Measurement.

Increased Quality of Patient Care.

Reduced Cost of Care.

Masimo SET Platform Allows for Expansion into Non-Critical Care Settings.

Upgradeable Platform for the Monitoring of Additional Parameters.

Our Strategy

Since inception, our mission has been to develop non-invasive patient monitoring solutions that improve patient outcomes and reduce the cost of patient care. We intend to continue to grow our business and to improve our market position by pursuing the following strategies:

Continue to expand our market share in pulse oximetry.

Expand the pulse oximetry market to other patient care settings.

Utilize our customer base and OEM relationships to market our Masimo Rainbow SET Pulse CO-Oximetry products incorporating licensed Rainbow technology.

Continue to innovate and maintain our technology leadership position.

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Nellcor Patent Litigation Settlement

In October 1999, we filed a patent infringement lawsuit in the United States District Court for the Central District of California against Mallinckrodt, Inc., now part of Covidien Ltd. (formerly Tyco Healthcare), and one of its subsidiaries, Nellcor Puritan Bennett, Inc., collectively referred to as Nellcor. Nellcor is one of the largest manufacturers and distributors of pulse oximetry products in the world. The lawsuit was filed for infringement of our pulse oximetry signal processing patents. Nellcor denied our claims and made counterclaims alleging infringement of its patents by us. This lawsuit resulted in a jury verdict that Nellcor had infringed several of our patents. In September 2005, the U.S. Federal Court of Appeals ruled that Nellcor infringed several Masimo patents and ordered the lower court to enjoin Nellcor s infringing products. Prior to the issuance of a permanent injunction, Nellcor entered into a settlement agreement with us on January 17, 2006, under which we agreed to settle all pending patent litigation with Nellcor. In return, Nellcor agreed to pay us $263.0 million for damages incurred through January 2006. We granted Nellcor a covenant not to sue on certain new products and Nellcor agreed to pay us royalties on its total U.S. pulse oximetry revenue at least through March 14, 2011. In addition, in January 2006, Nellcor made an advance royalty payment to us of $67.5 million for estimated sales of its products in the United States during the remainder of the calendar year 2006. Through December 31, 2006, we have received $330.5 million in cash from Nellcor pursuant to the settlement agreement.

We believe the result of this judgment was to strengthen the patents on which we prevailed, which included some patents supporting our Masimo SET platform. We intend to continue protecting our rights and pursuing additional infringement claims against other companies whose products we believe infringe our patents.

In March 2006 and February 2007, we declared dividends to holders of our common stock and preferred stock in the aggregate amount of approximately $208.9 million. In addition, in March 2006 and March 2007, we made special bonus payments in the aggregate amount of $11.7 million to our employees and directors who held vested stock options as of March 1, 2006. The funds used to pay these cash dividends and special bonus payments were made from the after-tax proceeds that we received from our patent infringement lawsuit against Nellcor and the interest on those proceeds.

We recorded the $263.0 million lump sum payment as patent litigation proceeds in January 2006 and we recognized approximately $68.8 million of royalty revenue in 2006. We recognize royalty revenue based on the estimated average royalty rate per the settlement agreement multiplied by our estimate of Nellcor s sales for each quarter. This estimate is adjusted when we receive the Nellcor royalty report, 60 days after the end of each quarter. Per our settlement agreement, the 2006 royalty rate will decline significantly and, as a result, we expect our future Nellcor royalties to be significantly below the levels recognized in 2006.

We do not intend to distribute any future royalties received from Nellcor under the settlement agreement to our stockholders or our option holders.

Masimo Laboratories, Inc.

Masimo Laboratories, Inc., or Masimo Labs, is an independent entity spun off from us to our stockholders in 1998. Joe E. Kiani and Jack Lasersohn, members of our board of directors, are also members of the board of directors of Masimo Labs. Joe E. Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Masimo Labs. We are a party to a cross-licensing agreement with Masimo Labs, which was recently amended and restated effective January 1, 2007, or the Cross-Licensing Agreement, that governs each party s rights to certain of the intellectual property held by the two companies.

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Under the Cross-Licensing Agreement, we granted Masimo Labs an exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET owned by us, including all improvements on this technology, for the measurement of non-vital signs parameters and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs parameters in any product market in which a product is intended to be used by a patient or pharmacist rather than a professional medical caregiver, which we refer to as the Labs Market. We also granted Masimo Labs a non-exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET for the measurement of vital signs in the Labs Market.

Vital signs parameters include peripheral venous oxygen saturation, arterial oxygen saturation, or SpO2, mixed venous oxygen saturation, fetal oximetry, sudden infant death syndrome, electrocardiogram, or ECG, blood pressure (non-invasive blood pressure, invasive blood pressure and continuous non-invasive blood pressure), temperature, respiration rate, carbon dioxide, or CO2, pulse rate, cardiac output, electroenchephalogram, or EEG, perfusion index, depth of anesthesia, cerebral oximetry, tissue oximetry and/or electromyography, or EMG, and associated features derived from these parameters, such as 3-D alarms, Pleth Variability Index and other features. Non-vital signs parameters are body fluid constituents other than vital signs parameters, and include, but are not limited to, carbon monoxide, methemoglobin, blood glucose, total hemoglobin and bilirubin.

We exclusively license from Masimo Labs the right to make and distribute products in the professional medical caregiver markets, or the Masimo Market, that utilize Rainbow technology for the measurement of carbon monoxide, methemoglobin, fractional arterial oxygen saturation, and total hemoglobin, which includes hematocrit. To date, we have developed and commercially released devices that measure carbon monoxide and methemoglobin using licensed Rainbow technology. We also have the option to obtain the exclusive license to make and distribute products that utilize Rainbow technology for the measurement of other non-vital signs parameters, including blood glucose, in product markets where the product is intended to be used by a professional medical caregiver, which we refer to as the Masimo Market.

Risks Associated with Our Business

Our business is subject to numerous risks, as more fully described in the section entitled Risk Factors immediately following this prospectus summary. There are several risks associated with our business, such as:

- We currently derive substantially all of our revenue from our Masimo SET platform and related products.
- If the patents we own or license, or our other intellectual property rights, do not adequately protect our products, we may lose market share to our competitors and be unable to operate our business profitably.
- If third parties claim that we infringe their intellectual property rights, we may incur liabilities and costs and may have to redesign or discontinue selling certain products.
- Some of our products, including those based on licensed Rainbow technology, are in development or have been recently introduced into the market and may not achieve market acceptance, which could adversely affect our potential growth.
- Our operating results are volatile and difficult to predict and, prior to 2005, we had a history of net losses. We may experience significant fluctuations in our quarterly results and we may not maintain our recent profitability in the future.

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Corporate Information

We were incorporated in California in May 1989 and reincorporated in Delaware in May 1996. Our executive offices are located at 40 Parker, Irvine, California 92618. Our telephone number at that address is (949) 297-7000 and our website is www.masimo.com. The information contained on, or that can be accessed through, our website is not incorporated by reference into this prospectus and should not be considered to be part of this prospectus.

Masimo, Rainbow, SET, Signal Extraction Technology, Radical, RAD, Rad-5, Rad-8, Rad-9, Rad-Link, LNCS, LNOP, DCI, FastSat, Signal I.Q., MS-3, MS-5, MS-7, DST, FST, Discrete Saturation Transform, SpCO, SPO2.COM, CleanShield, N When You Need It Most, Improving Patient Outcome And Reducing Cost Of Care, Improving Patient Outcome And Reducing Cost Of Care. . . By Taking Non-Invasive Monitoring To New Sites And Applications, The Proof Is In The Performance, SensAid, Stethos, I Stethos, Androscope and Androsonix are our registered trademarks.

Pulse CO-Oximeter, Signal Extraction Pulse CO-Oximeter, RadNet, Patient SafetyNet, Personal Pulse Oximeter, SofTouch, Blue, R PPO+, PVI, SafetyNetwork, SEPCO, SPAO2, SpHB, SpMET, SPVO2, NCT, BCM, MX-1, and Androfact, Androflo, Androlink are the subject of pending trademark applications owned by us.

RAD-57, Signal Extraction Pulse Oximeter and Improving Patient Outcomes And Reducing Cost Of Care By Making Non-Invasive Patient Monitoring Effective And Reliable And Taking It To New Sites And Applications are other of our trademarks.

We have also applied for or registered some of our trademarks in other jurisdictions, including Europe, Japan and other selected geographies.

All other trademarks, trade names and service marks appearing in this prospectus are the property of their respective owners.

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The Offering

Common stock offered by us	1,500,000 shares
Common stock offered by the selling stockholders	10,416,626 shares
Common stock to be outstanding after this offering	52,816,788 shares
Initial public offering price	$ per share
Use of proceeds	We expect to use approximately $10.0 million of the net proceeds from this offering for capital expenditures and the placement of equipment, approximately $5.0 million for sales and marketing activities, approximately $5.0 million for research and development activities and the remaining amount for working capital and general corporate purposes. We will not receive any proceeds from the sale of common stock by the selling stockholders. See Use of Proceeds.
Proposed NASDAQ Global Market symbol	MASI

The number of shares of common stock to be outstanding upon completion of this offering is based on 51,316,788 shares of common stock outstanding as of June 30, 2007 which assumes the conversion of all outstanding shares of preferred stock into an aggregate of 34,612,503 shares of common stock, and excludes as of that date:

- 8,143,575 shares of common stock issuable upon exercise of outstanding options with a weighted average exercise price of $6.12 per share, of which 3,605,943 options were vested;
- 2,661,642 shares of common stock reserved for awards available for future issuance under our current equity incentive plans; and
- 3,000,000 shares of our common stock reserved for future issuance under our 2007 Stock Incentive Plan, which will become effective in connection with this offering. Shares available for future issuance under our 2007 Stock Incentive Plan do not include shares that may become available for issuance pursuant to a provision in this plan that provides for the automatic annual increase in the number of shares reserved thereunder.

Unless otherwise indicated, the information in this prospectus assumes:

- the conversion of all outstanding shares of preferred stock into 34,612,503 shares of common stock immediately prior to the closing of this offering;

no exercise of the underwriters over-allotment option;

a three-for-one forward split of our common stock effected on June 25, 2007; and

the filing of our amended and restated certificate of incorporation, which will become effective at the closing of this offering.

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Summary Consolidated Financial Data

The following table presents summary consolidated historical and pro forma as adjusted financial data. We derived the summary statement of operations data for the years ended December 31, 2004, 2005 and 2006 and the summary balance sheet data as of December 31, 2006 from our audited consolidated financial statements and notes thereto included in this prospectus. We derived the summary statement of operations data for the three months ended March 31, 2006 and 2007 and the summary balance sheet data as of March 31, 2007 from our unaudited consolidated financial statements and notes thereto included in this prospectus. We have prepared this unaudited information on the same basis as the audited financial statements and have included all adjustments, consisting of normal recurring adjustments, that we consider necessary for a fair statement of our financial position and operating results for such periods. Our historical results are not necessarily indicative of the results that may be expected in the future. You should read this data together with our consolidated financial statements and the notes thereto, Selected Consolidated Financial Data, and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this prospectus.

The pro forma basic and diluted net income per common share data in the statement of operations data for the year ended December 31, 2006 and the three months ended March 31, 2007, reflect the conversion of all of our outstanding shares of convertible preferred stock into 34,612,503 shares of common stock in connection with this offering.

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	Year ended December 31,			Three months ended March 31,	
	2004	2005	2006	2006 (unaudited)	2007 (unaudited)
	(in thousands, except share data)				
Statement of Operations Data[1]:					
Revenue:					
Product	$ 69,069	$ 107,613	$ 155,131	$ 34,679	$ 45,764
Royalty and license fee	288	277	69,207	14,627	13,190
Total revenue	69,357	107,890	224,338	49,306	58,954
Cost of goods sold	29,354	42,717	61,640	16,138	16,901
Gross profit	40,003	65,173	162,698	33,168	42,053
Operating expenses:					
Research and development	6,044	8,548	24,875	11,794	5,454
Selling, general and administrative	30,118	43,085	91,493	36,139	21,412
Patent litigation expenses (proceeds)	6,204	1,736	(262,605)	(262,665)	
Purchased in-process research and development		2,800			
Total operating expenses	42,366	56,169	(146,237)	(214,732)	26,866
Operating income (loss)	(2,363)	9,004	308,935	247,900	15,187
Non-operating income (expense):					
Interest income	107	224	6,741	2,659	355
Interest expense	(1,434)	(1,851)	(1,824)	(505)	(427)
Other	8	(8)	551	99	41
Total non-operating income (expense):	(1,319)	(1,635)	5,468	2,253	(31)
Income (loss) before provision for (benefit from) income taxes	(3,682)	7,369	314,403	250,153	15,156
Provision for (benefit from) income taxes	161	(26,012)	132,577	105,456	6,059
Net income (loss)	(3,843)	33,381	181,826	144,697	9,097
Preferred stock dividend			(77,785)	(58,571)	
Accretion of preferred stock	(8,477)	(8,278)	(7,985)	(2,117)	(1,956)
Undistributed income attributable to preferred stockholders		(19,599)	(34,275)	(34,783)	(4,828)
Net income (loss) attributable to common stockholders	$ (12,320)	$ 5,504	$ 61,781	$ 49,226	$ 2,313
Net income (loss) per common share[2]:					
Basic	$ (1.31)	$ 0.57	$ 3.79	$ 3.18	$ 0.14
Diluted	$ (1.31)	$ 0.42	$ 3.04	$ 2.53	$ 0.11
Weighted-average number of common shares:					
Basic	9,378,741	9,717,882	16,319,898	15,475,221	16,592,163
Diluted	9,378,741	13,102,611	20,302,872	19,471,926	20,662,530
Pro forma net income per common share (unaudited)[2]:					
Basic			$ 3.57		$ 0.18
Diluted			$ 3.31		$ 0.16
Weighted-average number of common shares used in computing pro forma net income per common share (unaudited):					

Basic	50,932,401	51,204,666
Diluted	54,915,375	55,275,033

	As of March 31, 2007	
	Actual	Pro Forma As Adjusted[3]
	(in thousands)	
	(unaudited)	(unaudited)
Balance Sheet Data[1]:		
Cash and cash equivalents	$ 22,907	$ 43,122
Working capital	44,259	64,474
Total assets	152,137	172,352
Long-term debt, including current portion	31,736	31,736
Stockholders equity	66,143	86,358

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(1) Pursuant to Financial Accounting Standards Board Interpretation No. 46(R), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51,* or FIN 46(R), Masimo Labs is consolidated within our financial statements. Accordingly, all inter-company royalties, option and licensing fees, and other charges between us and Masimo Labs have been eliminated in the consolidation. Also in accordance with FIN 46(R), all direct engineering expenses that have been incurred by us and charged to Masimo Labs have not been eliminated and are included as research and development expense in our consolidated statements of operations. For additional discussion of accounting for Masimo Labs, see Note 4 to the Notes to Consolidated Financial Statements.

(2) See Note 2 to the Notes to Consolidated Financial Statements for a description of the method used to compute basic and diluted net income (loss) per common share and basic and diluted pro forma net income per common share.

(3) On a pro forma as adjusted basis giving effect to the conversion of all outstanding shares of our convertible preferred stock into common stock and to reflect the sale of 1,500,000 shares of our common stock in this offering at an assumed initial public offering price of $17.00 per share, the midpoint of the range on the cover of this prospectus. A $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) cash and cash equivalents, working capital, total assets and stockholders equity by $1.4 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same, and after deducting the underwriting discount and estimated offering expenses payable by us.

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RISK FACTORS

Investing in our common stock involves a high degree of risk. You should consider carefully the risks described below, together with all of the other information contained in this prospectus, before making your decision to invest in shares of our common stock. The occurrence of any of the following risks, and the risks described elsewhere in this prospectus, including the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations, could materially and adversely affect our financial condition, results of operations, cash flow and per share trading price and could cause you to lose some or all of your investment.

Risks Related to Our Business

We currently derive substantially all of our revenue from our Masimo SET platform and related products. If this technology and the related products do not continue to achieve market acceptance, our business, financial condition and results of operations would be adversely affected.

We are dependent upon the success and market acceptance of our proprietary Masimo Signal Extraction Technology, or Masimo SET. Currently, our primary product offerings are based on the Masimo SET platform. Continued market acceptance of products incorporating Masimo SET will depend upon our ability to continue to provide evidence to the medical community that our products are cost-effective and provide significantly improved performance compared to conventional pulse oximeters. Health care providers that currently have significant investments in competitive pulse oximetry products may be reluctant to purchase our products. If hospitals and other health care providers do not believe our Masimo SET platform to be cost-effective, more accurate or reliable, they may not buy our products in sufficient quantities to enable us to be profitable. If we are unable to achieve additional market acceptance of our core technology or products incorporating Masimo SET, we will not generate significant revenue growth from the sale of our products.

If the patents we own or license, or our other intellectual property rights, do not adequately protect our products, we may lose market share to our competitors and be unable to operate our business profitably.

Our success depends significantly on our ability to protect our rights to the technologies used in our products, including Masimo SET and licensed Rainbow technology. We rely on patent protection, trade secrets, as well as a combination of copyright and trademark laws and nondisclosure, confidentiality and other contractual arrangements to protect our technology. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep any competitive advantage. In addition, we cannot be assured that any of our pending patent applications will result in the issuance of a patent to us. The U.S. Patent and Trademark Office, or PTO, may deny or require significant narrowing of claims in our pending patent applications, and patents issued as a result of the pending patent applications, if any, may not provide us with significant commercial protection or be issued in a form that is advantageous to us. We could also incur substantial costs in proceedings before the PTO. These proceedings could result in adverse decisions as to the claims included in our patents.

Our issued and licensed patents and those that may be issued or licensed in the future may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related products. Additionally, upon expiration of our issued or licensed patents, we may lose some of our rights to exclude others from making, using, selling or importing products using the technology based on the expired patents. We also must rely on contractual rights with the third parties that license technology to us to protect our rights in the technology licensed to us. Although we have taken steps to protect our intellectual property and technology, there is no assurance that competitors will not be able to design around our patents. We also rely on unpatented proprietary technology. We cannot assure you that we

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can meaningfully protect all our rights in our unpatented proprietary technology or that others will not independently develop substantially equivalent proprietary products or processes or otherwise gain access to our unpatented proprietary technology. We seek to protect our know-how and other unpatented proprietary technology with confidentiality agreements and intellectual property assignment agreements with our employees, or OEM partners, independent distributors and consultants. However, such agreements may not be enforceable or may not provide meaningful protection for our proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements or in the event that our competitors discover or independently develop similar or identical designs or other proprietary information. In addition, we rely on the use of registered and common law trademarks with respect to the brand names of some of our products. Our common law trademarks provide less protection than our registered trademarks. Loss of rights in our trademarks could adversely affect our business, financial condition and results of operations.

Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the United States. If we fail to apply for intellectual property protection or if we cannot adequately protect our intellectual property rights in these foreign countries, our competitors may be able to compete more effectively against us, which could adversely affect our competitive position, as well as our business, financial condition and results of operations.

If third parties claim that we infringe their intellectual property rights, we may incur liabilities and costs and may have to redesign or discontinue selling certain products.

Companies in the medical device industry have used intellectual property litigation to gain a competitive advantage in the marketplace. Whether a product infringes a patent involves complex legal and factual issues, the determination of which is often uncertain. We face the risk of claims that we have infringed on third parties intellectual property rights. Prior to launching major new products in our key markets, we normally evaluate existing intellectual property rights. However, searching for existing intellectual property rights may not reveal important intellectual property and our competitors may also have filed for patent protection, which is not as yet a matter of public knowledge, or claimed trademark rights that have not been revealed through our availability searches. Our efforts to identify and avoid infringing on third parties intellectual property rights may not always be successful. Any claims of patent or other intellectual property infringement, even those without merit, could:

- increase the cost of our products;
- be expensive and time consuming to defend;
- result in us being required to pay significant damages to third parties;
- force us to cease making or selling products that incorporate the challenged intellectual property;
- require us to redesign, reengineer or rebrand our products;
- require us to enter into royalty or licensing agreements in order to obtain the right to use a third party s intellectual property, the terms of which may not be acceptable to us;
- require us to indemnify third parties pursuant to contracts in which we have agreed to provide indemnification to such parties for intellectual property infringement claims;
- divert the attention of our management; and

result in our customers or potential customers deferring or limiting their purchase or use of the affected products until the litigation is resolved.

In addition, new patents obtained by our competitors could threaten a product s continued life in the market even after it has already been introduced.

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We believe competitors may currently be violating and may in the future violate our proprietary rights, and we may bring additional litigation to enforce our intellectual property rights, which may result in substantial expense and may divert our attention from the implementation of our business strategy.

We believe that the success of our business depends, in significant part, on obtaining patent protection for our products and technology, defending our patents once obtained and preserving our trade secrets. We were previously involved in significant litigation to protect our patent position and may be required to engage in further litigation. In 2006, we settled a costly, six-year lawsuit against Mallinckrodt, Inc., now a part of Covidien Ltd. (formerly Tyco Healthcare), and one of its subsidiaries, Nellcor Puritan Bennett, Inc., collectively referred to as Nellcor, in which we claimed that Nellcor was infringing certain of our pulse oximetry signal processing patents. See Business Nellcor Patent Litigation Settlement. We believe that other competitors of ours, including some of our OEM partners, may be infringing at least one of our patents. See Business Competition. Our failure to pursue any potential claim could result in the loss of our proprietary rights and harm our position in the marketplace. Therefore, we may be forced to pursue litigation to enforce our rights. We cannot be certain that we will have the required financial resources to pursue litigation or otherwise to protect these rights in the future. In addition, any future litigation could result in the diversion of management s attention from the implementation of our business strategy and may not be adequate to protect our intellectual property rights.

Some of our products, including those based on licensed Rainbow technology, are in development or have been recently introduced into the market and may not achieve market acceptance, which could limit our growth and adversely affect our business, financial condition and results of operations.

Our products that have been recently introduced, including those based on Rainbow technology, a technology that we license, may not be accepted in the market. Our first product incorporating licensed Rainbow technology was made commercially available in September 2005. Accordingly, we do not know to what degree the market will accept these products, if at all. Even if our customers recognize the benefits of our products, we cannot assure you that our customers will purchase them in quantities sufficient for us to be successful. We will need to invest in significant sales and marketing resources to achieve market acceptance of these products with no assurance of success. The degree of market acceptance of these products will depend on a number of factors, including:

- perceived effectiveness of our products;
- cost of our products;
- perceived advantages over competing products;
- introduction and acceptance of competing products or technologies; and
- obtaining the required domestic and international regulatory approvals for our products under development.

In order for any of these products to be accepted, we must prove that they are effective and commercially beneficial. Even if customers accept these products, this acceptance may not translate into sales if our competitors develop similar products that our customers prefer. If our products do not gain market acceptance or if our customers prefer our competitors products, our potential growth could be limited, which could adversely affect our business, financial condition and results of operations.

Our products are subject to reporting requirements and may be subject to recalls, which could be expensive, damage our reputation and result in a diversion of management resources.

After a device is placed on the market, numerous regulatory requirements apply, including medical device reporting regulations that require us to report to the FDA or similar governmental bodies in other countries if our products cause or contribute to a death or serious injury or malfunction in a way that would be reasonably likely to contribute to death or serious injury if the malfunction were to recur. The FDA and

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similar governmental bodies in other countries have the authority to require the recall of our products in the event of material deficiencies or defects in design or manufacture. A government mandated or voluntary recall by us could occur as a result of manufacturing or labeling errors or design defects. Any voluntary or government mandated recall may divert management attention and financial resources and harm our reputation with customers. Any recall involving one of our products could also harm the reputation of the product and us and would be particularly harmful to our business and financial results.

We may recall our products, either voluntarily or involuntarily, if any prove or are perceived to be defective. Much of our growth may come from the introduction and sale of new products, which may result in a greater frequency of recalls. From our inception through June 30, 2007, we initiated three voluntary recalls of our products, none of which was material.

On July 31, 2007, we determined to initiate a voluntary recall of our Rad-9 pulse oximeter, a standalone bedside pulse oximeter product, sales of which represented less than 0.6% and 0.4% of our product revenue in 2006 and the first fiscal quarter of 2007, respectively. In accordance with its original design and similar to other pulse oximeter devices, the Rad-9 gives a visual alarm if there is a sensor fault; under other circumstances, the Rad-9 gives both a visual and audio alarm. In late 2006, we sent notice to owners of the Rad-9 that a free upgrade was available to add an audio alarm to the Rad-9 when a sensor fault is detected. We have now determined to voluntarily recall the Rad-9 to implement this upgrade. We do not believe that a non-upgraded Rad-9 poses a significant risk to health. We decided to voluntarily recall the Rad-9 because we believe it has the possibility of improving the care of patients. This decision follows a customer report that an elderly patient, who may have damaged her pulse oximeter sensor, had died after removing her tracheostomy tube. Based on what is currently known, the Rad-9 appears to have been operating in accordance with its specifications. We estimate that the total costs resulting from this voluntary recall will be approximately $300,000 to $500,000, although this is an estimate and the actual cost may differ. Any future recall could result in a diversion of management resources, substantial cost and negative publicity, all of which could adversely affect our business, financial condition and results of operations.

Our ability to commercialize products that incorporate Masimo SET or Rainbow technology is limited.

In May 1998, we created a newly-formed entity, Masimo Laboratories, Inc., or Masimo Labs, and provided it rights to use Masimo SET to commercialize non-vital signs monitoring applications while we retained the rights to Masimo SET to commercialize vital signs monitoring applications. On May 2, 1998, we entered into a cross-licensing agreement with Masimo Labs, which has been amended several times, most recently in an Amended and Restated Cross-Licensing Agreement, effective January 1, 2007, or the Cross-Licensing Agreement. Under the Cross-Licensing Agreement, we granted Masimo Labs:

- an exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET owned by us, including all improvements on this technology, for the measurement of non-vital signs parameters and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs parameters in any product market in which a product is intended to be used by a patient or pharmacist rather than by a professional medical caregiver, which we refer to as the Labs Market, and

- a non-exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET for measurement of vital signs in the Labs Market.

Non-vital signs parameters consist of body fluid constituents other than vital signs parameters, including but not limited to carbon monoxide, methemoglobin, blood glucose, total hemoglobin, and bilirubin.

Under the Cross-Licensing Agreement, we are only permitted to sell devices utilizing Masimo SET for the measurement of non-vital signs parameters in markets where the product is intended to be used by a professional medical caregiver, including but not limited to hospital caregivers and emergency medical

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services, or EMS, facility caregivers, rather than by a patient or pharmacist, which we refer to as the Masimo Market. Accordingly, our ability to commercialize new products, new or improved technologies and additional applications for Masimo SET is limited. In particular, our inability to expand beyond the Masimo Market may impair our growth and adversely affect our financial condition and results of operations.

Pursuant to the Cross-Licensing Agreement, we have licensed from Masimo Labs the right to make and distribute products in the Masimo Market that utilize Rainbow technology for the measurement of carbon monoxide, methemoglobin, fractional arterial oxygen saturation, and total hemoglobin, which includes hematocrit. As a result, the opportunity to expand the market for our products incorporating Rainbow technology is limited, which could limit our revenue and impair our growth.

We will be required to pay Masimo Labs for the right to use certain improvements to Masimo SET that we develop.

Under the Cross-Licensing Agreement, when we develop improvements to Masimo SET for the non-invasive measurement of non-vital signs parameters, we would be required to assign these developments to Masimo Labs and then license the technology back from Masimo Labs in consideration for a license fee and royalty obligations to Masimo Labs. Therefore, any improvement to this technology would be treated as if it had been developed exclusively by Masimo Labs. In addition, we will not be reimbursed by Masimo Labs for our expenses relating to the development of any such technology. As a result of these terms, we may not generate any revenue from the further development of Masimo SET for the measurement of non-vital signs parameters, which could adversely affect our business, financial condition and results of operations.

In the event that the Cross-Licensing Agreement is terminated for any reason, or Masimo Labs grants a license to Rainbow technology to a third party, our business would be materially and adversely affected.

Masimo Labs owns all of the proprietary rights to Rainbow technology developed with our proprietary Masimo SET for products intended to be used in the Labs Market, and all rights for any non-vital signs parameter for which we do not exercise an option pursuant to the Cross-Licensing Agreement. In addition, Masimo Labs has the right to terminate the Cross-Licensing Agreement or grant licenses covering Rainbow technology to third parties if we breach certain terms of the agreement, including failure to meet our minimum royalty payment obligations or failure to use commercially reasonable efforts to develop or market products incorporating licensed Rainbow technology. If we lose our exclusive license to Rainbow technology, we may not be able to develop comparable technology or license similar technology on commercially favorable terms or at all, and we would lose the ability to prevent others from making, using, selling or importing products using Rainbow technology in our market. As a result, we would likely be subject to increased competition within our market, and Masimo Labs or competitors who obtain a license to Rainbow technology from Masimo Labs would be able to offer related products.

We may not be able to commercialize our products incorporating licensed Rainbow technology cost-effectively or successfully.

It costs us more to make products that incorporate Rainbow technology than products without Rainbow technology due to increased production costs in addition to the royalties that we must pay to Masimo Labs. In order to successfully commercialize these products, we must be able to pass these higher costs on to the market. We cannot assure you that we will be able to sell products incorporating Rainbow technology at a price the market is willing to accept. If we cannot commercialize our products incorporating licensed Rainbow technology successfully, we may not be able to generate sufficient product revenue to be profitable, which could adversely affect our business, financial condition and results of operations.

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We are required to pay royalties to Masimo Labs for all products sold that contain Rainbow technology, including certain annual minimum royalty payments and this may impact our gross margins.

The Cross-Licensing Agreement requires us to pay Masimo Labs a royalty for all products that we sell which include their proprietary Rainbow technology. This includes hand-held, table-top and multi-parameter products that incorporate licensed Rainbow technology. Beginning in 2009, for hospital contracts where we place equipment and enter into a sensor contract, we will pay a royalty to Masimo Labs on the total sensor contract revenues based on the ratio of Rainbow enabled devices to total devices. The agreement also requires that we provide to Masimo Labs, at its request, up to 10% of our annual board and sensor production volume at our total manufactured cost. In addition to these specific royalty and product obligations, our Cross-Licensing Agreement requires that we pay Masimo Labs specific annual minimum royalty payments.

While the payment of royalties for enabled Rainbow parameters should not have a negative impact on our overall margins, the minimum annual royalties will have a negative impact to the extent that we do not generate sufficient Rainbow product revenues to offset the minimum royalties owed to Masimo Labs. In addition, the requirement for us to provide Masimo Labs with up to 10% of our board and sensor production at our manufactured cost will, if requested by Masimo Labs, have a negative impact on our gross margins.

Rights provided to Masimo Labs in the Cross-Licensing Agreement may impede a change in control of our company.

In the event we undergo a change in control, which, as defined in the Cross-Licensing Agreement, includes the resignation or termination of Joe E. Kiani from his position of Chief Executive Officer of either Masimo or Masimo Labs, we are required to immediately pay a $2.5 million fee to exercise an option to license technology developed by Masimo Labs for use in blood glucose monitoring. Additionally, our per product royalties payable to Masimo Labs will become subject to specified minimums, and the minimum aggregate annual royalties for all licensed Rainbow parameters payable to Masimo Labs will increase to up to $15.0 million for carbon monoxide, methemoglobin, fractional arterial oxygen saturation, total hemoglobin and blood glucose, plus up to $2.0 million per other Rainbow parameters. Also, if the surviving or acquiring entity ceases to use Masimo as a company name and trademark following a change in control, all rights to the Masimo trademark will automatically be assigned to Masimo Labs. This could delay or discourage transactions involving an actual or potential change in control of us, including transactions in which our stockholders might otherwise receive a premium for their shares over then current prices. In addition, our requirement to assign all future improvements for non-vital signs to Masimo Labs could impede a change in control.

Masimo Labs has conducted most of the research and development of Rainbow technology and we are dependent upon Masimo Labs to develop improvements to Rainbow technology.

Masimo Labs has conducted the research and development of Rainbow technology. Although we expect Masimo Labs to continue its research and development activities related to Rainbow technology and specific non-invasive monitoring parameters, including blood glucose and total hemoglobin, no assurance can be given that it will do so. In the event Masimo Labs does not continue to develop and improve Rainbow technology, our business, financial condition and results of operations could be adversely affected.

We will experience conflicts of interest with Masimo Labs with respect to business opportunities and other matters. Investors in this offering will not receive an equity interest in Masimo Labs.

As of June 30, 2007, our stockholders owned approximately 99.9% of the outstanding shares of capital stock of Masimo Labs. In addition, Joe E. Kiani and Jack Lasersohn, members of our board of directors, are also members of the board of directors of Masimo Labs. Joe E. Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Masimo Labs. Due to the interrelated nature of Masimo Labs with us, conflicts of interest will arise with respect to transactions

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involving business dealings between us and Masimo Labs, potential acquisitions of businesses or products, development of products and technology, the sale of products, markets and other matters in which our best interests and the best interests of our stockholders may conflict with the best interests of the stockholders of Masimo Labs. We cannot assure you that any conflict of interest will be resolved in our favor, or that with respect to our transactions with Masimo Labs we will negotiate terms that are as favorable to us as if such transactions were with an unaffiliated third party. Investors in this offering are not receiving an equity interest in Masimo Labs.

Our operating results are volatile and difficult to predict and, prior to 2005, we had a history of net losses. We may experience significant fluctuations in our quarterly results and we may not maintain our recent profitability in the future.

We incurred net losses attributable to common stockholders in each year from our inception through 2004. Our net losses attributable to common stockholders were approximately $8.6 million, $15.4 million and $12.3 million in 2002, 2003 and 2004, respectively. We expect our expenses to increase as we expand our research and development and sales and marketing activities. As a result, if we are unable to maintain or increase our revenue, we may incur net losses and negative cash flows in the future.

Our operating results have fluctuated in the past and are likely to fluctuate significantly in the future. We may experience fluctuations in our quarterly results of operations as a result of:

- delays or interruptions in manufacturing and shipping of our products;
- varying demand for and market acceptance of our technology and products;
- the effect of competing technological and market developments resulting in lower selling prices or significant promotional costs;
- changes in the timing of product orders and the volume of sales to our OEM partners;
- actions taken by group purchasing organizations, or GPOs;
- delays in hospital conversions to our products;
- our legal expenses, particularly those related to litigation matters;
- changes in our product or customer mix;
- unanticipated delays or problems in the introduction of new products, including delays in obtaining clearance or approval from the FDA;
- product recalls; and
- high levels of returns and repairs.

These factors, some of which are not within our control, may cause the price of our stock to fluctuate substantially. To respond to these and other factors, we may need to make business decisions that could result in failure to meet financial expectations. If our quarterly operating results fail

to meet or exceed the expectations of securities analysts or investors, our stock price could drop suddenly and significantly. Most of our expenses, such as employee compensation, inventory and debt repayment obligations, are relatively fixed in the short term. Moreover, our expense levels are based, in part, on our expectations regarding future revenue levels. As a result, if our revenue for a particular period were below our expectations, we would not be able to proportionately reduce our operating expenses for that period. Any revenue shortfall would have a disproportionately negative effect on our operating results for the period.

Due to these and other factors, we believe that quarter-to-quarter comparisons of our operating results may not be meaningful. You should not rely on our results for any one quarter as an indication of our future performance. In future quarters, our operating results may be below the expectations of securities analysts or investors.

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We depend on our OEM partners for a portion of our revenue. If they do not devote sufficient resources to the promotion of products that use Masimo SET and licensed Rainbow technology, our business would be harmed.

We are, and will continue to be, dependent upon our OEM partners for a portion of our revenue through their marketing, selling and distribution of certain of their products that incorporate Masimo SET and licensed Rainbow technology. Although we expect that our OEM partners will accept and actively market, sell and distribute products that incorporate licensed Rainbow technology, they may elect not to do so in the near future or at all. The failure of our OEM partners to successfully market, sell or distribute products incorporating these technologies, the termination of OEM agreements, the loss of OEM partners or the inability to enter into future OEM partnership agreements would have a material adverse effect on our business, financial condition and results of operations. Our success will depend in part upon whether our OEM partners devote sufficient resources to the promotion of products that incorporate these technologies. These products may represent a relatively small percentage of business for some of our OEM partners. In addition, some of our OEM partners offer products that compete with ours. Therefore, we cannot guarantee that our OEM partners will vigorously promote products incorporating Masimo SET and licensed Rainbow technology. If any of our OEM partners were to be acquired, we cannot assure you that an acquiring company would devote sufficient resources to promote products that incorporate technology we own or license.

The loss of any large customer or any cancellation or delay of a significant purchase by a large customer could reduce our net sales and harm our operating results.

For the year ended December 31, 2006, we did not have any customers who accounted for over 10.0% of our total revenues. However, we have a concentration of OEM, distribution and direct customers. If, for any reason, we were to lose our ability to sell to a specific group or class of customers, we would experience a significant reduction in revenues. This would, in turn, adversely impact our operating results because we may not be able to react quickly enough to reduce our operating expenses. Also, we cannot assure you that we will retain our current customers or groups of customers or that we will be able to attract and retain additional customers.

Our royalty agreement with Nellcor provides for a declining royalty rate schedule over the term of the settlement agreement which, if not offset by other revenues and sources of income, could significantly harm our total sales and operating results.

In fiscal 2006, our royalties from the Nellcor settlement totaled $68.8 million. Because these royalty payments do not carry any significant cost, they result in significant improvements to our reported gross profit and operating income levels. As a result, any decline in royalties that we earn under this agreement will have a significant impact on our revenues, gross margins and operating income. Under terms of the agreement, we earn royalties on Nellcor s total U.S. based pulse oximetry sales. The royalty rate in 2006 was nearly 20% if averaged over the entire year. The royalty rates in 2007 will decline to a range of 12% to 15% depending on Nellcor s ability to re-design their products in a manner that would avoid some of our patent coverage in the settlement agreement. In 2008 and through the term of the royalty agreement, at least through March 14, 2011, the royalty rates will decline to a range of 10% to 12%, also subject to Nellcor s ability to develop new products that avoid the current patent coverage as negotiated in the settlement agreement. As a result of these declining royalty rates in 2007 and beyond, there is a significant financial risk to our operating income if we are unable to generate sufficient revenues and gross margins to offset the impact of declining royalty rates on sales of Nellcor s U.S. pulse oximetry products.

If we fail to maintain relationships with GPOs, sales of our products would decline.

Our ability to sell our products to U.S. hospitals depends in part on our relationships with GPOs. Many existing and potential customers for our products become members of GPOs. GPOs negotiate pricing arrangements and contracts, sometimes exclusive, with medical supply manufacturers and distributors,

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and these negotiated prices are made available to a GPO s affiliated hospitals and other members. If we are not one of the providers selected by a GPO, affiliated hospitals and other members may be less likely to purchase our products, and if the GPO has negotiated a strict sole source, market share compliance or bundling contract for another manufacturer s products, we may be precluded from making sales to members of the GPO for the duration of the contractual arrangement. Our failure to renew contracts with GPOs may cause us to lose market share and could have a material adverse effect on our sales, financial condition and results of operations. In 2006, revenue from the sale of our pulse oximetry products related to GPOs amounted to $66.6 million, representing 80.7% of our revenue from sales to U.S. hospitals. We do not have any contracts expiring in 2007. In the future, if we are unable to keep our relationships and develop new relationships with GPOs, our competitive position would likely suffer.

In addition, some GPOs have tested the use of new internet bidding which has resulted in business shifting from one vendor to another vendor. We cannot assure you that continued movement to these internet bidding procedures will not increase and that this may result in our failure to secure contracts with these organizations.

If we do not successfully develop and commercialize enhanced or new products that remain competitive with new products or alternative techniques developed by others, we could lose revenue opportunities and customers, and our ability to achieve growth would be impaired.

The medical device industry is characterized by rapid product development and technological advances, which places our products at risk of obsolescence. Our long-term success depends upon the development and successful commercialization of new products, new or improved technologies and additional applications for Masimo SET and licensed Rainbow technology. The research and development process is time-consuming and costly and may not result in products or applications that we can successfully commercialize. In particular, we may not be able to successfully commercialize our products for applications other than arterial blood oxygen saturation and pulse rate monitoring, including carboxyhemoglobin and methemoglobin monitoring. If we do not successfully adapt our products and applications both within and outside these parameters, we could lose revenue opportunities and customers. In addition, we may not be able to improve our products or develop new products or technologies quickly enough to maintain a competitive position in our markets and continue to grow our business. Furthermore, one or more of our competitors may develop products that are substantially equivalent to our FDA-cleared products, or those of our OEM partners, whereby they may be able to use our products or those of our OEM partners, as predicate devices to more quickly obtain FDA clearance of their competing products.

We face competition from other companies, many of which have substantially greater resources than we do and may be able to develop products perceived as more effective or easier to use than ours or are more readily accepted, or offer their products at lower prices than we can, which could adversely affect our business, financial condition and results of operations.

We face substantial competition from companies developing products that compete with our Masimo SET platform for use with third-party monitoring systems. We also face competition from companies currently marketing pulse oximetry monitors. One company in particular, Nellcor, a subsidiary of Tyco Healthcare, currently holds a substantial share of the pulse oximetry market. Our revenues and profit are significantly smaller than our primary competitors. A number of the companies in the pulse oximetry market have substantially greater capital resources, larger customer bases, larger sales forces, greater marketing and management resources, larger research and development staffs and larger facilities than ours, and have established reputations with our target customers, as well as worldwide distribution channels that are more effective than ours. Competition could result in price reductions, fewer orders, reduced gross margins and loss of market share.

Reliance on clinical studies is an important means of demonstrating the effectiveness of products in our industry. We are aware of a number of clinical and laboratory studies with results that are less favorable

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to the Masimo SET platform than those contained in the over 100 independent studies that validate our technology. We believe that these studies either (i) lack independence because they were funded by competing companies evaluated in the studies or were conducted by employees of such companies, or (ii) lack objectivity because of the absence of clinical procedures and protocols required to ensure objective and accurate results. If subsequent independent studies validate these studies or these studies are otherwise shown to be accurate, market acceptance and sales of our products could be adversely impacted and we could lose market share to our competitors.

Our suppliers may not supply us with a sufficient amount of materials and components or materials and components of adequate quality.

We depend on sole or limited source suppliers for key materials and components of our patient monitoring solutions, and if we are unable to obtain these components on a timely basis, we will not be able to deliver our patient monitoring solutions to customers. Also, we cannot guarantee that any of the materials or components that we purchase, if available at all, will be of adequate quality or that the prices we pay for these materials or components will not increase. From time to time, there are industry-wide shortages of several electronic components that we use in our patient monitoring solutions. We may experience delays in production of our products if we fail to identify alternate vendors, or any parts supply is interrupted or reduced or there is a significant increase in production costs, each of which could adversely affect our business, financial condition and results of operations.

We may be subject to damages resulting from claims that we or our employees have wrongfully used or disclosed alleged trade secrets of their former employers.

Many of our employees were previously employed at other medical device companies. We may be subject to claims that employees have disclosed, or that we have used, trade secrets or other proprietary information of their former employers. Defending against these claims could result in substantial costs and be a distraction to management. If we fail in defending such claims, in addition to paying monetary damages, we may lose valuable intellectual property rights or personnel. A loss of key research and development or sales personnel could limit our ability to sell our existing products, which could adversely affect our business, financial condition and results of operations.

If product liability claims are brought against us, we could face substantial liability and costs.

The manufacture and sale of products using Masimo SET and licensed Rainbow technology expose us to product liability claims and product recalls, including those that may arise from misuse or malfunction of, or design flaws in, our products or the use of our products with incompatible components or systems. Any losses that we may suffer from future liability claims, and the effect that any product liability litigation may have upon the reputation and marketability of our technology and products, together with the corresponding diversion of the attention of our key employees, could adversely affect our business, financial condition and results of operations. Any product liability claims could require significant cost and management resources and may subject us to significant damages. We currently have product liability insurance that we believe to be adequate, but we cannot be certain that it will be sufficient to cover damages or claims. Furthermore, we may not be able to obtain or maintain insurance in the future at satisfactory rates or in adequate amounts to protect us against any product liability claims.

Our failure to obtain and maintain FDA clearances or approvals on a timely basis, or at all, would prevent us from commercializing our current or upgraded products in the United States, which could severely harm our business.

Each medical device that we wish to market in the United States generally must first receive either 510(k) clearance, by filing a 510(k) pre-market notification, or PMA approval, by filing a PMA application, from the FDA pursuant to the Federal Food, Drug, and Cosmetic Act. Even if regulatory approval of a product is granted, the approval may be subject to limitations on the indicated uses for which the

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product may be marketed. We cannot assure you that the FDA will grant 510(k) clearance on a timely basis, if at all, for new products or uses that we propose for the Masimo SET or licensed Rainbow technology. The FDA s 510(k) clearance process usually takes from four to twelve months, although it can last longer. The process of obtaining PMA approval is much more costly, lengthy and uncertain and generally takes from one to three years or even longer. See Business Government Regulation for more detailed information about 510(k) clearances and PMA approvals.

To date, the FDA has regulated pulse oximeters incorporating Masimo SET and licensed Rainbow technology, and our sensors, cables and other products incorporating Masimo SET and licensed Rainbow technology for pulse oximetry under the 510(k) process. Although 510(k) clearances have been obtained for all of our current products, these clearances may be revoked by the FDA if safety or effectiveness problems develop with our devices. Any modifications to an FDA-cleared device that could significantly affect its safety or effectiveness or that would constitute a major change in its intended use would require a new 510(k) clearance. Furthermore, our new products or significantly modified marketed products could be denied 510(k) clearance and be required to undergo the more burdensome PMA approval process. If so, our ability to upgrade our products in a timely fashion could be limited. The withdrawal of existing 510(k) clearances or the inability to obtain new ones on a timely basis, or at all, could severely harm our business.

The failure of our OEM partners to obtain FDA clearances or approvals could have a negative impact on our revenue.

Our OEM partners will be required to obtain their own FDA clearances for products incorporating Masimo SET and licensed Rainbow technology to market these products in the United States. We cannot assure you that the FDA clearances we have obtained will make it easier for our OEM partners to obtain clearances of products incorporating these technologies, or that the FDA will ever grant clearances on a timely basis, if at all, for any future product incorporating Masimo SET and licensed Rainbow technology that our OEM partners propose to market.

If we or our suppliers fail to comply with ongoing regulatory requirements, or if we experience unanticipated problems with our products, these products could be subject to restrictions or withdrawal from the market.

Our products, along with the manufacturing processes and promotional activities for such products, are subject to continual review and periodic inspections by the FDA and other regulatory bodies. In particular we and our suppliers are required to comply with the quality system regulation, or QSR, which covers the methods and documentation of the design, testing, production, control, quality assurance, labeling, packaging, storage and shipping of our products. The FDA enforces the QSR through unannounced inspections. We are also subject to similar state requirements and licenses. Failure by us or one of our suppliers to comply with statutes and regulations administered by the FDA and other regulatory bodies, discovery of previously unknown problems with our products (including unanticipated adverse events or adverse events of unanticipated severity or frequency), manufacturing problems, or failure to comply with regulatory requirements, or failure to adequately respond to any FDA observations concerning these issues, could result in, among other things, any of the following actions:

- issuance of public warning letters;
- a shut-down or interruption of our manufacturing operations;
- withdrawal or suspension of clearance or approval by the FDA or other regulatory bodies;
- product recall, detention or seizure;
- fines and civil penalties;
- unanticipated expenditures;

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operating restrictions;

injunctions; and

criminal prosecution.

If any of these actions were to occur, it would harm our reputation and adversely affect our business, financial condition and results of operations. Furthermore, our key component suppliers may not currently be, or may not continue to be, in compliance with applicable regulatory requirements.

Failure to obtain regulatory approval in foreign jurisdictions will prevent us from marketing our products abroad.

We currently market, and intend to continue to market, our products internationally. Outside the United States, we can market a product only if we receive a marketing authorization and, in some cases, pricing approval, from the appropriate regulatory authorities. The approval procedure varies among countries and can involve additional testing, and the time required to obtain approval may differ from that required to obtain FDA approval. The foreign regulatory approval process may include all of the risks associated with obtaining FDA approval in addition to other risks. We may not obtain foreign regulatory approvals on a timely basis, if at all. Approval by the FDA does not ensure approval by regulatory authorities in other countries, and approval by one foreign regulatory authority does not ensure approval by regulatory authorities in other foreign countries or by the FDA. If we fail to receive necessary approvals to commercialize our products in foreign jurisdictions on a timely basis, or at all, our business, financial condition and results of operations could be adversely affected.

Modifications to our marketed devices may require new regulatory clearances or premarket approvals, or may require us to cease marketing or recall the modified devices until clearances or approval is obtained.

Any modifications to an FDA-cleared device that would significantly affect its safety or effectiveness or that would constitute a major change in its intended use would require a new 510(k) clearance or possibly a PMA approval. We may not be able to obtain such clearances or approvals in a timely fashion, or at all. Delays in obtaining future clearances would adversely affect our ability to introduce new or enhanced products in a timely manner, which in turn would have an adverse effect on our business, financial condition and results of operations. We have made modifications to our devices in the past and we may make additional modifications in the future, some of which we may believe do not or will not require additional clearances or approvals. If the FDA disagrees and requires new clearances or approvals for the modifications, we may be required to recall and to stop marketing the modified devices, which could have an adverse effect on our business, financial conditions and results of operations.

Off-label promotion of our products or promotional claims deemed false or misleading could subject us to substantial penalties.

Obtaining 510(k) clearance only permits us to promote our products for the uses cleared by the FDA. Although we may request additional cleared indications for our current products, the FDA may deny those requests, require additional expensive clinical data to support any additional indications or impose limitations on the intended use of any cleared product as a condition of clearance. We must have adequate substantiation for our product performance claims. If the FDA determines that we or our OEM partners have promoted our products for off-label use, or have made false or misleading or inadequately substantiated promotional claims, we could be subject to fines, injunctions or other significant penalties or restrictions.

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If we are unable to increase our sales, marketing and distribution capabilities or maintain or establish arrangements with third parties to sell, market, manufacture and distribute our pulse oximetry and Rainbow technology products, our business, financial condition and results of operations could be adversely affected.

We have limited sales and marketing experience both in the United States and internationally and may not be successful in developing and implementing our business strategy. In addition, we currently have a small sales organization compared to many of our competitors. To increase our commercial success, we need to:

- increase our sales and marketing force;
- continue to maintain domestic and international OEM partners;
- ensure that distributors and OEM partners provide the technical and educational support customers need to use products incorporating Masimo SET and Rainbow technology successfully;
- promote monitoring systems using Masimo SET and Rainbow technology so that sales of those systems and, in turn, sales of our consumable products increase; and
- be prepared to provide services, as necessary, to geographically dispersed users of monitoring systems using Masimo SET and Rainbow technology.

We currently plan to increase the size of our direct sales force to further market our products in the United States and internationally. Our sales force will be competing with the experienced and well-funded sales and marketing operations of our competitors. Increasing our direct sales capabilities is expensive and time consuming. We may not be able to further develop this capacity on a timely basis or at all. If we are unable to expand our sales and marketing capabilities, we will need to continue to contract with third parties to market and sell our approved products in the United States and internationally. To the extent that we enter into arrangements with third parties to perform sales, marketing and distribution services, our product revenue could be lower than if we directly marketed and sold our products. Furthermore, to the extent that we enter into co-promotion or other sales and marketing arrangements with other companies, any revenue received will depend on the skills and efforts of others, and we do not know whether these efforts will be successful. If we are unable to maintain adequate sales, marketing, manufacturing and distribution capabilities, independently or with others, we may not be able to generate sufficient product revenue to be profitable.

If we are unable to manufacture an adequate supply of our products, we could lose customers and our revenue and growth could be limited.

Our anticipated growth may strain our ability to manufacture an increasingly large supply of our products. Manufacturing facilities often experience difficulties in scaling up production, including problems with production yields and quality control and assurance. If we cannot scale our manufacturing operations appropriately, maintain control over expenses or otherwise adapt to anticipated growth, or if we have underestimated our future growth, we may not have the capability to satisfy market demand, which would have an adverse effect on our business, financial condition and results of operations.

We anticipate and plan for significant growth, which we may not be able to effectively manage.

We expect to rapidly expand our operations and our research and development, product development, sales, marketing and administrative organizations. This growth and activity will likely result in new and increased responsibilities for management personnel and place significant strain upon our operating and financial systems and resources. To accommodate our expected growth and compete effectively, we will

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be required to improve our information systems, create additional procedures and controls and expand, train, motivate and manage our work force. We also may need to expand our manufacturing resources.

We cannot be certain that our personnel, systems, procedures, facilities and controls will be adequate to support our future operations. Any failure to effectively manage our growth could impede our ability to successfully develop, market and sell our products, our anticipated growth may be impaired and our business, financial condition and results of operations would be adversely affected.

We manufacture our products at two locations. Any disruption in these manufacturing facilities could adversely affect our business, financial condition and results of operations.

We have relied, to date, on our manufacturing facilities in Irvine, California and Mexicali, Mexico. These facilities and the manufacturing equipment we use to produce our products would be difficult to replace and could require substantial lead-time to repair or replace. Our facilities may be affected by natural or man-made disasters. In the event that one of our facilities was affected by a disaster, we would be forced to rely on third-party manufacturers if we could not shift production to another of our manufacturing facilities. Although we believe we possess adequate insurance for damage to our property and the disruption of our business from casualties, such insurance may not be sufficient to cover all of our potential losses and may not continue to be available to us on acceptable terms, or at all. If we are forced to seek alternative facilities, we may incur additional costs and we may experience a disruption in the supply of our products until those facilities are available. Any disruption in our manufacturing capacity could have an adverse impact on our ability to produce sufficient inventory of our products or may require us to incur additional expenses in order to produce sufficient inventory, and, therefore, may adversely affect our revenue, gross margins and results of operations. Any disruption or delay at our manufacturing facilities could impair our ability to meet the demand of our customers and our customers may cancel orders or purchase products from our competitors, which could adversely affect our business, financial condition and results of operations.

In the future, we may choose to add new manufacturing capabilities in either our existing facilities or in new facilities throughout the world. If we expand our worldwide manufacturing locations, there can be no assurance that this expansion will occur without implementation difficulties or that such expansion will ultimately lower our overall cost of production.

If we lose the services of our key personnel, or if we are unable to attract and retain other key personnel, we may not be able to manage our operations or meet our growth objectives.

We are highly dependent on our senior management, especially Joe E. Kiani, our Chief Executive Officer, and other key officers. We are also heavily dependent on our engineers and field sales team, including sales representatives and clinical specialists. Our success will depend on our ability to retain our current management, engineers and field sales team, and to attract and retain qualified personnel in the future, including scientists, clinicians, engineers and other highly skilled personnel. Competition for senior management, engineers and field sales personnel is intense and we may not be able to retain our personnel. The loss of the services of members of our key personnel could prevent the implementation and completion of our objectives, including the development and introduction of our products. Each of our officers may terminate their employment at any time without notice and without cause or good reason. We carry key person life insurance on only Mr. Kiani, who is also the Chief Executive Officer of Masimo Labs. Mr. Kiani devotes substantially all of his time to us.

Existing or future acquisitions of businesses could negatively affect our business, financial condition and results of operations if we fail to integrate the acquired businesses successfully into our existing operations or if we discover previously undisclosed liabilities.

In order to expand our products and technology platform, we have acquired four businesses since our inception and we may acquire additional businesses in the future. Successful acquisitions depend upon

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our ability to identify, negotiate, complete and integrate suitable acquisitions and to obtain any necessary financing. Even if we complete acquisitions, we may experience:

- difficulties in integrating any acquired companies, personnel and products into our existing business;
- delays in realizing the benefits of the acquired company or products;
- diversion of our management s time and attention from other business concerns;
- limited or no direct prior experience in new markets or countries we may enter;
- higher costs of integration than we anticipated; and
- difficulties in retaining key employees of the acquired business who are necessary to manage these acquisitions.

In addition, an acquisition could materially impair our operating results by causing us to incur debt or requiring us to amortize acquisition expenses and acquired assets. We may also discover deficiencies in internal controls, data adequacy and integrity, product quality, regulatory compliance and product liabilities that we did not uncover prior to our acquisition of such businesses, which could result in us becoming subject to penalties or other liabilities. Any difficulties in the integration of acquired businesses or unexpected penalties or liabilities in connection with such businesses could have a material adverse effect on our business, financial condition and results of operations.

We may be subject to or otherwise affected by federal and state health care laws, including fraud and abuse and health information privacy and security laws, and could face substantial penalties if we are unable to fully comply with such laws.

Although we do not provide health care services, nor receive payments directly from Medicare, Medicaid, or other third-party payers for our products or the procedures in which our products are used, health care regulation by federal and state governments will impact our business. Health care fraud and abuse and health information privacy and security laws potentially applicable to our operations include, but are not limited to:

- the Federal Health Care Programs Anti-Kickback Law, which prohibits, among other things, knowingly and willfully soliciting, receiving, offering or providing remuneration intended to induce the purchase, order or recommendation of an item or service reimbursable under a federal health care program (such as the Medicare or Medicaid programs);
- federal false claims laws which prohibit, among other things, knowingly and willfully presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payers that are false or fraudulent;
- the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA, and its implementing regulations, which established new federal crimes that prohibit knowingly and willfully executing a scheme to defraud any healthcare benefit program or making false statements in connection with the delivery of or payment for healthcare benefits, items or services, as well as imposed certain requirements relating to the privacy, security and transmission of individually identifiable health information; and

state laws analogous to each of the above federal laws, such as anti-kickback and false claims laws that may apply to items or services reimbursed by non-governmental third-party payers, including commercial insurers, and state laws governing the privacy of certain health information.

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We have certain arrangements with hospitals that may be affected by these laws. For instance, under our standard customer arrangements, we provide hospitals with free pulse oximetry monitoring devices in exchange for their agreement to purchase future pulse oximetry sensor requirements from us. In addition, we occasionally provide our customers with rebates in connection with their annual purchases. While we believe that we are currently in compliance with applicable federal and state health care laws, certain of these arrangements may not meet the Federal Anti-Kickback Law s safe harbor requirements, which may result in increased scrutiny by government authorities having responsibility for enforcing these laws.

There can be no assurance that we will not be found to be in violation of any of such laws or other similar governmental regulations to which we are directly or indirectly subject, and as a result we may be subject to penalties, including civil and criminal penalties, damages, fines, exclusion of our products from reimbursement under Medicare, Medicaid, and other federal health care programs, and the curtailment or restructuring of our operations. Any penalties could adversely affect our ability to operate our business and our financial results. Any action against us for violation of these laws, even if we successfully defend against them, could cause us to incur significant legal expenses and divert our management s attention from the operation of our business.

We face environmental liabilities related to certain hazardous materials used in our operations.

Our manufacturing processes involve the use, generation and disposal of certain hazardous materials and wastes, including silicone adhesives, solder and solder paste, sealants, epoxies and various solvents such as methyl ethyl ketone, acetone and isopropyl alcohol. As such, we are subject to stringent federal, state and local laws relating to the protection of the environment, including those governing the use, handling and disposal of hazardous materials and wastes. We may incur significant costs to comply with environmental regulations. Future environmental laws may significantly affect our operations because, for instance, our manufacturing processes may be required to be altered, thereby increasing our manufacturing costs. In our research and manufacturing activities, we use materials that are hazardous to human health, safety or the environment. These materials and various wastes resulting from their use are stored at our facility pending ultimate use and disposal. The risk of accidental injury or contamination from these materials cannot be eliminated. In the event of such an accident, we could be held liable for any resulting damages, and any such liability could exceed our reserves. Although we maintain general liability insurance, we do not specifically insure against environmental liabilities. If an enforcement action were to occur, our reputation and our business and financial condition may be harmed, even if we were to prevail or settle the action. Similarly, if the physicians or other providers or entities with which we do business are found to be non-compliant with applicable laws, they may be subject to sanctions, which could also have a negative impact on our business.

The risks inherent in operating internationally and the risks of selling and shipping our products and of purchasing our components and products internationally may adversely impact our business, financial conditions and results of operations.

We derive a portion of our net sales from operations in international markets. In 2005 and 2006, 19.2% and 22.6%, respectively, of our product revenue was derived from our international operations. In addition, we purchase a portion of our raw materials and components on the international market. The sale and shipping of our products across international borders, as well as the purchase of materials and components from international sources, subject us to extensive U.S. and foreign governmental trade regulations. Compliance with such regulations is costly and we would be exposed to potentially significant penalties for non-compliance. Any failure to comply with applicable legal and regulatory obligations could impact us in a variety of ways that include, but are not limited to, significant criminal, civil and administrative penalties, including imprisonment of individuals, fines and penalties, denial of export privileges, seizure of shipments, restrictions on certain business activities, and exclusion or debarment from government contracting. Also, the failure to comply with applicable legal and regulatory obligations could result in the disruption of our shipping and sales activities.

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In addition, our international sales operations expose us and our representatives, agents and distributors to risks inherent in operating in foreign jurisdictions. These risks include:

- the imposition of additional U.S. and foreign governmental controls or regulations;
- the imposition of costly and lengthy new export licensing requirements;
- a shortage of high-quality sales people and distributors;
- loss of any key personnel that possess proprietary knowledge, or who are otherwise important to our success in certain international markets;
- changes in duties and tariffs, license obligations and other non-tariff barriers to trade;
- the imposition of new trade restrictions;
- the imposition of restrictions on the activities of foreign agents, representatives and distributors;
- scrutiny of foreign tax authorities which could result in significant fines, penalties and additional taxes being imposed on us;
- pricing pressure that we may experience internationally;
- laws and business practices favoring local companies;
- longer payment cycles; and
- difficulties in enforcing or defending intellectual property rights.

We cannot assure you that one or more of these factors will not harm our business. Any material decrease in our international sales would adversely affect our business, financial condition and results of operations.

We are subject to fluctuations in foreign currency exchange rates.

We market our products in certain foreign markets through our subsidiaries and other international distributors. The related distribution agreements may provide for payments in a foreign currency. Accordingly, if the U.S. dollar strengthens against international currencies, our U.S. dollar payments from such distributors, if any, will decrease.

Inadequate levels of coverage or reimbursement from governmental or other third-party payers for our products, or for procedures using our products, may cause our revenues to decline.

Sales of our products depend in part on the reimbursement and coverage policies of governmental and private health care payers. The ability of our health care provider customers, including hospitals, to obtain adequate coverage and reimbursement for our products, or for the procedures in which our products are used, may impact our customers purchasing decisions and, therefore, could have a material adverse effect on our business.

Third-party payers have adopted, and are continuing to adopt, health care policies intended to curb rising health care costs. These policies include:

- controls on reimbursement for health care services and price controls on medical products and services;
- limitations on coverage and reimbursement for new medical technologies and procedures; and
- the introduction of managed care and prospective payment systems in which health care providers contract to provide comprehensive health care for a fixed reimbursement amount per person or per procedure.

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These trends could lead to pressure to reduce prices for our current products and product candidates and could cause a decrease in the size of the market or a potential increase in competition that could adversely affect our business, financial condition and results of operations.

Legislative and regulatory changes in the health care industry could have a negative impact on our financial performance.

Changes in the health care industry in the United States and elsewhere could adversely affect the demand for our products as well as the way in which we conduct business. Additionally, there have been, and we expect there will continue to be, federal, state or local legislative and regulatory changes and proposals to change the health care system, which could affect our business. For instance, the Centers for Medicare and Medicaid Services, or CMS, the federal agency that administers the Medicare and Medicaid programs, has determined that, beginning in 2007, certain uses of pulse oximetry monitoring are eligible for separate Medicare payment in the hospital outpatient setting and are no longer bundled into payments for other services. The result of this change could be an increase in Medicare payments to hospitals for use of our products. However, each year CMS examines the reimbursement rates for both the inpatient and outpatient settings and could either increase or decrease the reimbursement rate for procedures utilizing our products. Overall, we are unable to predict when legislation or regulation that affects our business may be proposed or enacted in the future or what effect any such legislation or regulation would have on our business. Any such legislation, regulation or policies that affect the coverage and reimbursement of our current or future products, or the procedures utilizing our current or future products, could cause our sales to decrease and, as a result, our revenues to decline.

Further, our success in international markets also depends upon the eligibility of reimbursement for our products through government-sponsored health care payment systems and other third-party payers. Outside of the United States, reimbursement systems vary by country. These systems are often subject to the same pressures to curb rising health care costs and control health care expenditures as those in the United States. In addition, as economies of emerging markets develop, these countries may implement changes in their health care delivery and payment systems. If adequate levels of reimbursement from third-party payers outside of the United States are not obtained, sales of our products outside of the United States may be adversely affected.

Our ongoing antitrust litigation against Tyco Healthcare could result in significant additional costs and further divert the attention of our management and key personnel from our business operations.

In May 2002, we filed a lawsuit against Tyco Healthcare, parent company of Nellcor, in the United States District Court for the Central District of California, alleging damage to our business as a result of the anti-competitive business practices of Tyco Healthcare in connection with its Nellcor pulse oximetry brand in violation of federal antitrust laws. Specifically, we alleged that we had incurred damages as a result of a series of illegal exclusionary and anti-competitive acts by Tyco Healthcare that were designed to maintain its monopoly in the pulse oximetry market.

In March 2005, a jury found that Tyco Healthcare s use of sole-source contracts, product bundling, market share-based compliance pricing contracts and co-marketing agreements with OEM patient monitoring companies were unlawful restraints of trade and exclusionary dealing arrangements and, as a result, violated federal antitrust laws. The jury awarded us $140.0 million in damages. Tyco Healthcare filed post-trial motions requesting that the District Court either override the jury decision or grant a new trial. In March 2006, the District Court upheld a portion of the jury verdict and vacated the remaining verdict. In addition, the District Court vacated the jury s damages award and granted Tyco Healthcare a new trial on damages. The District Court held an evidentiary hearing in October 2006 to re-try the damages. On January 25, 2007, the District Court issued a preliminary ruling which did not set damages, but resolved some issues of dispute about damages, and ordered another evidentiary hearing on issues still undecided by the District Court. The District Court held this evidentiary hearing in March 2007. On July 2, 2007, the District Court entered its final judgment, awarding us damages which were trebled to

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$43.5 million and denying our request for a permanent injunction with respect to the Tyco Healthcare business practices found to be anti-competitive. We and Tyco Healthcare have each filed a notice of appeal from the judgment. Even if we are ultimately awarded damages in this litigation, the amount will be subject to a 50% legal fee contingency agreement, in which case we would receive 50% of the net (of costs) proceeds from the award.

We believe that Nellcor continues to enter into sole-source contracts, product bundling agreements, market share-based agreements, and co-marketing agreements. In bundling agreements, the customer is able to obtain discounts on unrelated products when they purchase Nellcor pulse oximeters for most of their pulse oximetry needs. Co-marketing agreements also provide significant impediments to competition in that Nellcor pays large patient monitoring companies to integrate Nellcor pulse oximetry products into their products.

Continued litigation could result in substantial costs and diversion of resources that would harm our business. In addition, there can be no assurance that we will receive any cash award or any equitable relief from the litigation. See Business Legal Proceedings for more information regarding our antitrust litigation against Tyco Healthcare.

We may issue additional securities in the future, including shares, debt or equity-linked debt, which may depress our stock price.

Our issuance of additional securities could:

- cause substantial dilution of the percentage ownership of our stockholders at the time of the issuance;
- cause substantial dilution of our earnings per share;
- subject us to the risks associated with increased leverage, including a reduction in our ability to obtain financing or an increase in the cost of any financing we obtain;
- subject us to restrictive covenants that could limit our flexibility in conducting future business activities; and
- adversely affect the prevailing market price for our outstanding securities.

We do not intend to seek stockholder approval for any such acquisition or security issuance unless required by applicable law or regulation or the terms of existing securities. If these securities are issued, such issuances may cause the trading price of our stock to decline.

We may require additional capital in the future, which may not be available on favorable terms, if at all.

To the extent that our existing capital is insufficient to meet our requirements and cover any losses, we will need to raise additional funds through financings or borrowings or curtail our growth and reduce our assets. Any equity or debt financing, if available at all, may be on terms that are not favorable to us. Equity financings could result in dilution to our stockholders, and the securities issued in future financings may have rights, preferences and privileges that are senior to those of our common stock. If our need for capital arises because of significant losses, the occurrence of these losses may make it more difficult for us to raise the necessary capital. If we cannot raise funds on acceptable terms, if and when needed, we may not be able to develop or enhance our products, take advantage of future opportunities, grow our business or respond to competitive pressures or unanticipated requirements.

If we fail to comply with the reporting obligations of the Securities Exchange Act of 1934 and Section 404 of the Sarbanes-Oxley Act, or if we fail to achieve and maintain adequate internal controls over financial reporting, our business results of operations and financial condition and investors confidence in us could be materially affected.

As a public company, we will be required to comply with the periodic reporting obligations of the Securities Exchange Act of 1934, as amended, or the Exchange Act, including preparing annual reports,

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quarterly reports and current reports. Our failure to prepare and disclose this information in a timely manner could subject us to penalties under federal securities laws, expose us to lawsuits and restrict our ability to access financing. In addition, we will be required under applicable law and regulations to integrate our systems of internal controls over financial reporting. We plan to evaluate our existing internal controls with respect to the standards adopted by the Public Company Accounting Oversight Board. During the course of our evaluation, we may identify areas requiring improvement and may be required to design enhanced processes and controls to address issues identified through this review. This could result in significant delays and costs to us and require us to divert substantial resources, including management time from other activities.

We expect to dedicate significant management, financial and other resources in connection with our compliance with Section 404 of the Sarbanes-Oxley Act in 2007. We expect these efforts to include a review of our existing internal control structure. As a result of this review, we may either hire or outsource additional personnel to expand and strengthen our finance function. We cannot be certain at this time that we will be able to comply with all of our reporting obligations and successfully complete the certification and attestation requirements of Section 404 of the Sarbanes-Oxley Act by the time that we are required to file our annual report on Form 10-K for the year ending December 31, 2008. If we fail to achieve and maintain the adequacy of our internal control and do not address the deficiencies identified by our auditors, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with the Sarbanes-Oxley Act. Moreover, effective internal controls are necessary for us to produce reliable financial reports and are important to help prevent fraud. As a result, our failure to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act on a timely basis could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading price of our common stock.

Risks Related to Our Common Stock and this Offering

There is no existing market for our common stock, and we do not know if one will develop to provide you with adequate liquidity.

Prior to this offering, there has not been a public market for our common stock. We cannot predict the extent to which investor interest in our company will lead to the development of an active trading market on the NASDAQ Global Market or otherwise or how liquid that market might become. If an active trading market does not develop, you may have difficulty selling any of our common stock that you buy. The initial public offering price for our common stock will be determined by negotiations between representatives of the underwriters and us and may not be indicative of prices that will prevail in the open market following this offering. Consequently, you may not be able to sell our common stock at prices equal to or greater than the price you paid in this offering.

Our stock price may be volatile, and your investment in our common stock could suffer a decline in value.

There has been significant volatility in the market price and trading volume of equity securities, which is unrelated to the financial performance of the companies issuing the securities. These broad market fluctuations may negatively affect the market price of our common stock. You may not be able to resell your shares at or above the initial public offering price due to fluctuations in the market price of our common stock caused by changes in our operating performance or prospects and other factors.

Some specific factors that may have a significant effect on our common stock market price include:

- actual or anticipated fluctuations in our operating results or future prospects;
- our announcements or our competitors announcements of new products;

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- the public s reaction to our press releases, our other public announcements and our filings with the Securities and Exchange Commission, or SEC;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- changes in accounting standards, policies, guidance, interpretations or principles;
- changes in our growth rates or our competitors growth rates;
- developments regarding our patents or proprietary rights or those of our competitors;
- our inability to raise additional capital as needed;
- concern as to the efficacy of our products;
- changes in financial markets or general economic conditions;
- sales of common stock by us or members of our management team; and
- changes in stock market analyst recommendations or earnings estimates regarding our common stock, other comparable companies or our industry generally.

This offering will cause immediate and substantial dilution in pro forma net tangible book value.

The initial public offering price of our common stock is substantially higher than what the pro forma net tangible book value per share of our outstanding common stock will be after giving effect to the stock split and this offering. Pro forma net tangible book value per share represents the amount of total tangible assets less total liabilities after giving effect to the stock split of our common stock, divided by the number of shares outstanding after giving effect to the stock split. If you purchase our common stock in this offering, you will incur an immediate dilution of approximately $15.46 in the pro forma net tangible book value per share of common stock after giving effect to the stock split.

We will also have a significant number of outstanding options to purchase our common stock with exercise prices significantly below the initial public offering price of the common stock. To the extent these options are exercised, you will experience further dilution. Upon consummation of this offering, there will be options to purchase 8,143,575 shares of our common stock outstanding, 3,605,943 of which would have been immediately exercisable as of June 30, 2007.

We have broad discretion in how we use the net proceeds from this offering and we may not use these proceeds in a manner desired by our public stockholders.

While we expect to use the funds from this offering for those purposes outlined in the Use of Proceeds section of this prospectus, there can be no assurance that we will ultimately deploy the proceeds in the manner we anticipate. Accordingly, our management will have broad discretion with respect to the use of this portion of our net proceeds and investors will be relying on the judgment of our management regarding the application of these proceeds. Our management could spend these proceeds in ways that our public stockholders may not desire or that do not yield a

favorable return. You will not have the opportunity, as part of your investment in our common stock, to influence the manner in which the net proceeds of the offering are used. We also may use a portion of these proceeds to acquire complementary businesses, but we currently do not have any specific acquisition plans. Any investment may not yield a favorable return. Our financial performance may differ from our current expectations or our business needs may change as our business evolves. As a result, a substantial portion of the proceeds we receive in the offering may be used in a manner significantly different from our current expectations.

Concentration of ownership among our existing directors, executive officers and principal stockholders may prevent new investors from influencing significant corporate decisions.

Upon closing of this offering, based upon beneficial ownership as of June 30, 2007 and assuming no exercise of the underwriters over-allotment option, our current directors, executive officers, holders of

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more than five percent of our common stock, and their affiliates will, in the aggregate, beneficially own approximately 33.8% of our outstanding common stock. As a result, these stockholders, subject to any fiduciary duties owed to our other stockholders under Delaware law, will be able to exercise a controlling influence over matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, and will have significant control over our management and policies. Some of these persons or entities may have interests that are different from yours. For example, these stockholders may support proposals and actions with which you may disagree or which are not in your interests. The concentration of ownership could delay or prevent a change in control of us or otherwise discourage a potential acquirer from attempting to obtain control of us, which in turn could reduce the price of our common stock. In addition, these stockholders, some of whom have representatives sitting on our board of directors, could use their voting influence to maintain our existing management and directors in office, delay or prevent changes in control of us, or support or reject other management and board proposals that are subject to stockholder approval, such as amendments to our employee stock plans and approvals of significant financing transactions.

If there are substantial sales of our common stock, our stock price could decline.

If our existing stockholders sell a large number of shares of our common stock or the public market perceives that these sales may occur, the market price of our common stock could decline. Based on shares outstanding on June 30, 2007 upon the closing of this offering, assuming no outstanding options are exercised prior to the closing of this offering or exercise of the underwriters over-allotment option, we will have approximately 52,816,788 shares of common stock outstanding. All of the shares offered under this prospectus will be freely tradable without restriction or further registration under the federal securities laws, unless purchased by our affiliates. Taking into consideration the effect of lock-up agreements entered into by our stockholders, the remaining 40,900,162 shares outstanding upon the closing of this offering will be available for sale pursuant to Rules 144 and 701, and the volume, manner of sale and other limitations under these rules, as follows:

- 1,218,159 shares of common stock will be eligible for sale in the public market at the date of this prospectus;
- 60,300 shares of common stock will be eligible for sale in the public market beginning 90 days after the effective date of this prospectus;
- 39,564,703 shares of common stock will be eligible for sale in the public market, beginning 180 days after the effective date of this prospectus, unless the lock-up period is otherwise extended pursuant to its terms; and
- the remaining 57,000 shares of common stock will be eligible for sale in the public market at various times thereafter.

Piper Jaffray & Co. may waive the restrictions set forth in the lock-up agreements in their sole discretion at any time.

Existing stockholders holding an aggregate of 30,112,503 shares of common stock, based on conversion of preferred shares outstanding as of June 30, 2007, have rights with respect to the registration of these shares of common stock with the SEC. See Description of Capital Stock Registration Rights. If we register their shares of common stock following the expiration of the lock-up agreements, they can immediately sell those shares in the public market.

Following this offering, we intend to register up to approximately 13,805,217 shares of common stock that are authorized for issuance under our stock incentive plans, including 3,000,000 shares to be reserved under our 2007 Stock Incentive Plan, which will become effective in connection with this offering. As of June 30, 2007, 8,143,575 shares were subject to outstanding options, of which 3,605,943

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options were vested and exercisable as of that date. Once we register these shares, they can be freely sold in the public market upon issuance, subject to the lock-up agreements referred to above and restrictions on our affiliates.

Our corporate documents and Delaware law contain provisions that could discourage, delay or prevent a change in control of our company.

Our board of directors and stockholders have approved an amendment and restatement of our certificate of incorporation and bylaws, which will become effective at the closing of this offering. Provisions in our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. For example, our amended and restated certificate of incorporation authorizes our board of directors to issue up to five million shares of blank check preferred stock. As a result, without further stockholder approval, the board of directors has the authority to attach special rights, including voting and dividend rights, to this preferred stock. With these rights, preferred stockholders could make it more difficult for a third party to acquire us. In addition, our amended and restated certificate of incorporation provides for a staggered board of directors, whereby directors serve for three year terms, with approximately one third of the directors coming up for reelection each year. A staggered board will make it more difficult for a third party to obtain control of our board of directors through a proxy contest, which may be a necessary step in an acquisition of us that is not favored by our board of directors.

We are also subject to the anti-takeover provisions of the Delaware General Corporation Law. Under these provisions, if anyone becomes an interested stockholder, we may not enter into a business combination with that person for three years without special approval, which could discourage a third party from making a takeover offer and could delay or prevent a change in control of us. An interested stockholder means, generally, someone owning 15% or more of our outstanding voting stock or an affiliate of ours that owned 15% or more of our outstanding voting stock during the past three years, subject to certain exceptions as described in the Delaware General Corporation Law.

In addition, our board of directors has adopted a form of stockholder rights plan. We expect our pricing committee to implement the stockholder rights plan promptly following the closing of this offering. The stockholder rights plan will grant all of our stockholders other than the acquiring person the right to purchase common stock at approximately eight times the price at which our shares are sold in this offering if any person becomes the beneficial owner of 15% or more of the outstanding shares of common stock, subject to a number of exceptions set forth in the plan. Our stockholder rights plan could discourage a takeover attempt and make an unsolicited takeover of our company more difficult. As a result, without the approval of our board of directors, you may not have the opportunity to sell your shares to a potential acquirer of us at a premium over prevailing market prices. This could reduce the market price of our common stock.

We will incur significant increased costs as a result of operating as a public company, and our management and key employees will be required to devote substantial time to new compliance initiatives.

We have never operated as a public company. As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. In addition, we will be subject to the reporting requirements of the Exchange Act and the Sarbanes-Oxley Act. These requirements may place a strain on our people, systems and resources. The Exchange Act will require that we file annual, quarterly and current reports with respect to our business and financial condition. The Sarbanes-Oxley Act will require that we maintain effective disclosure controls and procedures and internal controls over financial reporting. In order to maintain and improve the effectiveness of our disclosure controls and procedures and internal controls over financial reporting, significant resources and management oversight will be required. In addition, changing laws, regulations and standards relating to corporate governance and public disclosure, including regulations implemented by the SEC

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and the NASDAQ Global Market, are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time-consuming. This may divert management s attention from other business concerns, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We will be exposed to risks relating to evaluations of controls required by Section 404 of the Sarbanes-Oxley Act.

We will be evaluating our internal controls systems to allow management to report on, and our independent registered public accounting firm to attest to, our internal controls over financial reporting. We will be performing the system and process evaluation and testing (and any necessary remediation) required to comply with the management certification and auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act. While we anticipate being able to fully implement the requirements relating to internal controls and all other aspects of Section 404 by our compliance deadlines, we cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations because there is presently no precedent available by which to measure compliance adequacy. If we are unable to implement the requirements of Section 404 in a timely manner or with adequate compliance, we may be subject to sanctions or investigation by regulatory authorities, including the SEC or the NASDAQ Global Market. This type of action could adversely affect our financial results or investors confidence in our company and our ability to access capital markets, and could cause our stock price to decline. In addition, the controls and procedures that we will implement may not comply with all of the relevant rules and regulations of the SEC and the NASDAQ Global Market. If we fail to develop and maintain effective controls and procedures, we may be unable to provide the required financial information in a timely and reliable manner.

We do not intend to declare cash dividends on our stock after this offering, and any return on investment may be limited to the value of our stock.

We currently intend to retain all future earnings for the operation and expansion of our business and, therefore, do not anticipate declaring or paying cash dividends on our common stock in the foreseeable future. Any payment of cash dividends on our common stock will be at the discretion of our board of directors and will depend upon our results of operations, earnings, capital requirements, financial condition, business prospects, contractual restrictions and other factors deemed relevant by our board of directors. Therefore, you should not expect to receive dividend income from shares of our common stock.

Securities analysts may not initiate coverage of our common stock or may issue negative reports, which may have a negative impact on the market price of our common stock.

Securities analysts may elect not to provide research coverage of our common stock after the completion of this offering. If securities analysts do not cover our common stock after the completion of this offering, the lack of research coverage may cause the market price of our common stock to decline. The trading market for our common stock may be affected in part by the research and reports that industry or financial analysts publish about our business or the pulse oximetry market. If one or more of the analysts who elects to cover us downgrades our stock, our stock price could decline rapidly. If one or more of these analysts ceases coverage of us, we could lose visibility in the market, which in turn could cause our stock price to decline. In addition, recently-adopted rules mandated by the Sarbanes-Oxley Act, and a global settlement reached in 2003 between the SEC, other regulatory agencies and a number of investment banks, has led to a number of fundamental changes in how analysts are reviewed and compensated. In particular, many investment banking firms are required to contract with independent financial analysts for their stock research. As long as we have a smaller market capitalization, it may be difficult for us to attract independent financial analysts that will cover our common stock, which could have a negative effect on the market price of our stock.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus includes forward-looking statements. All statements other than statements of historical facts included in this prospectus that address activities, events or developments that we expect, believe or anticipate will or may occur in the future are forward-looking statements including, in particular, the statements about our plans, objectives, strategies and prospects regarding, among other things, the financial condition, results of operations and business of ours and our subsidiaries. We have identified some of these forward-looking statements with words like believe, may, could, might, forecast, possible, potential, project, will, should, expect, intend, plan, predi approximate or continue and other words and terms of similar meaning. These forward-looking statements may be contained under the captions Prospectus Summary, Risk Factors, Selected Combined Consolidated Financial Data, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business or elsewhere in this prospectus. These forward-looking statements are based on current expectations about future events affecting us and are subject to uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control. Many factors mentioned in our discussion in this prospectus, including the risks outlined under Risk Factors, will be important in determining future results. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we do not know whether our expectations will prove correct. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including, with respect to us or Masimo Labs, the following, among others:

- our reliance on Masimo SET and related products for substantially all of our revenue;
- the failure in protecting our intellectual property;
- exposure to competitors assertions of intellectual property claims;
- the highly competitive nature of the markets in which we sell our products;
- the failure to continue developing innovative products;
- introduction of competing products;
- lack of acceptance of new products;
- the loss of our customers;
- increases in prices for raw materials or the loss of key supplier contracts;
- product liability claims exposure;
- risks in connection with our operations outside the United States;

conditions and changes in the medical device industry generally;

the failure to retain senior management or replace lost senior management;

changes in generally accepted accounting principles;

changes in general economic and business conditions;

changes in currency exchange rates and interest rates;

employee slowdowns, strikes or similar actions;

the vertical integration by our customers of the production of our products into their own manufacturing process;

our inability to meet performance enhancement objectives, including efficiency and cost-reduction strategies;

adverse changes in applicable laws or regulations;

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conflicts of interest due to our ownership structure;

the incurrence of additional debt, contingent liabilities and expenses in connection of future acquisitions;

the failure to effectively integrate newly acquired operations;

the absence of expected returns from the amount of intangible assets we have recorded; and

39,564,703 shares of common stock will be eligible for sale in the public market, beginning 180 days after the effective date of this prospectus, unless the lock-up period is otherwise extended pursuant to its terms.

The factors identified above are believed to be important factors, but not necessarily all of the important factors, that could cause our actual results to differ materially from those expressed in any forward-looking statement. Unpredictable or unknown factors could also have material adverse effects on us. Since our actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements, we cannot give any assurance that any of the events anticipated by the forward-looking statements will occur or, if any of them do, what impact they will have on our results of operations and financial condition. All forward-looking statements included in this prospectus are expressly qualified in their entirety by the foregoing cautionary statements. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this prospectus. We do not undertake any obligation to update, amend or clarify these forward-looking statements or the risk factors contained in this prospectus, whether as a result of new information, future events or otherwise, except as may be required under the federal securities laws.

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USE OF PROCEEDS

We estimate that the net proceeds from the sale of the 1,500,000 shares of common stock that we are offering will be approximately $20.2 million, after deducting the underwriting discount and estimated offering expenses payable by us, and assuming an initial public offering price of $17.00 per share, the midpoint of the range on the cover of this prospectus. We will not receive any proceeds from the sale of common stock by the selling stockholders. If the underwriters exercise their over-allotment option in full, we estimate that our net proceeds from this offering will be approximately $48.5 million, after deducting the underwriting discount and estimated offering expenses payable by us. A $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) the net proceeds to us from this offering by $1.4 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the underwriting discount and estimated offering expenses payable by us.

The principal purposes of this offering are to obtain additional capital and to create a public market for our common stock. Of the net proceeds we will receive from this offering, we expect to use:

- approximately $10.0 million for capital expenditures and the placement of equipment;
- approximately $5.0 million for sales and marketing activities to support the ongoing commercialization of the Masimo SET and Masimo Rainbow SET products, including, but not limited to, expansion of our sales force, additional participation in trade shows and symposia, and expanding our international sales;
- approximately $5.0 million for research and development activities, including support of hardware and software product development and clinical study initiatives; and
- a portion of the remaining amount for increased working capital and general corporate purposes.

We may also use a portion of the net proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business. We have no present understandings, commitments or agreements to enter into any material acquisitions or investments. Pending these uses, we intend to invest the net proceeds of this offering in short-term, investment-grade interest-bearing securities or guaranteed obligations of the U.S. government.

The amounts we actually expend in these areas may vary significantly from our expectations and will depend on a number of factors, including operating costs, capital expenditures and any expenses related to our product development and commercialization efforts, the amount of proceeds actually raised in this offering, competition, manufacturing, any strategic partnerships arrangements we may enter into and enforcing our intellectual property rights. Accordingly, management will retain broad discretion in the allocation of the net proceeds of this offering. We may also use a portion of the proceeds for the potential acquisition of, or investment in, products, technologies or companies that complement our business, although we have no current understandings, commitments or agreements to do so.

We believe that the net proceeds from this offering, together with our cash and cash equivalent balances will be sufficient to meet our anticipated cash requirements for at least the next 12 months.

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DIVIDEND POLICY

In March 2006, we paid a cash dividend of $3.365 per share, in the aggregate amount of approximately $171.8 million, to holders of our common and preferred stock, assuming the conversion of all outstanding shares of preferred stock into an aggregate of 34,612,503 shares of common stock. In February 2007, we paid additional cash dividends of $0.468 per share and $0.257 per share, in the aggregate amount of approximately $37.1 million, to holders of our common and preferred stock assuming conversion into common stock. The majority of the funds used to pay these cash dividends were paid to our stockholders from the after-tax proceeds that we received from our patent infringement lawsuit against Nellcor and the interest thereon.

We anticipate that we will retain all of our future earnings, if any, for use in the expansion and operation of our business and do not anticipate paying cash dividends in the foreseeable future. Any future determination relating to our dividend policy will be made at the discretion of our board of directors, based on our financial condition, results of operations, earnings, contractual restrictions, capital requirements, business prospects and other factors our board of directors may deem relevant. We do not intend to distribute any future royalties received from Nellcor under the settlement agreement to our stockholders.

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CAPITALIZATION

The following table sets forth our capitalization as of March 31, 2007:

- on an actual basis; and
- on a pro forma as adjusted basis to give effect to the conversion of our outstanding preferred stock into 34,612,503 shares of our common stock in connection with this offering and the sale by us of 1,500,000 shares of our common stock in this offering at an assumed public offering price of $17.00 per share, the midpoint of the range on the cover of this prospectus, after deducting the underwriting discount and estimated offering expenses payable by us.

The pro forma as adjusted information below is illustrative only, and our capitalization following the completion of this offering will be adjusted based on the actual initial public offering price and other terms of this offering determined at pricing. You should read this table in conjunction with Selected Consolidated Financial Data, Management s Discussion and Analysis of Financial Condition and Results of Operations, and the consolidated financial statements and related notes included in this prospectus.

	As of March 31, 2007	
		Pro Forma
	Actual	As Adjusted[1]
	(in thousands, except share data)	
Stockholders equity		
Convertible preferred stock, $0.001 par value per share; 12,500,000 shares authorized, 11,537,501 shares issued and outstanding, actual; no shares authorized, issued and outstanding, pro forma as adjusted	$ 90,284	$
Preferred stock, par value $0.001 per share; no shares authorized, issued or outstanding, actual; 5,000,000 shares authorized, no shares issued and outstanding, pro forma as adjusted.		
Common stock, $0.001 par value per share; 77,500,000 shares authorized, 16,656,435 shares issued and outstanding, actual; 100,000,000 shares authorized, 52,768,938 shares issued and outstanding, pro forma as adjusted	17	53
Treasury stock, 126,240 shares, at fair market value	(786)	(786)
Additional paid-in capital		110,463
Accumulated other comprehensive loss	(321)	(321)
Accumulated deficit	(23,051)	(23,051)
Total stockholders equity	$ 66,143	$ 86,358

(1) A $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) additional paid-in capital and total stockholders equity by $1.4 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same, and after deducting the underwriting discount payable by us.

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The outstanding share information in the table above excludes as of March 31, 2007:

- 7,463,085 shares of our common stock issuable upon exercise of outstanding options, with a weighted average exercise price of $5.05 per share, of which 3,337,329 options were vested and exercisable as of that date;
- 1,889,982 shares of common stock reserved for awards available for future issuance under our current equity incentive plans;
- 3,000,000 shares of our common stock reserved for future issuance under our 2007 Stock Incentive Plan, which will become effective in connection with this offering; and
- 1,787,494 shares of our common stock that may be purchased by the underwriters to cover over-allotments.

Shares available for future issuance under our 2007 Stock Incentive Plan do not include shares that may become available for issuance pursuant to a provision in this plan that provides for the automatic annual increase in the number of shares reserved thereunder. See Compensation Employee Benefit Plans 2007 Stock Incentive Plan.

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DILUTION

If you invest in our common stock, your interest will be diluted to the extent of the difference between the initial public offering price per share of our common stock and the pro forma as adjusted net tangible book value per share of our common stock after this offering.

Our pro forma net tangible book value at March 31, 2007 was $61.0 million, or $1.19 per share of common stock. Pro forma net tangible book value per share represents total tangible assets less total liabilities, divided by the number of outstanding shares of common stock on March 31, 2007, after giving effect to the conversion of all outstanding shares of preferred stock into shares of common stock as if the conversion occurred on March 31, 2007. Our pro forma as adjusted net tangible book value, which gives effect to the sale of shares of common stock in this offering at an assumed initial public offering price of $17.00 per share, the midpoint of the range on the cover of this prospectus, and after deducting the underwriting discount and estimated offering expenses payable by us, would have been $81.2 million, or $1.54 per share, at March 31, 2007. This represents an immediate increase in pro forma as adjusted net tangible book value of $0.35 per share to existing stockholders and an immediate dilution of $15.46 per share to investors in this offering. The following table illustrates this per share dilution:

Assumed initial public offering price per share		$ 17.00
Pro forma net tangible book value per share at March 31, 2007	$ 1.19	
Increase in pro forma net tangible book value per share attributable to this offering	0.35	
Pro forma as adjusted net tangible book value per share after this offering		1.54
Dilution per share to new investors		$ 15.46

A $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) our pro forma as adjusted net tangible book value by $1.4 million, the pro forma as adjusted net tangible book value per share by $0.03 per share and the dilution in the pro forma net tangible book value to investors in this offering by $0.03 per share, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the underwriting discount and estimated offering expenses payable by us.

The following table shows, as of March 31, 2007, the number of shares of common stock purchased from us, the total consideration paid to us and the average price paid per share by existing stockholders and by investors purchasing common stock in this offering at an assumed initial public offering price of $17.00 per share, the midpoint of the range on the cover of this prospectus, before deducting the underwriting discount and estimated offering expenses payable by us.

	Shares Purchased		Total Consideration		Average Price Per
	Number	Percent	Amount (in thousands)	Percent	Share
Existing stockholders	51,269	97.2%	$ 97,971	79.3%	$ 1.91
New investors	1,500	2.8	25,500	20.7	$ 17.00
Total	52,769	100%	$ 123,471	100%	

A $1.00 increase (decrease) in the assumed initial public offering price of $17.00 per share would increase (decrease) total consideration paid by new investors in this offering and total consideration paid by all stockholders by $1.5 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same.

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Sales of common stock by the selling stockholders in the offering will reduce the number of shares of common stock held by existing stockholders to 40,852,312, or approximately 77.4% of the total shares of common stock outstanding after the offering, and will increase the number of shares held by new investors to 11,916,626, or approximately 22.6% of the total shares of common stock outstanding after the offering.

The above discussion and tables exclude, as of March 31, 2007:

- 7,463,085 shares of our common stock issuable upon exercise of outstanding options, with a weighted average exercise price of $5.05 per share, of which 3,337,329 options were vested and exercisable as of that date;
- 1,889,982 shares of common stock reserved for awards available for future issuance under our current equity incentive plans;
- 3,000,000 shares of our common stock reserved for future issuance under our 2007 Stock Incentive Plan, which will become effective in connection with this offering; and
- 1,787,494 shares of our common stock that may be purchased by the underwriters to cover over-allotments.

Shares available for future issuance under our 2007 Stock Incentive Plan do not include shares that may become available for issuance pursuant to a provision in plan that provides for the automatic annual increase in the number of shares reserved thereunder.

If the underwriters exercise their over-allotment option in full:

- the number of shares of our common stock held by existing stockholders would decrease to approximately 74.9% of the total number of shares of our common stock outstanding after this offering;
- the number of shares of our common stock held by new investors would increase to approximately 25.1% of the total number of shares of our common stock outstanding after this offering; and
- our pro forma as adjusted net tangible book value at March 31, 2007 would have been $109.5 million, or $2.01 per share of common stock, representing an immediate increase in pro forma net tangible book value of $0.82 per share of common stock to our existing stockholders and an immediate dilution of $14.99 per share to investors purchasing shares in this offering.

To the extent that outstanding options are exercised, you will experience further dilution. If all of our outstanding options were exercised, our pro forma net tangible book value as of March 31, 2007 would have been $98.7 million, or $1.64 per share, and our pro forma as adjusted net tangible book value after this offering would be $118.9 million, or $1.92 per share, causing dilution to investors purchasing shares in this offering of $15.08 per share. In addition, if options outstanding as of March 31, 2007 are exercised, on a pro forma as adjusted basis before deducting underwriting discounts and estimated offering expenses payable by us, existing stockholders will have purchased shares, or 94.7% of the shares purchased from us, for approximately $135.6 million, or 70.8% of the total consideration paid to us, with an average price per share of $2.31. Shares purchased by new investors will represent 5.3% of shares purchased for 29.2% of the total consideration.

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SELECTED CONSOLIDATED FINANCIAL DATA

We derived the selected statement of operations data for the years ended December 31, 2004, 2005 and 2006 and the selected balance sheet data as of December 31, 2005 and 2006 from our audited consolidated financial statements and notes thereto included in this prospectus. We derived the selected statement of operations data for the year ended December 31, 2003 and the selected balance sheet data as of December 31, 2003 and 2004 from our audited consolidated financial statements and notes thereto that are not included in this prospectus. We derived the selected statement of operations data for the year ended December 31, 2002 and the selected balance sheet data as of December 31, 2002 from our unaudited consolidated financial statements that are not included in this prospectus. We derived the summary statement of operations data for the three months ended March 31, 2006 and 2007 and the summary balance sheet data as of March 31, 2007 from our unaudited consolidated financial statements and notes thereto included in this prospectus. We have prepared this unaudited information on the same basis as the audited financial statements and have included all adjustments, consisting of normal recurring adjustments, that we consider necessary for a fair statement of our financial position and operating results for such periods. Our historical results are not necessarily indicative of the results that may be expected in the future. The following financial data are only a summary and should be read together with our financial statements and the notes thereto, and the information under Management s Discussion and Analysis of Financial Condition and Results of Operations included in this prospectus.

The pro forma basic and diluted net income per common share data in the statement of operations data for the year ended December 31, 2006 and the three months ended March 31, 2007 reflect the conversion of all of our outstanding shares of convertible preferred stock into an aggregate of 34,612,503 shares of common stock in connection with this offering.

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	Year ended December 31,					Three months ended March 31,	
	2002 (unaudited)	2003	2004	2005	2006	2006 (unaudited)	2007 (unaudited)
	(in thousands, except share data)						
Statement of Operations Data[1]:							
Revenue:							
Product	$ 38,603	$ 46,419	$ 69,069	$ 107,613	$ 155,131	$ 34,679	$ 45,764
Royalty and license fee	229	315	288	277	69,207	14,627	13,190
Total revenue	38,832	46,734	69,357	107,890	224,338	49,306	58,954
Cost of goods sold	18,635	22,448	29,354	42,717	61,640	16,138	16,901
Gross profit	20,197	24,286	40,003	65,173	162,698	33,168	42,053
Operating expenses:							
Research and development	4,369	4,567	6,044	8,548	24,875	11,794	5,454
Selling, general and administrative	14,636	21,947	30,118	43,085	91,493	36,139	21,412
Patent litigation expenses (proceeds)	1,118	4,245	6,204	1,736	(262,605)	(262,665)	
Purchased in-process research and development				2,800			
Total operating expenses	20,123	30,759	42,366	56,169	(146,237)	(214,732)	26,866
Operating income (loss)	74	(6,473)	(2,363)	9,004	308,935	247,900	15,187
Non-operating income (expense):							
Interest income	84	52	107	224	6,741	2,659	355
Interest expense	(331)	(468)	(1,434)	(1,851)	(1,824)	(505)	(427)
Other	(8)	(3)	8	(8)	551	99	41
Total non-operating income (expense)	(255)	(419)	(1,319)	(1,635)	5,468	2,253	(31)
Income (loss) before provision for (benefit from) income taxes	(181)	(6,892)	(3,682)	7,369	314,403	250,153	15,156
Provision for (benefit from) income taxes	1	2	161	(26,012)	132,577	105,456	6,059
Net income (loss)	(182)	(6,894)	(3,843)	33,381	181,826	144,697	9,097
Preferred stock dividend					(77,785)	(58,571)	
Accretion of preferred stock	(8,401)	(8,477)	(8,477)	(8,278)	(7,985)	(2,117)	(1,956)
Undistributed income attributable to preferred stockholders				(19,599)	(34,275)	(34,783)	(4,828)
Net income (loss) attributable to common stockholders	$ (8,583)	$ (15,371)	$ (12,320)	$ 5,504	$ 61,781	$ 49,226	$ 2,313
Net income (loss) per common share[2]:							
Basic	$ (0.93)	$ (1.64)	$ (1.31)	$ 0.57	$ 3.79	$ 3.18	$ 0.14
Diluted	$ (0.93)	$ (1.64)	$ (1.31)	$ 0.42	$ 3.04	$ 2.53	$ 0.11
Weighted-average number of common shares:							
Basic	9,274,365	9,350,340	9,378,741	9,717,882	16,319,898	15,475,221	16,592,163
Diluted	9,274,365	9,350,340	9,378,741	13,102,611	20,302,872	19,471,926	20,662,530
Pro forma net income per common share (unaudited)[2]:							
Basic					$ 3.57		$ 0.18
Diluted					$ 3.31		$ 0.16

Weighted-average number of common shares used in computing pro forma net income per common share (unaudited):		
Basic	50,932,401	51,204,666
Diluted	54,915,375	55,275,033

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(1) Pursuant to Financial Accounting Standards Board Interpretation No. 46(R), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51,* or FIN 46(R), Masimo Labs is consolidated within our financial statements. Accordingly, all inter-company royalties, option and licensing fees, and other charges between us and Masimo Labs have been eliminated in the consolidation. Also in accordance with FIN 46(R), all direct engineering expenses that have been incurred by us and charged to Masimo Labs have not been eliminated and are included as research and development expense in our consolidated statements of operations. For additional discussion of accounting for Masimo Labs, see Note 4 to the Notes to Consolidated Financial Statements.

(2) See Note 2 to the Notes to Consolidated Financial Statements for a description of the method used to compute basic and diluted net income (loss) per common share and basic and diluted pro forma net income per common share.

	As of December 31,					As of March 31,
	2002 (unaudited)	2003	2004	2005	2006	2007 (unaudited)
	(in thousands)					
Balance Sheet Data:						
Cash and cash equivalents	$ 7,792	$ 11,124	$ 11,794	$ 14,172	$ 55,382	$ 22,907
Working capital	12,343	9,083	6,030	34,213	30,125	44,259
Total assets	32,602	40,397	54,221	100,589	159,073	152,137
Long-term debt, including current portion	4,457	14,393	23,828	29,060	21,042	31,736
Convertible preferred stock(3)	118,727	127,204	135,681	143,959		
Stockholders equity (deficit)(3)	(100,192)	(115,393)	(127,573)	(101,082)	56,961	66,143

(3) Our convertible preferred stock was reclassified to stockholders equity when we eliminated its mandatory redemption provisions in connection with the March 2006 dividend.

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

You should read this discussion together with the financial statements, related notes and other financial information included in this prospectus. The following discussion may contain predictions, estimates and other forward-looking statements that involve a number of risks and uncertainties, including those discussed under Risk Factors and elsewhere in this prospectus. These risks could cause our actual results to differ materially from any future performance suggested below.

Overview

We are a global medical technology company that develops, manufactures and markets non-invasive patient monitoring products that improve patient care. We invented Masimo Signal Extraction Technology, or Masimo SET, which provides the capabilities of read-through motion and low perfusion pulse oximetry to address the primary limitations of conventional pulse oximetry. Pulse oximetry is the non-invasive measurement of the oxygen saturation level of arterial blood, or the blood that delivers oxygen to the body s tissues, and pulse rate. Conventional pulse oximetry is subject to technological limitations that reduce its effectiveness and the quality of patient care. In particular, when using conventional pulse oximetry, arterial blood signal recognition can be distorted by motion artifact, or patient movement, and low perfusion, or low arterial blood flow. Low perfusion can also cause the failure of the conventional pulse oximeter to obtain an accurate measurement. Conventional pulse oximetry readings can also be impacted by bright light and electrical interference from the presence of electrical surgical equipment. Published independent research shows that over 70% of the alarms were false outside the operating room using conventional pulse oximetry. Our Masimo SET platform has significantly addressed many of the previous technology limitations. The benefits of Masimo SET have been validated in over 100 independent clinical and laboratory studies. During 2006, we generated product revenue of $155.1 million, representing a compound annual growth rate, or CAGR, of 41.6% for the four years ended December 31, 2006.

We market a family of patient monitoring solutions which incorporate a monitor or circuit board and consumables, including both proprietary single-patient use and reusable sensors and cables. In addition, we offer a remote-alarm/monitoring solution, software and other accessories. Although our Masimo SET platform is only operable with our proprietary sensors, our sensors have the capability to work with certain competitor pulse oximeters through the use of our adapter cables. In 2005, we launched our Masimo Rainbow SET Pulse CO-Oximetry platform utilizing licensed Rainbow technology from Masimo Labs, which enables the non-invasive measurement of not only arterial blood oxygen saturation level and pulse rate, but also carboxyhemoglobin, or carbon monoxide levels in the blood, and methemoglobin saturation levels in the blood. Along with the release of our Masimo Rainbow SET Pulse CO-Oximetry products, we have developed multi-wavelength sensors that have the ability to monitor multiple parameters with a single sensor.

We have focused on building our U.S. and international sales and marketing infrastructure to market our products to end-users, such as hospitals, and OEM partners for incorporation into their patient-monitoring products. We market our pulse oximetry products to hospitals and the EMS market through our direct sales force, and market our circuit boards to our OEM partners. Today, the primary focus of our hospital sales force is to facilitate the conversion of hospitals to our Masimo SET or Masimo Rainbow SET products. In the United States, we typically enter into long-term sales contracts with hospitals, pursuant to which we ship and install our pulse oximeters at no cost to the hospital in exchange for a commitment to purchase a minimum number of sensors from us over a specified period of time. With the introduction of Masimo Rainbow SET Pulse CO-Oximetry, we have established a small sales force to concentrate on the EMS market. Over the past two years, we have expanded our hospital

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sales force, including clinical specialists, from 50 employees at December 31, 2004 to 129 employees as of December 31, 2006. We supplement our direct sales with sales through our distributors. During this two year period, direct and distributor sales have increased to approximately $104.0 million, or 67.1%, of product revenues for 2006, from $40.6 million, or 58.7%, of product revenues in 2004. We expect the percentage of our revenue from direct sales to continue to increase as we expand our worldwide direct sales force.

The building of our installed base of pulse oximeters and circuit boards generates recurring sales of our consumables, primarily single-patient use sensors. A user of one of our pulse oximeters or our OEMs pulse oximeters can obtain the benefit of the Masimo SET or Masimo Rainbow SET only by using our proprietary sensors that are designed for our system. We estimate that our worldwide installed base was approximately 399,000 units as of March 31, 2007, up from 313,000 units as of March 31, 2006. We estimate our installed base to be the number of pulse oximeters and circuit boards that we have shipped in the past seven years.

We currently manufacture bedside and handheld pulse oximeters, a full line of single-patient use and reusable sensors and patient cables. We use third-party contract manufacturers for some of our products and components that can be more efficiently manufactured by these parties, primarily circuit boards, cables and plastics for instrument housings. We perform incoming inspection, final assembly and testing of any products or subassemblies manufactured by third-party contract manufacturers to assure quality control.

Masimo Laboratories, Inc.

Masimo Laboratories, Inc., or Masimo Labs, is an independent entity spun off from us to our stockholders in 1998. Joe E. Kiani and Jack Lasersohn, members of our board of directors, are also members of the board of directors of Masimo Labs. Joe E. Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Masimo Labs. We are a party to a cross-licensing agreement with Masimo Labs, which was recently amended and restated effective January 1, 2007, or the Cross-Licensing Agreement, that governs each party s rights to certain of the intellectual property held by the two companies.

Under the Cross-Licensing Agreement, we granted Masimo Labs an exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET owned by us, including all improvements on this technology, for the measurement of non-vital signs parameters and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs parameters in any product market in which a product is intended to be used by a patient or pharmacist rather than a professional medical caregiver, which we refer to as the Labs Market. We also granted Masimo Labs a non-exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET for the measurement of vital signs in the Labs Market.

Vital signs parameters include peripheral venous oxygen saturation, arterial oxygen saturation, or SpO2, mixed venous oxygen saturation, fetal oximetry, sudden infant death syndrome, electrocardiogram, or ECG, blood pressure (non-invasive blood pressure, invasive blood pressure and continuous non-invasive blood pressure), temperature, respiration rate, carbon dioxide, or CO2, pulse rate, cardiac output, electroenchephalogram, or EEG, perfusion index, depth of anesthesia, cerebral oximetry, tissue oximetry and/or electromyography, or EMG, and associated features derived from these parameters, such as 3-D alarms, Pleth Variability Index and other features. Non-vital signs parameters are body fluid constituents other than vital signs parameters, and include, but are not limited to, carbon monoxide, methemoglobin, glucose, total hemoglobin and bilirubin.

We exclusively license from Masimo Labs the right to make and distribute products in the Masimo Market that utilize Rainbow technology for the measurement of carbon monoxide, methemoglobin,

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fractional arterial oxygen saturation, and total hemoglobin, which includes hematocrit. To date, we have developed and commercially released devices that measure carbon monoxide and methemoglobin using licensed Rainbow technology. We also have the option to obtain the exclusive license to make and distribute products that utilize Rainbow technology for the measurement of other non-vital signs parameters, including blood glucose, in product markets where the product is intended to be used by a professional medical caregiver.

From May 1998 through December 2006, Masimo Labs contracted the services of our employees for the development of Rainbow technology. We paid Masimo Labs for the option to market and develop products based on Masimo Labs technology in defined markets. Through December 2005, we had paid Masimo Labs $7.5 million in option fees and nearly all these option fees were used by Masimo Labs to repay us for the services that we had provided to Masimo Labs. In addition, through December 2006, we exercised two licenses, for $2.5 million each, for the right to market products based on the new carbon monoxide and methemoglobin parameter technologies developed by Masimo Labs. As of December 31, 2006, $3.6 million out of the $5.0 million in fees had been used by Masimo Labs to repay us for the shared engineering and other services that we provided to Masimo Labs. We also entered into a Services Agreement with Masimo Labs to govern the services we will provide to Masimo Labs going forward, effective as of January 1, 2007. As part of the Cross-Licensing Agreement, we exercised an additional license for total hemoglobin for a fee of $2.5 million.

The Cross-Licensing Agreement requires us to pay certain royalties on products incorporating the licensed Rainbow technology. The royalty is up to 10% of the Rainbow royalty base, which will include handhelds, tabletop and multi-parameter devices. Handheld products incorporating Rainbow technology will carry a 10% royalty rate. For other products, only the proportional amount attributable for that portion of our products used to measure non-vital sign parameters, sensors and accessories, rather than for measuring vital sign parameters, will be included in the 10% Rainbow royalty base. For multi-parameter devices, the Rainbow royalty base will include the percentage of the revenues based on the number of Rainbow-enabled parameters. Beginning in 2009, for hospital contracts where we place equipment and enter into a sensor contract, we will pay a royalty to Masimo Labs on the total sensor contract revenues based on the ratio of Rainbow enabled devices to total devices.

We are also subject to certain specific annual minimum aggregate royalty payments. These minimum aggregate royalty payments are $3.15 million, $3.5 million, $4.0 million and $5.0 million in the years ended 2007, 2008, 2009 and 2010, respectively, and $5.0 million per year thereafter. In addition, in connection with a change in control, as defined in the Cross-Licensing Agreement, the minimum aggregate annual royalties for all licensed Rainbow parameters payable to Masimo Labs will increase to $5.0 million, $7.0 million, $10.0 million and $15.0 million in the years ending 2007, 2008, 2009 and 2010, respectively, and $15.0 million per year thereafter, and up to $2.0 million per year for each additional Rainbow parameter.

Pursuant to Financial Accounting Standards Board Interpretation No. 46(R), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51,* or FIN 46(R), Masimo Labs is consolidated within our financial statements for all periods presented. Accordingly, all inter-company royalties, option and license fees and other charges between us and Masimo Labs have been eliminated in the consolidation. Also in accordance with FIN 46(R), all direct engineering expenses that have been incurred by us and charged to Masimo Labs have not been eliminated and are included as research and development expense in our consolidated statements of operations. For additional discussion of Masimo Labs, see Note 4 to the Notes to Consolidated Financial Statements.

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Nellcor Patent Litigation Settlement

In October 1999, we filed a patent infringement lawsuit in the United States District Court for the Central District of California against Mallinckrodt, Inc., now part of Covidien (formerly Tyco Healthcare), and one of its subsidiaries, Nellcor Puritan Bennett, Inc., collectively referred to as Nellcor. Nellcor is one of the largest manufacturers and distributors of pulse oximetry products in the world. The lawsuit was filed for infringement of our pulse oximetry signal processing patents. Nellcor denied our claims and made counterclaims alleging infringement of its patents by us. This lawsuit resulted in a jury verdict that Nellcor had infringed several of our patents, including one of our read-through motion pulse oximeter patents. In September 2005, the U.S. Federal Court of Appeals ruled that Nellcor infringed several Masimo patents and ordered the lower court to enjoin Nellcor s infringing products. Prior to the issuance of a permanent injunction, Nellcor entered into a settlement agreement with us on January 17, 2006, under which we agreed to settle all pending patent litigation with Nellcor. In return, Nellcor agreed to pay us $263.0 million for damages incurred through January 2006. We granted Nellcor a covenant not to sue on certain new products and Nellcor agreed to pay us royalties on its total U.S. pulse oximetry revenue at least through March 14, 2011. In addition, in January 2006, Nellcor made an advance royalty payment to us of $67.5 million for estimated sales of its products in the United States during the remainder of calendar 2006. In total, we have received $330.5 million in cash from Nellcor pursuant to the settlement agreement.

We recorded the $263.0 million lump sum payment as patent litigation proceeds in January 2006 and we recognized approximately $68.8 million of royalty revenue in 2006. We recognize royalty revenue based on the estimated average royalty rate per the settlement agreement multiplied by our estimate of Nellcor s sales for each quarter. This estimate is adjusted when we receive the Nellcor royalty report, 60 days after the end of each quarter. Per our settlement agreement, the 2006 royalty rate will decline significantly and, as a result, we expect our future Nellcor royalties to be significantly below the levels recognized in 2006.

Cash Dividends and Special Bonus Payments

In March 2006, we paid a cash dividend of $3.365 per share, in the aggregate amount of approximately $171.8 million, to holders of our common and preferred stock, assuming the conversion of all outstanding shares of preferred stock into an aggregate of 34,612,503 shares of common stock. Of this amount, $21.7 million relates to dividend payments made to stockholders who exercised stock options by delivering us a promissory note. In accordance with Emerging Issues Task Force, or EITF, 95-16, the $21.7 million in cash dividends have been classified as compensation expense in the accompanying consolidated financial statements, under cost of goods sold, research and development and selling, general and administrative expenses. In February 2007, we paid additional cash dividends of $0.468 per share and $0.257 per share, in the aggregate amount of approximately $37.1 million, to holders of our common and preferred stock assuming conversion into common stock. In March 2006 and March 2007, we also made special bonus payments in the aggregate amount of approximately $9.7 million and $2.0 million, respectively, to our employees and directors who held vested stock options as of March 1, 2006. These cash dividends and special bonus payments were made from the after-tax proceeds that we received from our patent infringement lawsuit against Nellcor and interest earned thereon. We do not intend to distribute any future royalties received from Nellcor under the settlement agreement to our stockholders or our option holders.

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The following table identifies the 2006 activity in dividends payable and convertible preferred stock resulting from the accretion, dividends declared and dividends paid during 2006.

	Dividends Payable	Convertible Preferred Stock
	(in thousands)	
Balance as of December 31, 2005	$	$ (143,959)
Accretion of redemption value on convertible preferred stock		(7,985)
Dividends declared:		
Reclassification of cumulative dividends accreted to dividends payable	(63,616)	63,616
Common shares securing the outstanding non recourse notes	(21,673)	
Dividends declared in excess of (i) amounts previously accreted to holders of preferred stock and (ii) amount included in stock compensation expense	(123,620)	
Total dividends declared	(208,909)	63,616
Dividends paid in 2006[1]	171,376	
Balance as of December 31, 2006	$ (37,533)	$ (88,328)

(1) Dividends paid of $149,703 reflected on the Consolidated Statements of Cash Flows for the year ended December 31, 2006 represents the total dividend payment of $171,376 less the amount of $21,673 included in stock compensation expense.

The following is stock-based compensation expense for the year ended December 31, 2006 associated with the dividend and special bonus payment discussed above, as well as related to implementation of FASB 123(R) and other stock related compensation.

	Cost of Goods Sold	Research and Development	Selling, General and Administrative	Total
		(in thousands)		
Dividends declared on common shares securing the outstanding non recourse notes	$ 308	$ 5,101	$ 16,264	$ 21,673
Special bonus payments to holders of vested options to purchase common stock	1,822	3,990	5,900	11,712
Stock option compensation pursuant to adoption of SFAS 123(R)	249	287	794	1,330
Other			355	355
	$ 2,379	$ 9,378	$ 23,313	$ 35,070

Tyco Healthcare Antitrust Litigation

In May 2002, we filed a lawsuit against Tyco Healthcare, parent company of Nellcor, in the United States District Court for the Central District of California, alleging damage to our business as a result of the anti-competitive business practices of Tyco Healthcare in connection with its Nellcor pulse oximetry brand in violation of federal antitrust laws. Specifically, we alleged that we had incurred damages as a result of a series of illegal exclusionary and anti-competitive acts by Tyco Healthcare that were designed to maintain its monopoly in the pulse oximetry market.

In March 2005, a jury found that Tyco Healthcare s use of sole-source contracts, product bundling, market share-based compliance pricing contracts and co-marketing agreements with patient monitoring companies were unlawful restraints of trade and exclusionary dealing arrangements and, as a result, violated federal antitrust laws. The jury awarded us $140.0 million in damages. Under the antitrust laws,

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if the jury verdict is sustained in whole or in part, any damages that are sustained are trebled. Tyco Healthcare filed post-trial motions requesting that the District Court either override the jury decision or grant a new trial. In March 2006, the District Court upheld a portion of the jury verdict and vacated the remaining verdict. In addition, the District Court vacated the jury s damages award and granted Tyco Healthcare a new trial on damages. The District Court held an evidentiary hearing in October 2006 to re-try the damages. On January 25, 2007, the District Court issued a preliminary ruling which did not set damages, but resolved some issues of dispute about damages, and ordered another evidentiary hearing on issues still undecided by the District Court. The District Court held this evidentiary hearing in March 2007. On July 2, 2007, the District Court entered its final judgment awarding us damages which were trebled to $43.5 million and denying our request for a permanent injunction with respect to the Tyco Healthcare business practices found to be anti-competitive. We and Tyco Healthcare have each filed a notice of appeal from the judgment. Even if we are ultimately awarded damages in this litigation, the amount will be subject to a 50% legal fee contingency agreement, in which case we would receive 50% of the net (of costs) proceeds from the award. Even though most of the legal expenses to date have been on a contingency basis, we expect to incur expenses related to the appellate work, which will be treated as general and administrative expense as incurred.

Revenue and Expense Components

The following is a description of the primary components of our revenue and expenses:

Revenue. Our product revenue consists primarily of sales of consumables, including sensors and cables, circuit boards and pulse oximeters. We sell our consumables and circuit boards to our OEM partners and, pursuant to our OEM agreements, typically recognize revenue upon shipment. We also sell consumables and pulse oximeters directly through our sales force and, based on individual contracts, typically recognize revenue upon shipment. Sales to our distributors are recognized upon the sell-through of our products by our distributors, rather than upon shipment. In the United States, we have long-term contracts with hospitals under which we typically ship and install our pulse oximeters at hospitals at no cost to the hospital in exchange for commitments by the hospital to purchase a minimum number of sensors from us over a specified period of time. In these cases, we do not recognize any revenue at the time the equipment is installed at the hospital. Rather, pursuant to our revenue recognition policy, we recognize revenue as we ship sensors in accordance with the contract.

Our royalty revenue consists of royalties associated with our January 2006 patent infringement settlement with Nellcor. Pursuant to the settlement agreement, we will receive quarterly royalty payments based on the amount of Nellcor s U.S. pulse oximetry revenues. A predetermined royalty rate will be applied against the amount of Nellcor s U.S. oximetry sales and this will determine the amount of royalties we will be paid. Under terms of the agreement, the royalty rates decline from 20% in 2006 to a range of 12% to 15% in 2007 and then to a range of 10% to 12% in each year throughout the remainder of the settlement agreement. As a result of these declining royalty rates, we anticipate that 2006 will represent the highest level of annual royalties that we will earn under this settlement agreement.

Cost of Goods Sold. We manufacture a substantial majority of the products that we sell. Our cost of goods sold includes material and component costs, direct labor and other direct and indirect manufacturing overhead costs. We recognize cost of goods sold when we recognize revenue for the transaction. For equipment placed with a customer pursuant to a long-term sales contract, we capitalize the cost of the equipment shipped as deferred cost of goods sold and amortize the cost to cost of goods sold on a straight-line basis over the term of the contract. In addition, pursuant to our Cross-Licensing Agreement, we are required to pay certain royalties on products incorporating the licensed Rainbow technology.

Research and Development. Our research and development expenses consist primarily of costs associated with the design, development, enhancement and testing of new and existing products. These

expenses include personnel costs, the cost of materials, supplies and services and an allocation of facility and overhead costs. Through December 31, 2006, an aggregate of $10.5 million of our historical research and development expenses were attributable to research and development activities performed by Masimo Labs. However, pursuant to FIN 46(R), Masimo Labs is consolidated within our financial statements and, as a result, these research and development expenses are included in these consolidated financial statements.

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of salaries, promotional, training, trade show, professional fees, facility costs and travel and entertainment expenses. We expect our selling, general and administrative expenses will continue to increase as we continue to build our selling, general and administrative organizations and as we become subject to the additional costs associated with being a public company. Through December 31, 2006, an aggregate of $700,000 of our selling, general and administrative expenses were attributable to Masimo Labs.

Patent Litigation Expenses (Proceeds). Patent litigation expenses (proceeds), which we report separately from selling, general and administrative expenses, consist of external legal costs exclusively related to our patent infringement lawsuit against Nellcor. Also included are the proceeds received from our patent infringement lawsuit, which we settled in January 2006. See Business Nellcor Patent Litigation Settlement. We expect future patent litigation expenses that are unrelated to our patent litigation against Nellcor will be classified as selling, general and administrative expenses.

Purchased In-Process Research and Development. Purchased in-process research and development is related to the value assigned to those projects acquired in business combinations or in the acquisition of assets for which the related products have not received regulatory approval or have no alternative future use.

Interest Income (Expense) and Other, Net. Interest income (expense) and other, net is comprised of interest income from our cash and cash equivalents and interest expense on our debt and term loans. Other expense typically consists of gains or losses on sales of fixed assets.

Provision for (Benefit from) Income Taxes. Provision for (benefit from) income taxes is comprised of federal, state, local and foreign taxes based on income.

Accretion of Preferred Stock. Accretion of preferred stock represents the increase in carrying value of the convertible preferred stock for accrued dividends and direct offering costs. Accretion is recorded as a reduction to net income (loss) attributable to common stockholders.

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Results of Operations

The following table sets forth, for the periods indicated, our results of operations expressed as dollar amounts and as a percentage of revenues. The patent litigation proceeds and the royalty received from Nellcor in the first three months of 2006 have significantly affected our revenues, results of operations and financial position. Accordingly, our results of operations for the year ended December 31, 2006 are difficult to compare to our results of operations for the year ended December 31, 2005 and our results of operations for the three months ended March 31, 2006 are difficult to compare to the three months ended March 31, 2007.

	Year ended December 31,						Three months ended March 31,			
	2004	% of Revenue	2005	% of Revenue	2006	% of Revenue	2006 (unaudited)	% of Revenue	2007 (unaudited)	% of Revenue
	(in thousands, except percentages)									
Revenue:										
Product	$ 69,069	99.6%	$ 107,613	99.7%	$ 155,131	69.2%	$ 34,679	70.3%	$ 45,764	77.6%
Royalty and license fee	288	0.4	277	0.3	69,207	30.8	14,627	29.7	13,190	22.4
Total revenue	69,357	100.0	107,890	100.0	224,338	100.0	49,306	100.0	58,954	100.0
Cost of goods sold	29,354	42.3	42,717	39.6	61,640	27.5	16,138	32.7	16,901	28.7
Gross profit	40,003	57.7	65,173	60.4	162,698	72.5	33,168	67.3	42,053	71.3
Operating expenses:										
Research and development	6,044	8.7	8,548	7.9	24,875	11.1	11,794	23.9	5,454	9.3
Selling, general and administrative	30,118	43.4	43,085	39.9	91,493	40.8	36,139	73.3	21,412	36.3
Patent litigation expenses (proceeds)	6,204	8.9	1,736	1.6	(262,605)	(117.1)	(262,665)	(532.7)		0.0
Purchased in-process research and development		0.0	2,800	2.6		0.0		0.0		0.0
Total operating expenses	42,366	61.1	56,169	52.1	(146,237)	(65.2)	(214,732)	(435.5)	26,866	45.6
Operating income (loss)	(2,363)	(3.3)	9,004	8.4	308,935	137.7	247,900	502.8	15,187	25.8
Non-operating income (expense):										
Interest income	107	0.2	224	0.2	6,741	3.0	2,659	5.4	355	0.6
Interest expense	(1,434)	(2.1)	(1,851)	(1.7)	(1,824)	(0.8)	(505)	(1.0)	(427)	(0.7)
Other	8	0.0	(8)	0.0	551	0.2	99	0.2	41	0.1
Total non-operating income (expense)	(1,319)	(1.9)	(1,635)	(1.5)	5,468	2.4	2,253	4.6	(31)	(0.1)
Income (loss) before provision for (benefit from) income taxes	(3,682)	(5.2)	7,369	6.9	314,403	140.1	250,153	507.3	15,156	25.7
Provision for (benefit from) income taxes	161	0.2	(26,012)	(24.1)	132,577	59.1	105,456	213.9	6,059	10.3
Net income (loss)	(3,843)	(5.5)	33,381	30.9	181,826	81.0	144,697	293.5	9,097	15.4
Preferred stock dividend		0.0		0.0	(77,785)	(34.7)	(58,571)	(118.8)		0.0
Accretion of preferred stock	(8,477)	(12.2)	(8,278)	(7.7)	(7,985)	(3.6)	(2,117)	(4.3)	(1,956)	(3.3)
Undistributed income attributable to preferred stockholders		0.0	(19,599)	(18.2)	(34,275)	(15.3)	(34,783)	(70.5)	(4,828)	(8.2)
Net income (loss) attributable to common stockholders	$ (12,320)	(17.7)%	$ 5,504	5.0%	$ 61,781	27.4%	$ 49,226	99.8%	$ 2,313	3.9%

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Comparison of the Three Months ended March 31, 2007 to the Three Months ended March 31, 2006

Revenue. Total revenue increased $9.7 million, or 19.6%, to $59.0 million for the three months ended March 31, 2007 from $49.3 million for the three months ended March 31, 2006.

Product revenues increased $11.1 million, or 32.0%, to $45.8 million in the three months ended March 31, 2007 from $34.7 million for the three months ended March 31, 2006. This increase was primarily due to higher consumable sales resulting from an increase in our installed base of circuit boards and pulse oximeters to 399,000 units at March 31, 2007 from 313,000 units at March 31, 2006. Revenue generated by our direct and distribution sales channels increased $9.7 million, or 41.1%, to $33.3 million for the three months ended March 31, 2007, while revenues from our OEM channel increased $1.4 million, or 12.4%, to $12.4 million. As part of the increase in our direct and distribution sales channels, our Rainbow technology product revenue increased $868,000 to $1.2 million in the three months ended March 31, 2007 from $344,000 in the three months ended March 31, 2006.

Our royalty and license fee revenue decreased $1.4 million, to $13.2 million in the three months ended March 31, 2007 from $14.6 million in the three months ended March 31, 2006, primarily due to a lower royalty rate associated with our 2006 settlement agreement with Nellcor. For the three months ended March 31, 2007, our reported Nellcor royalties are based upon our estimate of Nellcor s U.S. pulse oximeter sales for that period. In the event that our quarterly estimate differs from their actual quarterly sales, there will be a required adjustment which will be in the following fiscal quarter.

Cost of Goods Sold. Cost of goods sold increased 4.7% to $16.9 million in the three months ended March 31, 2007 from $16.1 million in the three months ended March 31, 2006. Our gross margin increased to 71.3% for the three months ended March 31, 2007 from 67.3% for the three months ended March 31, 2006. The improvement in gross margin was due to a special bonus payment of $1.8 million and an increase in our provision for obsolete inventory of $620,000 in the three months ended March 31, 2006. These improvements were offset by lower royalty revenues from Nellcor of $1.4 million in the three months ended March 31, 2007.

Research and Development. Research and development expenses decreased 53.8% to $5.5 million for the three months ended March 31, 2007, from $11.8 million for the three months ended March 31, 2006. The prior year expense included a charge of $8.3 million in stock-based compensation associated with the dividend and special bonus payments. Notwithstanding that charge, research and development expenses increased $1.3 million due to increased payroll and payroll related costs associated with increased research and development staffing levels which rose from 69 at March 31, 2006 to 115 at March 31, 2007. Included in total research and development expenses are $259,000 and $831,000 of engineering expenses incurred by Masimo Labs for the three months ended March 31, 2007 and 2006, respectively.

Selling, General and Administrative. Selling, general and administrative expenses decreased 40.8% to $21.4 million for the three months ended March 31, 2007, from $36.1 million in the three months ended March 31, 2006, which included a $21.0 million charge in stock-based compensation associated with the dividend and special bonus payments. Notwithstanding that charge, selling, general and administrative expenses increased a total of $6.3 million, which was primarily due to a $2.6 million increase in staffing which rose from 219 at March 31, 2006 to 305 at March 31, 2007. Additional increased spending was attributable to $1.2 million in marketing related expenses, including trade show costs and product samples, $1.1 million in travel and entertainment expenses and $1.0 million in professional service fees. Included in these total selling, general and administrative expenses are $99,000 and $47,000 of expenses incurred by Masimo Labs for the three months ended March 31, 2007 and 2006, respectively.

Patent Litigation Expenses (Proceeds). Litigation proceeds from our patent infringement lawsuit against Nellcor decreased to $0 for the three months ended March 31, 2007, from $262.7 million for the three months ended March 31, 2006. This decrease was due to the one-time patent litigation settlement in January 2006, and related proceeds of $263.0 million less current and related legal fees.

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Interest Income (Expense) and Other, Net. Interest income (expense) and other, net was $31,000 of expense for the three months ended March 31, 2007, compared to $2.3 million of income for the three months ended March 31, 2006. This change was primarily due to the decrease in interest income of $2.3 million, resulting from lower cash balances in 2007.

Provision for (Benefit from) Income Taxes. Our provision for income taxes was $6.1 million for the three months ended March 31, 2007, compared to $105.5 million for the three months ended March 31, 2006. This decrease in the provision was primarily due to a decrease in our taxable income which resulted from the proceeds from the patent settlement during the three months ended March 31, 2006.

Accretion of Preferred Stock. Accretion of preferred stock decreased to $2.0 million for the three months ended March 31, 2007, from $2.1 million for the three months ended March 31, 2006. This decrease was due to the reduction in the accretion of the offering costs. The accretion represents the increase in the carrying value primarily for dividends on our redeemable Series B, Series C, Series D, Series E, Series F and Series G preferred stock in accordance with the purchase agreements for such securities.

Comparison of the Year ended December 31, 2006 to the Year ended December 31, 2005

Revenue. Total revenue increased $116.4 million, or 107.9%, to $224.3 million for the year ended December 31, 2006 from $107.9 million for the year ended December 31, 2005. A significant portion of the increase in revenue was due to fiscal 2006 royalties of $68.8 million related to the Nellcor settlement agreement.

Product revenues increased $47.5 million, or 44.2%, to $155.1 million in the year ended December 31, 2006, from $107.6 million for the year ended December 31, 2005. This increase was primarily due to an increase in our installed base of circuit boards and pulse oximeters from 292,000 units at December 31, 2005 to 377,000 units at December 31, 2006. Revenue generated by our direct and distribution sales channels increased $34.9 million, or 50.5% to $104.0 million, while revenues from our OEM channel increased $12.6 million, or 32.7%, to $51.1 million. As part of the increase in our direct and distribution sales channels, we generated $3.7 million in sales from Rainbow technology products in 2006 compared to $700,000 in 2005.

Our royalty and license fee revenue increased $68.9 million, from $277,000 in 2005 to $69.2 million in 2006, primarily due to royalties received from Nellcor under the terms of our settlement agreement.

Cost of Goods Sold. Cost of goods sold increased 44.3% to $61.6 million for the year ended December 31, 2006, from $42.7 million for the year ended December 31, 2005. Our gross margin increased to 72.5% for the year ended December 31, 2006, from 60.4% for the year ended December 31, 2005. This increase in gross margin was due to the Nellcor royalty revenue of $68.8 million, which was partially offset by $2.1 million of special bonus payments and $249,000 of stock-based compensation expense. Notwithstanding the Nellcor royalty and stock-based compensation, our product margins improved due to a high percentage of revenue from our sensor products combined with higher realized circuit board margins and the impact of higher Rainbow product revenues.

Research and Development. Research and development expenses increased 191.0% to $24.9 million for the year ended December 31, 2006, from $8.5 million for the year ended December 31, 2005. The $24.9 million included a charge of $9.4 million in stock-based compensation associated with the dividend and special bonus payments. Notwithstanding that charge, research and development expenses increased $5.3 million due to increased payroll and payroll related costs associated with increased research and development staffing levels. Research and development staffing increased from 65 at December 31, 2005 to 98 at December 31, 2006. Included in these total research and development expenses are $3.4 million and $2.6 million of engineering expenses incurred by Masimo Labs for the years ended December 31, 2006 and 2005, respectively.

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Selling, General and Administrative. Selling, general and administrative expenses increased 112.4% to $91.5 million for the year ended December 31, 2006, from $43.1 million in the year ended December 31, 2005. The $48.4 million increase included a charge of $23.3 million in stock-based compensation associated with the dividend and special bonus payments. Notwithstanding that charge, selling, general and administrative expenses increased $12.3 million due to increased selling, general and administrative staffing. Selling, general and administrative staffing increased from 201 at December 31, 2005 to 292 at December 31, 2006. Additional increased spending was attributable to $3.4 million in travel and entertainment expenses and $1.5 million in employee recruiting and training activities. Included in these total selling, general and administrative expenses are $147,000 and $147,000 of activities performed by Masimo Labs for the years ended December 31, 2006 and 2005, respectively.

Patent Litigation Expenses (Proceeds). Litigation proceeds from our patent infringement lawsuit against Nellcor was $262.6 million for the year ended December 31, 2006, as compared to $1.7 million of expense for the year ended December 31, 2005. This change was due to the one-time patent litigation settlement in January 2006, and related proceeds of $263.0 million less current and related legal fees.

Purchased In-Process Research and Development. We did not incur any charges related to purchased in-process research and development in 2006. As a result of our December 2005 acquisition of Andromed, we incurred purchased in-process research and development expenses of $2.8 million in 2005.

Interest Income (Expense) and Other, Net. Interest income (expense) and other, net was $5.5 million of income for the year ended December 31, 2006, compared to $1.6 million of expense for the year ended December 31, 2005. This change was primarily due to the increase in interest income of $6.5 million from the investment of the settlement proceeds during the year ended December 31, 2006.

Provision for (Benefit from) Income Taxes. Our provision for income taxes was $132.6 million for the year ended December 31, 2006, compared to a net benefit from income taxes of $26.0 million for the year ended December 31, 2005. This increase in provision was primarily due to an increase in our taxable income which resulted from both the income from the patent settlement and improved operating results during the year ended December 31, 2006. In addition, the net benefit from income taxes of $26.0 million for the year ended December 31, 2005 was primarily due to the reversal of all federal and state deferred tax valuation allowances.

Accretion of Preferred Stock. Accretion of preferred stock decreased to $8.0 million for the year ended December 31, 2006, from $8.3 million for the year ended December 31, 2005. This was due to the reduction in the accretion of the offering costs. The accretion represents the increase in the carrying value of our redeemable Series B, Series C, Series D, Series E, Series F and Series G preferred stock based on our certificate of incorporation, which requires the accretion of specific dividends and direct costs of issuing such securities. The accretion for each of Series B through G preferred stock began when such series was initially issued. In 2006, as a result of the dividend declarations made to stockholders in February 2006 and December 2006, all previous accretion for all Series B through Series G preferred stock was reclassified to dividends payable.

Comparison of the Year ended December 31, 2005 to the Year ended December 31, 2004

Revenue. Total revenue increased $38.5 million, or 55.6%, to $107.9 million for the year ended December 31, 2005, compared to $69.4 million for the year ended December 31, 2004. In 2005, we increased our installed base of circuit boards and pulse oximeters by 37.1% to 292,000 units at December 31, 2005, as compared to 213,000 units at December 31, 2004. The increase in our installed base resulted in an increase in sales of our product revenues, which rose $38.5 million to $107.6 million in 2005 from $69.1 million in 2004. Revenues generated by our direct and distribution sales channels increased $28.2 million, or 69.0%, to $69.1 million, while revenues from our OEM channel increased by

$10.3 million, or 36.6% to $38.5 million. As part of the increase in our direct and distribution sales channels, we introduced our new Rainbow technology product, the Rad-57, which accounted for $700,000 of 2005 revenue.

Cost of Goods Sold. Cost of goods sold increased 45.5% to $42.7 million for the year ended December 31, 2005, from $29.4 million for the year ended December 31, 2004. Our gross margins increased to 60.4% in 2005 from 57.7% in 2004. This increase was primarily due to increased sales of consumable products and higher margins realized on these products.

Research and Development. Research and development expenses increased 41.4% to $8.5 million for the year ended December 31, 2005, from $6.0 million for the year ended December 31, 2004. This was primarily due to increases in payroll and related expenses of $1.0 million resulting from the addition of research and development personnel, $500,000 of licensing expense and $400,000 of additional equipment and supplies to support product development activities. Included in these total research and development expenses are $2.6 million and $2.0 million of activities performed by Masimo Labs in the years ended December 31, 2005 and 2004, respectively.

Selling, General and Administrative. Selling, general and administrative expenses increased 43.1% to $43.1 million for the year ended December 31, 2005, from $30.1 million for the year ended December 31, 2004. This increase was primarily due to increases in personnel costs of $7.3 million, legal fees of $1.0 million, travel and related expenses of $930,000, group purchasing organization fees of $635,000 and employee recruiting and training of $640,000. Higher personnel costs were due to a 52.3% increase in headcount at December 31, 2005 from December 31, 2004, primarily as a result of our increased focus on direct sales. Included in these selling, general and administrative expenses are $147,000 and $100,000 of activities performed by Masimo Labs for the years ended December 31, 2005 and 2004, respectively.

Patent Litigation Expenses (Proceeds). Litigation expenses for our patent infringement lawsuit against Nellcor decreased 72.0% to $1.7 million for the year ended December 31, 2005, from $6.2 million for the year ended December 31, 2004. This decrease was primarily due to legal fees related to the 2004 jury trial for the Nellcor patent infringement lawsuit. In 2005, the costs were primarily related to the appeal of the jury verdict and subsequent settlement discussions.

Purchased In-Process Research and Development. As a result of our December 2005 acquisition of Andromed, we incurred purchased in-process research and development expense of $2.8 million in 2005. We did not incur any charges related to purchased in-process research and development in 2004.

Interest Income (Expense) and Other, Net. Interest income (expense) and other, net increased to $1.6 million of expense for the year ended December 31 2005, from $1.3 million of expense for the year ended December 31, 2004, due to an increase of interest expense of $417,000 caused by a higher principal balance on our long-term debt. This was partially offset by an increase of interest income of $117,000 from higher cash balances.

Provision for (Benefit from) Income Taxes. Our net benefit from income taxes was $26.0 million for the year ended December 31, 2005, compared to a provision for income taxes of $161,000 for the year ended December 31, 2004. As a result of the Nellcor settlement, we determined that a full valuation allowance against our net U.S. deferred tax assets was unnecessary. Therefore, during the fourth quarter of 2005, we recorded a reversal of all federal and state deferred tax valuation allowances.

Accretion of Preferred Stock. Accretion of preferred stock decreased to $8.3 million for the year December 31, 2005, from $8.5 million for the year December 31, 2004, due to the extension of the redemption date of our convertible preferred stock from December 2005 to June 2006. The accretion represents the increase in the carrying value of our Series B, Series C, Series D, Series E, Series F and Series G convertible preferred

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stock for accrued dividends and direct offering costs. The accretion for each series of preferred stock began when such series was initially issued.

Quarterly Results of Operations

The following table sets forth unaudited selected quarterly operating results for the two years ended December 31, 2006 and the three months ended March 31, 2007. We believe that the following selected quarterly information includes all adjustments that consist only of normal, recurring adjustments that we consider necessary to present this information fairly. This financial information should be read in conjunction with our financial statements and related notes appearing in this prospectus. Our results of operations have fluctuated in the past and are likely to continue to fluctuate significantly from quarter to quarter in the future. Therefore, results of operations for any previous periods are not necessarily indicative of results of operations to be recorded in the future.

	For the three months ended								
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006	March 31, 2007
	(in thousands, except per share data)								
	(unaudited)								
Revenue	$ 24,782	$ 26,290	$ 27,606	$ 29,212	$ 49,306	$ 55,774	$ 57,646	$ 61,612	$ 58,954
Gross profit	15,013	16,038	16,350	17,772	33,168	40,818	42,942	45,770	42,053
Operating income (loss)	3,693	3,775	3,289	(1,753)	247,900	22,496	20,301	18,238	15,187
Net income	2,922	3,117	2,555	24,787	144,697	13,923	12,296	10,910	9,097
Net income attributable to common stockholders[2]	$ 176	$ 228	$ 117	$ 5,062	$ 49,226	$ 4,496	$ 3,974	$ 3,497	$ 2,313
Net income per common share[1][3]:									
Basic	$ 0.02	$ 0.02	$ 0.01	$ 0.51	$ 3.18	$ 0.27	$ 0.24	$ 0.21	$ 0.14
Diluted	$ 0.02	$ 0.02	$ 0.01	$ 0.35	$ 2.53	$ 0.22	$ 0.19	$ 0.17	$ 0.11
Pro forma net income per common share[2][4]:									
Basic					$ 2.89	$ 0.27	$ 0.24	$ 0.21	$ 0.18
Diluted					$ 2.68	$ 0.25	$ 0.22	$ 0.20	$ 0.16

(1) See Note 2 to the Notes to Consolidated Financial Statements for a description of the method used to compute basic and diluted net income (loss) per common share and basic and diluted pro forma net income per common share.

(2) The sum of the quarterly net income attributable to common stockholders for the years ended December 31, 2005 and 2006 do not equal the annual amounts due to differences in the weighted average common shares outstanding between the quarterly and annual computations.

(3) The sum of the quarterly basic net income per common share for the year ended December 31, 2006 and the sum of the diluted net income per common share for the years ended December 31, 2005 and 2006, do not equal the annual related per common share amounts due to differences in the weighted average common shares outstanding and the undistributed earnings allocation percentages between the quarterly and annual computations.

(4) The sum of the quarterly basic and diluted pro forma net income per common share for the year ended December 31, 2006 does not equal the annual related per common share amount due to differences in the weighted average common shares outstanding, between the quarterly and annual computations.

In the fourth quarter of 2005, we incurred the write-off of $2.8 million in purchased in-process research and development expense related to the acquisition of Andromed. In addition, we expensed a previously capitalized license fee and incurred higher commission and tradeshow expenses than in prior fiscal 2005 quarters. The capitalized license fee related to two advance royalty payments totaling $500,000 that we made to a third party in June and November 2005 to assist the third party in developing a product of interest to us. We had the option to convert the advanced royalty payments into equity of the third party and, as a result, we capitalized these payments. Shortly after we made the second advanced royalty

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payment to the third party, however, we acknowledged that the product would not be developed by the third party and we determined that it would be unfeasible for us to convert our advanced royalty payments into equity of the third party. Accordingly, we concluded that the appropriate accounting treatment would be to write-off the advance royalty payment in the fourth quarter of 2005. The increase in fourth quarter net income was attributable to the reversal of the tax valuation allowance which had previously been established due to the uncertainty of future profitability.

In the first quarter of 2006, we recorded a $21.7 million compensation charge related to employee and non-employee directors exercise of stock options through the issuance of a promissory note, which required the payment of dividends on such shares to be treated as compensation expense. In addition, we recorded a $9.7 million charge related to a special bonus payment made to option holders who held vested shares on March 1, 2006. In total, these first quarter 2006 expenses amounted to $31.4 million and, without these charges, our first quarter 2006 operating income would have been $16.6 million. The significant increase in first quarter 2006 net income was due to the $263.0 million patent settlement with Nellcor. The first quarter 2006 net income attributable to common stockholders was impacted by the first quarter 2006 dividend declaration made to preferred stockholders. For further details on net income attributable to common stockholders, see Note 2 to the Notes to Consolidated Financial Statements.

In the fourth quarter of fiscal 2006, we declared an additional dividend of $37.1 million and incurred a $2.0 million special bonus charge related to a special bonus payment made to option holders who held vested options on March 1, 2006. In addition, we incurred higher tradeshow expenses and wrote off approximately $880,000 of previously capitalized initial public offering cost incurred in 2006 related to our discontinued 2006 registration statement process. The fourth quarter 2006 net income attributable to common stockholders was impacted by the fourth quarter 2006 dividend declaration to preferred stockholders. For further details on net income attributable to common stockholders, see Note 2 to the Notes to Consolidated Financial Statements.

Liquidity and Capital Resources

Since our inception, we have financed our operations primarily through the private sale of equity securities. As of March 31, 2007, we raised $81.7 million through seven preferred stock private equity financings, and $16.3 million through the exercise of stock options for a total of $98.0 million. Our most recent round of financing was completed in September 2001. As of March 31, 2007, we had cash and cash equivalents of $22.9 million.

Under the terms of our patent litigation settlement with Nellcor, Nellcor paid us $263.0 million for damages incurred through January 2006 and made an advance royalty payment to us of $67.5 million related to sales of Nellcor s products for the remainder of 2006. In total, we have received $330.5 million in cash from Nellcor through December 2006. In March 2006 and February 2007, we declared dividends in the aggregate amount of approximately $208.9 million to holders of our common and preferred stock. In addition, in March 2006 and March 2007, we made special bonus payments in the aggregate amount of approximately $11.7 million to our employees and directors who held vested stock options as of March 1, 2006. The majority of these cash dividends and special bonus payments were made from the after-tax proceeds that we received from our settlement with Nellcor and interest earned thereon. In the future, we do not intend to distribute any royalties received from Nellcor under the settlement agreement to our stockholders or our option holders. For further details on the litigation settlement, see Business Nellcor Patent Litigation Settlement.

In the fourth quarter of 2005, we wrote off $2.8 million in purchased in-process research and development expense related to the acquisition of Andromed. We believe this technology will provide a platform from which new acoustic monitoring products can be developed. In the near term, we are utilizing the technology to develop a new acoustic respiratory monitoring device. The total duration of the development effort as measured since the date of acquisition is expected to take at least 27 months to

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complete a commercially viable product; the product is expected to be available for sale in 2008. Since January 2006 and through April 2007, we have incurred approximately $2.9 million in development efforts and plan to spend an additional $2.6 million to cover the remaining development costs through March 31, 2008. As a result, we currently project the total development costs to be approximately $5.5 million. Salary and related expenses are projected to account for approximately 69.8% of the total development expense and the remaining expenses include prototype, engineering, and outside services and facilities. If the technology is not successful or timely, the financial effects on us will be very small. To date, and until we receive 510(k) clearance from the FDA, all our development costs are being expensed into the period in which they are incurred. While this product would expand our market opportunity and allow us to accelerate revenue growth, we believe we can support our annual projected product revenue growth without this new product.

Cash Flows from Operating Activities. Cash used by operating activities was $4.4 million in the three months ended March 31, 2007. This consists primarily of an increase in royalties receivable of $11.8 million, related primarily to a royalty receivable from Nellcor. In addition, accounts receivable and deferred costs of goods sold rose by $5.0 million and $3.4 million, respectively, due to a growth in our business. This cash used was offset by our net income of $9.1 million and an increase in accounts payable of $3.8 million and income taxes payable of $3.1 million also resulting from overall growth and profitability of our business.

Cash provided by operating activities was $189.6 million in 2006. This consists primarily of our net income of $181.8 million, an increase in deferred revenue of $6.7 million resulting from growth of the business, an increase in the provision for deferred income taxes of $6.4 million, an increase in accrued compensation of $5.0 million, including a $2.0 million accrual for the special bonus, and depreciation and amortization of $3.7 million. This was offset by an increase in accounts receivable of $8.0 million, an increase in deferred cost of goods sold of $6.1 million and an increase in inventory of $5.0 million, all resulting from growth of the business.

In 2005, net cash provided by operating activities was $4.5 million, mainly due to net income of $33.4 million and an increase in deferred revenue of $3.0 million, offset by a benefit from deferred income taxes of $27.7 million which was a result of the reversal of the valuation allowance provided to reduce deferred tax assets, an increase in inventory of $5.2 million and deferred cost of goods sold of $3.6 million.

In 2004, cash used in operating activities was $5.1 million. In addition to our net loss of $3.8 million, the cash used was primarily due to an increase in deferred cost of goods sold of $5.1 million, an increase in inventory of $3.4 million and an increase in accounts receivable of $2.6 million, all due to growth of the business. This was offset by a $2.1 million increase in accounts payable primarily due to increased inventory and deferred cost of goods.

Cash Flows from Investing Activities. Cash used in investing activities for the three months ended March 31, 2007, was $1.6 million consisting of $1.3 million of property and equipment purchases and $335,000 for the increase in intangible assets, to support the growth of the business.

Cash used in investing activities in 2006 was $8.3 million primarily consisting of $5.9 million of property and equipment purchases and $1.3 million related to the Andromed acquisition. The property and equipment purchases included purchases of manufacturing equipment of $2.1 million, computer hardware and software of $1.2 million and leasehold improvements of $800,000, to support the growth of the business.

Cash used in investing activities in 2005 was $8.3 million consisting primarily of $5.2 million of property and equipment purchases and $2.0 million related to the Andromed acquisition. The property and

equipment purchases include $2.3 million of manufacturing equipment, and $1.1 million of demonstration equipment.

Cash used in investing activities in 2004 was $3.8 million primarily due to $2.8 million of property and equipment purchases, to support the growth of the business.

Cash Flows from Financing Activities. Cash used in financing activities for the three months ended March 31, 2007 was $26.4 million. This primarily consists of dividends paid of $37.2 million and repayment of long term debt of $1.9 million, offset by $12.6 million of new borrowings.

Cash used in financing activities in 2006 was $139.9 million. This primarily consists of dividends paid of $149.7 million offset by $14.4 million of proceeds from the issuance of common stock from stock option exercises.

Cash provided by financing activities in 2005 was $6.2 million. This primarily consists of proceeds from equipment financing of $11.2 million, offset by $6.1 million in debt payments.

Cash provided by financing activities in 2004 was $9.5 million, primarily due to equipment financing of $13.4 million, offset by $3.9 million in debt payments.

Future Liquidity Needs. In the future, in addition to funding our working capital requirements, we anticipate our primary use of cash to be the equipment that we provide to hospitals under our long-term sensor purchase agreements. We anticipate additional capital purchases related to expanding our worldwide manufacturing capability as well as additional investments in productivity enhancing tools, including a new customer relationship management system. Our focus on international expansion will also require additional investments in facilities and infrastructure in the Americas, Europe, Japan and Asia. The amount and timing of our actual investing activities will vary significantly depending on numerous factors, such as the progress of our product development efforts, our timetable for international manufacturing and sales and marketing expansion and both domestic and international regulatory requirements. Despite these capital investment requirements, we anticipate that our existing cash and cash equivalents and the proceeds from this offering will be sufficient to meet our working capital requirements, capital expenditures, and operations for at least the next 12 months.

Current Financing Arrangements. As of March 31, 2007, we have various arrangements that allow for the financing of the equipment placed with hospitals in connection with the related long-term sensor purchase agreements. During the years ended December 31, 2004, 2005 and 2006 and the three months ended March 31, 2006 and 2007, we borrowed a total of $13.4 million, $11.2 million, $0, $0 and $12.6 million, respectively, under these facilities. As of December 31, 2005, 2006 and March 31, 2007, respectively, we had outstanding under these financing agreements $27.7 million, $20.5 million and $31.3 million. Principal and interest payments under these financing agreements are $1.0 million per month based on an average interest rate of 7.6%. At March 31, 2007, the carrying value of the equipment collateralizing these borrowings was $7.3 million.

In April 2007, the Company entered into an additional financing agreement for $7.5 million. This borrowing is for a period of four years and carries an interest rate of approximately 8.0%. This financing agreement allows the third-party financing company to file Uniform Commercial Code agreements on the related equipment. However, there are no other capital or debt covenant requirements associated with these borrowings. The borrowings can be repaid at any time without any pre-payment penalty. The monthly principal and interest payments on this new borrowing will be approximately $183,000.

In June 2001, we entered into a Master Selective Business Security Agreement, or Master Agreement, with one of our preferred stockholders allowing us to borrow up to a maximum of $5.0 million. The

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Master Agreement consisted of an equipment line whereby all draws are collateralized by equipment placed at hospitals under long-term sensor purchase agreements. Each draw is converted into a five-year note with interest and principal paid on a monthly basis. The interest rate on each note is based on 475 basis points over the U.S. Treasury Rate on the date of the borrowing. The most recent draw was in December 2002 and there are no additional borrowings available under this Master Agreement. As of December 31, 2005, 2006 and March 31, 2007, we had $1.3 million, $316,000 and $197,000, respectively, outstanding under this borrowing at an average interest rate of 8.3%. At March 31, 2007, the carrying value of the equipment collateralizing these borrowings was $122,000.

Contractual Obligations. The following table summarizes our outstanding contractual obligations as of December 31, 2006, and the effect those obligations are expected to have on our cash liquidity and cash flow in future periods: