

NETGEAR, INC  
Form 10-Q  
November 04, 2016  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-Q

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

For the quarterly period ended October 2, 2016.

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-50350

NETGEAR, Inc.

(Exact name of registrant as specified in its charter)

Delaware 77-0419172  
(State or other jurisdiction of (IRS Employer  
incorporation or organization) Identification No.)

350 East Plumeria Drive, 95134  
San Jose, California  
(Address of principal executive offices) (Zip Code)  
(408) 907-8000  
(Registrant's telephone number including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large Accelerated filer  Accelerated filer   
Non-Accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes  No

The number of outstanding shares of the registrant's Common Stock, \$0.001 par value, was 33,078,587 as of October 28, 2016.

Table of Contents

TABLE OF CONTENTS

PART I: FINANCIAL INFORMATION

Item 1.	<u>Financial Statements</u>	<u>3</u>
	<u>Unaudited Condensed Consolidated Balance Sheets</u>	<u>3</u>
	<u>Unaudited Condensed Consolidated Statements of Operations</u>	<u>4</u>
	<u>Unaudited Condensed Consolidated Statements of Comprehensive Income</u>	<u>5</u>
	<u>Unaudited Condensed Consolidated Statements of Cash Flows</u>	<u>6</u>
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	<u>7</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>32</u>
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>42</u>
Item 4.	<u>Controls and Procedures</u>	<u>42</u>

PART II: OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	<u>44</u>
Item 1A.	<u>Risk Factors</u>	<u>44</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>65</u>
Item 3.	<u>Defaults Upon Senior Securities</u>	<u>65</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>65</u>
Item 5.	<u>Other Information</u>	<u>65</u>
Item 6.	<u>Exhibits</u>	<u>65</u>
	<u>Signatures</u>	<u>66</u>

Table of Contents

## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

## NETGEAR, INC.

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	October 2, 2016	December 31, 2015
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$273,720	\$ 181,945
Short-term investments	129,296	96,321
Accounts receivable, net	233,911	290,642
Inventories	217,621	213,118
Prepaid expenses and other current assets	30,519	39,117
Total current assets	885,067	821,143
Property and equipment, net	19,476	22,384
Intangibles, net	36,216	48,947
Goodwill	81,721	81,721
Other non-current assets	74,268	76,374
Total assets	\$1,096,748	\$ 1,050,569
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$95,991	\$ 90,546
Accrued employee compensation	24,026	27,868
Other accrued liabilities	142,751	166,282
Deferred revenue	26,515	29,125
Income taxes payable	1,866	1,951
Total current liabilities	291,149	315,772
Non-current income taxes payable	15,610	14,444
Other non-current liabilities	12,793	11,643
Total liabilities	319,552	341,859
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock	33	33
Additional paid-in capital	555,167	513,047
Accumulated other comprehensive income	242	3
Retained earnings	221,754	195,627
Total stockholders' equity	777,196	708,710
Total liabilities and stockholders' equity	\$1,096,748	\$ 1,050,569

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

NETGEAR, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	October 2,	September 27,	October 2,	September 27,
	2016	2015	2016	2015
Net revenue	\$338,458	\$ 341,893	\$960,369	\$ 939,832
Cost of revenue	235,336	245,566	658,894	677,569
Gross profit	103,122	96,327	301,475	262,263
Operating expenses:				
Research and development	21,935	21,572	65,876	63,126
Sales and marketing	37,337	35,923	110,703	107,538
General and administrative	14,111	11,803	39,995	33,192
Restructuring and other charges	(130	) 1,016	3,859	6,384
Litigation reserves, net	13	—	58	(2,690
Total operating expenses	73,266	70,314	220,491	207,550
Income from operations	29,856	26,013	80,984	54,713
Interest income	291	65	804	184
Other income (expense), net	116	(199	) (582	) (67
Income before income taxes	30,263	25,879	81,206	54,830
Provision for income taxes	9,144	10,780	27,464	28,053
Net income	\$21,119	\$ 15,099	\$53,742	\$ 26,777
Net income per share:				
Basic	\$0.64	\$ 0.47	\$1.64	\$ 0.80
Diluted	\$0.62	\$ 0.47	\$1.60	\$ 0.79
Weighted average shares used to compute net income per share:				
Basic	32,913	31,979	32,688	33,473
Diluted	33,913	32,335	33,624	34,002

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

NETGEAR, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Three Months Ended		Nine Months Ended	
	October 2, September 27,		October 2, September 27,	
	2016	2015	2016	2015
Net income	\$21,119	\$ 15,099	\$53,742	\$ 26,777
Other comprehensive income (loss), before tax:				
Unrealized gain (loss) on derivative instruments	240	10	204	(102 )
Unrealized gain (loss) on available-for-sale securities	(43 )	6	104	34
Other comprehensive income (loss), before tax	197	16	308	(68 )
Tax expense related to items of other comprehensive income	(14 )	(2 )	(69 )	(13 )
Other comprehensive income (loss), net of tax	183	14	239	(81 )
Comprehensive income	\$21,302	\$ 15,113	\$53,981	\$ 26,696

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

NETGEAR, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended October 2, 2016		September 27, 2015
Cash flows from operating activities:			
Net income	\$ 53,742		\$ 26,777
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	24,601		27,336
Purchase premium amortization/discount accretion on investments, net	106		(73 )
Non-cash stock-based compensation	14,300		12,517
Income tax impact associated with stock option exercises	1,627		(1,049 )
Excess tax benefit from stock-based compensation	(2,290 )		(252 )
Deferred income taxes	1,327		(149 )
Changes in assets and liabilities:			
Accounts receivable	56,731		1,516
Inventories	(4,503 )		52,870
Prepaid expenses and other assets	9,772		7,332
Accounts payable	5,428		(7,696 )
Accrued employee compensation	(3,842 )		(174 )
Other accrued liabilities	(24,444 )		(4,405 )
Deferred revenue	(2,610 )		(899 )
Income taxes payable	1,082		2,002
Net cash provided by operating activities	131,027		115,653
Cash flows from investing activities:			
Purchases of short-term investments	(117,994 )		(50,301 )
Proceeds from sales and maturities of short-term investments	85,286		105,142
Purchase of property and equipment	(6,984 )		(11,142 )
	(39,692 )		43,699

Net cash provided by (used  
in) investing activities

Cash flows from financing  
activities:

Purchase and retirement of common stock	(27,616	)	(107,531	)
Proceeds from exercise of stock options	21,874		6,137	
Proceeds from issuance of common stock under employee stock purchase plan	3,892		2,985	
Excess tax benefit from stock-based compensation	2,290		252	
Net cash provided by (used in) financing activities	440		(98,157	)
Net increase in cash and cash equivalents	91,775		61,195	
Cash and cash equivalents, at beginning of period	181,945		141,234	
Cash and cash equivalents, at end of period	\$	273,720	\$	202,429

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

NETGEAR, Inc. ("NETGEAR" or the "Company") was incorporated in Delaware in January 1996. The Company is a global networking company that delivers innovative products to consumers, businesses and service providers. The Company's products are built on a variety of proven technologies such as wireless (WiFi and LTE), Ethernet and powerline, with a focus on reliability and ease-of-use. The product line consists of wired and wireless devices that enable networking, broadband access and network connectivity. These products are available in multiple configurations to address the needs of the end-users in each geographic region in which the Company's products are sold.

The accompanying unaudited condensed consolidated financial statements include the accounts of NETGEAR, Inc. and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated in consolidation. The balance sheet dated December 31, 2015 has been derived from audited financial statements at such date. Accordingly, these condensed consolidated financial statements do not include all of the information and footnotes typically found in the audited consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company's financial position, results of operations, comprehensive income and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

The Company's fiscal year begins on January 1 of the year stated and ends on December 31 of the same year. The Company reports its interim results on a fiscal quarter basis rather than on a calendar quarter basis. Under the fiscal quarter basis, each of the first three fiscal quarters ends on the Sunday closest to the calendar quarter end, with the fourth quarter ending on December 31.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of net revenue and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three and nine months ended October 2, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016 or any future period.

Note 2. Summary of Significant Accounting Policies

The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. The Company's significant accounting policies have not materially changed during the nine months ended October 2, 2016.

Recent Accounting Pronouncements

Accounting Pronouncement Recently Adopted

In November 2015, the FASB issued ASU 2015-17, "Balance Sheet Classification of Deferred Taxes" (Topic 740), which simplifies the presentation of deferred income taxes. This ASU requires that deferred tax assets and liabilities be classified as non-current in a statement of financial position. ASU 2015-17 may be adopted either prospectively or



retrospectively and is effective for reporting periods beginning after December 15, 2016, with early adoption permitted. The Company elected early adoption ASU 2015-17 effective December 31, 2015 on a prospective basis. Adoption of this ASU resulted in a reclassification of the Company's net current deferred tax asset to the net non-current deferred tax asset in its Consolidated Balance Sheet as of December 31, 2015. No prior periods were retrospectively adjusted.

#### Accounting Pronouncements Not Yet Effective

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" (Topic 606). The guidance in this update supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also specifies the accounting for some costs to obtain or fulfill a contract with a customer. An entity should apply the amendments in the update either

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. On July 9, 2015, the FASB concluded to delay the effective date of the new revenue standard by one year. ASU 2014-09 is effective for the Company beginning in the first quarter fiscal 2018. Early adoption is permitted but may not occur earlier than January 1, 2017, the original effective date of the standard for the Company. In 2016, the FASB issued additional guidance to clarify the implementation guidance (ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations; ASU 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing; and ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients). The Company is in the process of evaluating the available transition methods and the impact of the guidance on its financial position, results of operations and cash flows.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory" (Topic 330). The new guidance changes the subsequent measurement of inventory from lower of cost or market to lower of cost and net realizable value. ASU 2015-11 should be applied on a prospective basis and is effective for the Company beginning in the first fiscal quarter of 2017. Early adoption is permitted. The Company does not expect the adoption of this guidance to have a material impact on its financial position, results of operations and cash flows.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10). The changes to the current US GAAP financial instruments model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. This standard is effective for annual and interim reporting periods beginning after December 15, 2017. The Company is currently evaluating what impact, if any, the adoption of this standard will have on its financial position, results of operations and cash flows.

In February 2016, FASB issued ASU No. 2016-02, "Leases" (Topic 842), which requires lessees to recognize on the balance sheet a right-of-use asset, representing its right to use the underlying asset for the lease term, and a corresponding lease liability for all leases with terms greater than twelve months. This ASU becomes effective for the Company in the first quarter fiscal 2019 and early adoption is permitted. This ASU is required to be applied with a modified retrospective approach and requires application of the new standard at the beginning of the earliest comparative period presented. The Company is currently evaluating what impact the adoption of this standard will have on its financial position, results of operations and cash flows.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting" (Topic 718), which simplifies the accounting for share-based payment transactions, including the income tax consequences, forfeitures, and statutory tax withholding requirements, as well as classification on the statement of cash flows. ASU 2016-09 is effective for the Company beginning in the first quarter fiscal 2017, with early adoption permitted (an entity that elects early adoption must adopt all of the amendments in the same period). The Company is currently evaluating what impact the adoption of this standard will have on its financial position, results of operations and cash flows.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows-Classification of Certain Cash Receipts and Cash Payments" (ASC Topic 230), which clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This ASU is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The Company is in the process of assessing the impact, if any, of this ASU on its cash flows.



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Note 3. Balance Sheet Components

## Available-for-sale short-term investments (in thousands)

	As of October 2, 2016				December 31, 2015			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. treasuries	\$127,649	\$ 46	\$ (6 )	\$127,689	\$95,057	\$ 1	\$ (65 )	\$94,993
Certificates of deposit	156	—	—	156	147	—	—	147
Total	\$127,805	\$ 46	\$ (6 )	\$127,845	\$95,204	\$ 1	\$ (65 )	\$95,140

The Company's short-term investments are primarily comprised of marketable securities that are classified as available-for-sale and consist of government securities with an original maturity or remaining maturity at the time of purchase of greater than three months and no more than 12 months. Accordingly, none of the available-for-sale securities have unrealized losses greater than 12 months.

## Accounts receivable, net (in thousands)

	As of	
	October 2, 2016	December 31, 2015
Gross accounts receivable	\$253,117	\$ 309,926
Allowance for doubtful accounts	(1,255 )	(1,255 )
Allowance for sales returns	(13,312 )	(15,904 )
Allowance for price protection	(4,639 )	(2,125 )
Total allowances	(19,206 )	(19,284 )
Total accounts receivable, net	\$233,911	\$ 290,642

## Inventories (in thousands)

	As of	
	October 2, 2016	December 31, 2015
Raw materials	\$6,588	\$ 4,292
Work in process	3	2
Finished goods	211,030	208,824
Total inventories	\$217,621	\$ 213,118

The Company records provisions for excess and obsolete inventory based on forecasts of future demand. While management believes the estimates and assumptions underlying its current forecasts are reasonable, there is risk that additional charges may be necessary if current forecasts are greater than actual demand.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Property and equipment, net (in thousands)

	As of	
	October 2, 2016	December 31, 2015
Computer equipment	\$ 11,594	\$ 11,161
Furniture, fixtures and leasehold improvements	20,099	18,317
Software	30,741	30,396
Machinery and equipment	68,834	66,662
Total property and equipment, gross	131,268	126,536
Accumulated depreciation and amortization	(111,792)	(104,152)
Total property and equipment, net	\$ 19,476	\$ 22,384

Depreciation and amortization expense pertaining to property and equipment was \$3.4 million and \$11.5 million for the three and nine months ended October 2, 2016, respectively, and \$4.4 million and \$13.8 million for the three and nine months ended September 27, 2015, respectively.

Intangibles, net (in thousands)

	Gross	Accumulated Amortization	Net
October 2, 2016			
Technology	\$ 61,099	\$ (55,111)	\$ 5,988
Customer contracts and relationships	56,500	(28,604)	27,896
Other	10,545	(8,213)	2,332
Total intangibles, net	\$ 128,144	\$ (91,928)	\$ 36,216

	Gross	Accumulated Amortization	Net
December 31, 2015			
Technology	\$ 61,099	\$ (48,485)	\$ 12,614
Customer contracts and relationships	56,500	(23,290)	33,210
Other	10,545	(7,422)	3,123
Total intangibles, net	\$ 128,144	\$ (79,197)	\$ 48,947

Amortization of intangibles was \$4.2 million and \$12.7 million for the three and nine months ended October 2, 2016, respectively, and \$4.2 million and \$13.0 million for the three and nine months ended September 27, 2015, respectively.

Estimated amortization expense related to intangibles for each of the next five years and thereafter is as follows (in thousands):

Year Ending December 31	Amount
2016 (remaining three months)	\$ 4,190
2017	11,386
2018	7,871
2019	6,028
2020	5,316
Thereafter	1,425

Total estimated amortization expense \$36,216

10

---

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Other non-current assets (in thousands)

	As of	
	October 2,	December 31,
	2016	2015
Non-current deferred income taxes	\$67,118	\$ 68,445
Other	7,150	7,929
Total other non-current assets	\$74,268	\$ 76,374

## Other accrued liabilities (in thousands)

	As of	
	October 2,	December 31,
	2016	2015
Sales and marketing programs	\$55,421	\$ 69,693
Warranty obligation	53,826	56,706
Freight	7,631	5,748
Other	25,873	34,135
Total other accrued liabilities	\$142,751	\$ 166,282

## Note 4. Derivative Financial Instruments

The Company's subsidiaries have had, and will continue to have material future cash flows, including revenue and expenses, which are denominated in currencies other than the Company's functional currency. The Company and all its subsidiaries designate the U.S. dollar as the functional currency. Changes in exchange rates between the Company's functional currency and other currencies in which the Company transacts business will cause fluctuations in cash flow expectations and cash flow realized or settled. Accordingly, the Company uses derivatives to mitigate its business exposure to foreign exchange risk. The Company enters into foreign currency forward contracts in Australian dollars, British pounds, Euros, Canadian dollars, and Japanese yen to manage the exposures to foreign exchange risk related to expected future cash flows on certain forecasted revenue, costs of revenue, operating expenses and existing assets and liabilities. The Company does not enter into derivatives transactions for trading or speculative purposes.

The Company's foreign currency forward contracts do not contain any credit-risk-related contingent features. The Company is exposed to credit losses in the event of nonperformance by the counter-parties of its forward contracts. The Company enters into derivative contracts with high-quality financial institutions. In addition, the derivative contracts typically mature in two to nine months and the Company continuously evaluates the credit standing of its counter-party financial institutions. The counter-parties to these arrangements are large, highly rated financial institutions and the Company does not consider non-performance a material risk.

The Company may choose not to hedge certain foreign exchange exposures for a variety of reasons, including, but not limited to, materiality, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign exchange rates. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments in accordance with the authoritative guidance for derivatives and hedging. The Company records all derivatives on the balance sheet at fair value. The effective portions of cash flow hedges are recorded in other comprehensive income ("OCI") until the hedged item is recognized in earnings. Derivatives that are not designated as hedging instruments and the ineffective portions of its designated hedges are adjusted to fair value through earnings in other income (expense), net in the unaudited condensed consolidated statement of operations.





Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The fair values of the Company's derivative instruments and the line items on the unaudited condensed consolidated balance sheets to which they were recorded as of October 2, 2016 and December 31, 2015 are summarized as follows (in thousands):

Derivative Assets	Balance Sheet Location	Fair Value at October 2, 2016	Balance Sheet Location	Fair Value at December 31, 2015
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	\$ 431	Prepaid expenses and other current assets	\$ 3,203
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	622	Prepaid expenses and other current assets	2
Total		\$ 1,053		\$ 3,205

  

Derivative Liabilities	Balance Sheet Location	Fair Value at October 2, 2016	Balance Sheet Location	Fair Value at December 31, 2015
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	\$ 1,040	Other accrued liabilities	\$ 447
Derivative liabilities designated as hedging instruments	Other accrued liabilities	245	Other accrued liabilities	4
Total		\$ 1,285		\$ 451

For details of the Company's fair value measurements, see Note 11, Fair Value Measurements.

## Offsetting Derivative Assets and Liabilities

The Company has entered into master netting arrangements which allow net settlements under certain conditions. Although netting is permitted, it is currently the Company's policy and practice to record all derivative assets and liabilities on a gross basis in the unaudited condensed consolidated balance sheets.

The following tables set forth the offsetting of derivative assets as of October 2, 2016 and December 31, 2015 (in thousands):

As of October 2, 2016	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount

Edgar Filing: NETGEAR, INC - Form 10-Q

J.P. Morgan Chase	92	—	92	(92 )	—	—
Wells Fargo	\$ 961	\$	—\$ 961	\$ (961 )	\$	—\$ —
Total	\$ 1,053	\$	—\$ 1,053	\$ (1,053 )	\$	—\$ —

Gross Amounts Not  
Offset in the  
Condensed  
Consolidated Balance  
Sheets

As of December 31, 2015	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	\$ 577	\$	—\$ 577	\$ (56 )	\$	—\$ 521
Wells Fargo	2,628	—	2,628	(395 )	—	2,233
Total	\$ 3,205	\$	—\$ 3,205	\$ (451 )	\$	—\$ 2,754

Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following tables set forth the offsetting of derivative liabilities as of October 2, 2016 and December 31, 2015 (in thousands):

As of October 2, 2016	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
				Financial Instruments	Cash Collateral Pledged	Net Amount
JP Morgan Chase	\$ 132	\$	—\$ 132	\$ (92 )	\$	—\$ 40
Wells Fargo	1,153	—	1,153	(961 )	—	192
Total	\$ 1,285	\$	—\$ 1,285	\$ (1,053 )	\$	—\$ 232

  

As of December 31, 2015	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
				Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	\$ 56	\$	—\$ 56	\$ (56 )	\$	—\$ —
Wells Fargo	395	—	395	(395 )	—	—
Total	\$ 451	\$	—\$ 451	\$ (451 )	\$	—\$ —

## Cash flow hedges

To help manage the exposure of operating margins to fluctuations in foreign currency exchange rates, the Company hedges a portion of its anticipated foreign currency revenue, costs of revenue and certain operating expenses. These hedges are designated at the inception of the hedge relationship as cash flow hedges under the authoritative guidance for derivatives and hedging. Effectiveness is tested at least quarterly both prospectively and retrospectively using regression analysis to ensure that the hedge relationship has been effective and is likely to remain effective in the future. The Company typically hedges portions of its anticipated foreign currency exposure for three to eight months. The Company enters into about ten forward contracts per quarter with an average size of approximately \$8.0 million USD equivalent related to its cash flow hedging program.

The Company expects to reclassify to earnings all of the amounts recorded in OCI associated with its cash flow hedges over the next twelve months. OCI associated with cash flow hedges of foreign currency revenue is recognized as a component of net revenue in the same period as the related revenue is recognized. OCI associated with cash flow hedges of foreign currency costs of revenue and operating expenses are recognized as a component of cost of revenue and operating expense in the same period as the related costs of revenue and operating expenses are recognized.

Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur within the designated hedge period or if not recognized within 60 days following the end of the hedge period. Deferred gains and losses in OCI with such derivative instruments are reclassified immediately into earnings through other income and expense. Any subsequent changes in fair value of such derivative instruments also are reflected in current earnings unless they are re-designated as hedges of other transactions. The Company did not recognize any material net gains or losses related to the loss of hedge designation as there were no discontinued cash flow hedges during the three and nine months ended October 2, 2016 and September 27, 2015.

Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The pre-tax effects of the Company's derivative instruments on OCI and the unaudited condensed consolidated statement of operations for the three and nine months ended October 2, 2016 and September 27, 2015 are summarized as follows (in thousands):

Derivatives Designated as Hedging Instruments	Three Months Ended October 2, 2016		Gain (Loss) Reclassified from OCI into Income - Effective Portion (1)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
	Gain (Loss) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion			
Cash flow hedges:					
Foreign currency forward contracts	\$(417)	Net revenue	\$ (824 )	Other income (expense), net	\$ 116
Foreign currency forward contracts	—	Cost of revenue	4	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	163	Other income (expense), net	—
Total	\$(417)		\$ (657 )		\$ 116

(1) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

Derivatives Designated as Hedging Instruments	Nine Months Ended October 2, 2016		Gain (Loss) Reclassified from OCI into Income - Effective Portion (1)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
	Gain (Loss) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion			
Cash flow hedges:					
Foreign currency forward contracts	\$(1,116)	Net revenue	\$ (1,543 )	Other income (expense), net	\$ 169
Foreign currency forward contracts	—	Cost of revenue	4	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	219	Other income (expense), net	—
Total	\$(1,116)		\$ (1,320 )		\$ 169

(1) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

Derivatives Designated as Hedging Instruments	Three Months Ended September 27, 2015		Gain (Loss) Reclassified from OCI into Income and	Location of Gain (Loss) Recognized in	Amount of Gain (Loss) Recognized in Income and
	Gain (Loss) Recognized in OCI -	Location of Gain (Loss) Reclassified from OCI into Income -			

Edgar Filing: NETGEAR, INC - Form 10-Q

	Effective to Income - Portion Effective Portion	Income - Effective Portion (1)	Excluded from Effectiveness Testing	Excluded from Effectiveness Testing
Cash flow hedges:				
Foreign currency forward contracts	\$ (416)	Net revenue	\$ (552 )	Other income (expense), net \$ (9 )
Foreign currency forward contracts	—	Cost of revenue	3	Other income (expense), net —
Foreign currency forward contracts	—	Operating expenses	123	Other income (expense), net —
Total	\$ (416)		\$ (426 )	\$ (9 )

(1) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Derivatives Designated as Hedging Instruments	Nine Months Ended September 27, 2015				
	Gain (Loss) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (1)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	\$ (1,299)	Net revenue	\$ (1,474 )	Other income (expense), net	\$ (43 )
Foreign currency forward contracts	—	Cost of revenue	7	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	270	Other income (expense), net	—
Total	\$ (1,299)		\$ (1,197 )		\$ (43 )

(1) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

## Non-designated hedges

The Company enters into non-designated hedges under the authoritative guidance for derivatives and hedging to manage the exposure of non-functional currency monetary assets and liabilities held on its financial statements to fluctuations in foreign currency exchange rates, as well as to reduce volatility in other income and expense. The non-designated hedges are generally expected to offset the changes in value of its net non-functional currency asset and liability position resulting from foreign exchange rate fluctuations. Foreign currency denominated accounts receivable and payable are hedged with non-designated hedges when the related anticipated foreign revenue and expenses are recognized in the Company's financial statements. The Company also hedges certain non-functional currency monetary assets and liabilities that may not be incorporated into the cash flow hedge program. The Company adjusts its non-designated hedges monthly and enters into about 18 non-designated derivatives per quarter. The average size of its non-designated hedges is approximately \$3.0 million USD equivalent and these hedges range from one to three months in duration.

The effects of the Company's non-designated hedge included in other income (expense), net in the unaudited condensed consolidated statements of operations for the three and nine months ended October 2, 2016 and September 27, 2015 are as follows (in thousands):

Derivatives Not Designated as Hedging Instruments	Location of Gains (Losses) Recognized in Income on Derivative	Amount of Gains (Losses) Recognized in Income			
		Three Months Ended October 2, 2016	September 27, 2015	Nine Months Ended October 2, 2016	September 27, 2015
Foreign currency forward contracts	Other income (expense), net	\$(493)	\$ 1,267	\$(1,252)	\$ 3,278

Note 5. Net Income Per Share

Basic net income per share is computed by dividing the net income for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of shares of common stock and potentially dilutive common stock outstanding during the period. Potentially dilutive common shares include outstanding stock options and unvested restricted stock awards, which are reflected in diluted net income per share by application of the treasury stock method. Under the treasury stock method, the amount that the employee must pay for exercising stock options, the amount of stock-based compensation cost for future services that the Company has not yet recognized, and the estimated tax benefit that would be recorded in additional paid-in capital upon exercise are assumed to be used to repurchase shares.



Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Net income per share for the three and nine months ended October 2, 2016 and September 27, 2015 are as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	October 2, 2016		September 27, 2015	
	2016	2015	2016	2015
Numerator:				
Net income	\$21,119	\$ 15,099	\$53,742	\$ 26,777
Denominator:				
Weighted average common shares - basic	32,913	31,979	32,688	33,473
Potentially dilutive common share equivalent	1,000	356	936	529
Weighted average common shares - dilutive	33,913	32,335	33,624	34,002
Basic net income per share	\$0.64	\$ 0.47	\$1.64	\$ 0.80
Diluted net income per share	\$0.62	\$ 0.47	\$1.60	\$ 0.79
Anti-dilutive employee stock-based awards, excluded	—	2,768	235	2,486

## Note 6. Income Taxes

The income tax provision for the three and nine months ended October 2, 2016 was \$9.1 million, or an effective tax rate of 30.2%, and \$27.5 million, or an effective tax rate of 33.8% respectively. The income tax provision for the three and nine months ended September 27, 2015 was \$10.8 million, or an effective tax rate of 41.7%, and \$28.1 million, or an effective tax rate of 51.2%, respectively. The effective tax rate for the three and nine months ended October 2, 2016 compared to the three and nine months ended September 3, 2015 decreased partly due to changes in earnings incurred in a jurisdiction where a loss was not tax benefited for the three and nine months ended September 3, 2015. For the three and nine months ended September 3, 2015, the forecasted loss from this jurisdiction was excluded from the determination of tax expense. For the three and nine months ended October 2, 2016, the Company did not exclude any jurisdictions from the determination of tax expense. The decrease was also due to a \$1.8 million non-recurring tax benefit related to a change in estimate during the three and nine months ended October 2, 2016. The Company is subject to income taxes in the U.S. and numerous foreign jurisdictions. The future foreign tax rate could be affected by changes in the composition in earnings in countries with tax rates differing from the U.S. federal rate. The Company is under examination in various U.S. and foreign jurisdictions.

The Company files income tax returns in the U.S. federal jurisdiction as well as various state, local, and foreign jurisdictions. Due to the uncertain nature of ongoing tax audits, the Company has recorded its liability for uncertain tax positions as part of its long-term liability as payments cannot be anticipated over the next twelve months. The existing tax positions of the Company continue to generate an increase in the liability for uncertain tax positions. The liability for uncertain tax positions may be reduced for liabilities that are settled with taxing authorities or on which the statute of limitations could expire without assessment from tax authorities. The possible reduction in liabilities for uncertain tax positions resulting from the expiration of statutes of limitation in multiple jurisdictions in the next twelve months is approximately \$0.7 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

## Note 7. Commitments and Contingencies

Leases

The Company leases office space, cars and equipment under operating leases, some of which are non-cancelable, with various expiration dates through December 2026. The terms of some of the Company's office leases provide for rental payments on a graduated scale. The Company recognizes rent expense on a straight-line basis over the lease period, and has accrued for rent expense incurred but not paid.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Purchase Obligations

The Company has entered into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31 to 45 days prior to the expected shipment date. Orders are non-cancelable within 30 days prior to the expected shipment date. At October 2, 2016, the Company had approximately \$161 million in non-cancelable purchase commitments with suppliers. The Company establishes a loss liability for all products it does not expect to sell for which it has committed purchases from suppliers. Such losses have not been material to date. From time to time the Company's suppliers procure unique complex components on the Company's behalf. If these components do not meet specified technical criteria or are defective, the Company should not be obligated to purchase the materials. However, disputes may arise as a result and significant resources may be spent resolving such disputes.

## Warranty Obligation

Changes in the Company's warranty obligation, which is included in other accrued liabilities in the unaudited condensed consolidated balance sheets, are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, September 27,		October 2, September 27,	
	2016	2015	2016	2015
Balance as of beginning of the period	\$50,393	\$ 40,967	\$56,706	\$ 44,888
Provision for warranty obligation made during the period	27,939	22,625	62,748	53,862
Settlements made during the period	(24,506 )	(15,664 )	(65,628 )	(50,822 )
Balance at end of period	\$53,826	\$ 47,928	\$53,826	\$ 47,928

## Guarantees and Indemnifications

The Company, as permitted under Delaware law and in accordance with its Bylaws, indemnifies its officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a Director and Officer Insurance Policy that enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the fair value of each indemnification agreement is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of October 2, 2016.

In its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers for any expenses or liability resulting from claimed infringements by the Company's products of patents, trademarks or copyrights of third parties, subject to customary carve outs. The terms of these indemnification agreements are generally perpetual any time after execution date of the respective agreement. The maximum amount of potential future infringement indemnification is generally unlimited. The Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of October 2, 2016.

## Employment Agreements

The Company has signed various employment agreements with key executives pursuant to which, if their employment is terminated without cause, such employees are entitled to receive their base salary (and commission or bonus, as applicable) for 52 weeks (for the Chief Executive Officer), 39 weeks (for the Senior Vice President of Worldwide

Operations and Support) and up to 26 weeks (for other key executives). Such employees will also continue to have equity awards vest for up to a one-year period following such termination without cause. If a termination without cause or resignation for good reason occurs within one year of a change in control, such employees are entitled to full acceleration (for the Chief Executive Officer) and up to two years acceleration (for other key executives) of any unvested portion of his or her equity awards. The Company has no liabilities recorded for these agreements as of October 2, 2016.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Litigation and Other Legal Matters

The Company is involved in disputes, litigation, and other legal actions, including, but not limited to, the matters described below. In all cases, at each reporting period, the Company evaluates whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, the Company accrues for the amount, or if a range, the Company accrues the low end of the range, only if there is not a better estimate than any other amount within the range, as a component of legal expense within litigation reserves, net. The Company monitors developments in these legal matters that could affect the estimate the Company had previously accrued. In relation to such matters, the Company currently believes that there are no existing claims or proceedings that are likely to have a material adverse effect on its financial position within the next twelve months, or the outcome of these matters is currently not determinable. There are many uncertainties associated with any litigation, and these actions or other third-party claims against the Company may cause the Company to incur costly litigation and/or substantial settlement charges. In addition, the resolution of any intellectual property litigation may require the Company to make royalty payments, which could have an adverse effect in future periods. If any of those events were to occur, the Company's business, financial condition, results of operations, and cash flows could be adversely affected. The actual liability in any such matters may be materially different from the Company's estimates, which could result in the need to adjust the liability and record additional expenses.

## Ericsson v. NETGEAR, Inc.

On September 14, 2010, Ericsson Inc. and Telefonaktiebolaget LM Ericsson (collectively "Ericsson") filed a patent infringement lawsuit against the Company and defendants D-Link Corporation, D-Link Systems, Inc., Acer, Inc., Acer America Corporation, and Gateway, Inc. in the U.S. District Court, Eastern District of Texas alleging that the defendants infringe certain Ericsson patents. The Company has been accused of infringing eight U.S. patents: 5,790,516 (the "'516 Patent"); 6,330,435 (the "'435 Patent"); 6,424,625 (the "'625 Patent"); 6,519,223 (the "'223 Patent"); 6,772,215 (the "'215 Patent"); 5,987,019 (the "'019 Patent"); 6,466,568 (the "'568 Patent"); and 5,771,468 (the "'468 Patent"). Ericsson generally alleged that the Company and the other defendants have infringed and continue to infringe the Ericsson patents through the defendants' IEEE 802.11-compliant products. In addition, Ericsson alleged that the Company infringed the claimed methods and apparatuses of the '468 Patent through the Company's PCMCIA routers. The Company filed its answer to the Ericsson complaint on December 17, 2010 where it asserted the affirmative defenses of noninfringement and invalidity of the asserted patents. On June 8, 2011, Ericsson filed an amended complaint that added Dell, Toshiba and Belkin as defendants. At the status conference held on June 9, 2011, the Court set a Markman (claim construction) hearing for June 28, 2012 and trial for June 3, 2013. On June 21, 2012, Ericsson dismissed the '468 Patent ("Multi-purpose base station") with prejudice and gave the Company a covenant not to sue as to products in the marketplace now or in the past. On June 22, 2012, Intel filed its Complaint in Intervention, meaning that Intel became an official defendant in the Ericsson case. During the exchange of the expert reports, Ericsson dropped the '516 Patent (the OFDM "pulse shaping" patent). In addition, Ericsson dropped the '223 Patent (packet discard patent) against all the defendants' products, except for those products that use Intel chips. Thus, Ericsson has now dropped the '468 Patent (wireless base station), the '516 Patent (OFDM pulse shaping), and the '223 Patent (packet discard patent) for all non-Intel products.

A jury trial in the Ericsson case occurred in the Eastern District of Texas from June 3 through June 13, 2013. After hearing the evidence, the jury found no infringement of the '435 and '223 Patents, and the jury found infringement of claim 1 of the '625 Patent, claims 1 and 5 of the '568 Patent, and claims 1 and 2 of the '215 Patent. The jury also found that there was no willful infringement by any defendant. Additionally, the jury found no invalidity of the asserted claims of the '435 and '625 Patents. The jury assessed the following damages against the defendants: D-Link:

\$435,000; NETGEAR: \$3,555,000; Acer/Gateway: \$1,170,000; Dell: \$1,920,000; Toshiba: \$2,445,000; Belkin: \$600,000. The damages awards equated to 15 cents per unit for each accused 802.11 device sold by each defendant (5 cent per patent).

On December 16, 2013, the Company and defendants submitted their appeal brief to the Federal Circuit. Ericsson filed its response brief on February 20, 2014, and the defendants filed their reply brief before on March 24, 2014. The oral arguments before the Federal Circuit took place on June 5, 2014.

In December 4, 2014, the Federal Circuit issued its opinion and order in the Company's Ericsson appeal. The Federal Circuit vacated the entirety of the \$3.6 million jury verdict against the Company and the ongoing 15 cent per unit royalty verdict, and also vacated the entirety of the verdict against the other defendants and their ongoing royalties, finding that the District Court hadn't properly instructed the jury on royalty rates and Ericsson's licensing promises. The Federal Circuit held that the lower court had failed to adequately instruct the jury about Ericsson's actual commitments to license the infringed patents on reasonable and nondiscriminatory ("RAND") terms. Further, the Federal Circuit stated that the lower court had neglected to inform the jury that a royalty for a patented technology must be removed from the value of the entire standard, and that a RAND royalty rate should

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

be based on the invention's value, rather than any added value from standardization. The jury's damages awards were therefore completely vacated, and the case was remanded for further proceedings.

While the Federal Circuit found the district court had inadequate jury instructions, it held that there was enough evidence for the jury to find infringement of two claims of U.S. Patent Number 6,466,568 and two claims of U.S. Patent Number 6,772,215, but reversed the lower court's decision not to grant a noninfringement judgment as a matter of law regarding the third patent, U.S. Patent Number 6,424,625, finding that no reasonable jury could find that the '625 Patent was infringed by the defendants.

In September of 2013, Broadcom filed petitions in the USPTO at the Patent Trial and Appeal Board (PTAB) seeking inter partes review ("IPR") of Ericsson's three patents that the jury found were infringed by the Company and other defendants. On March 6, 2015, the PTAB invalidated all the claims of these three patents that were asserted against the Company and other defendants at trial -- claim 1 of the '625 Patent, claims 1 and 5 of the '568 Patent, and claims 1 and 2 of the '215 Patent -- ruling these claims were anticipated or obvious in light of prior art. The PTAB also rejected two motions to amend by Ericsson, which sought to substitute certain proposed claims in the '625 and '568 patents, should they be found unpatentable by the PTAB. This PTAB decision comes on top of the Federal Circuit decision (a) vacating the jury verdict after finding that the district court had not properly instructed the jury on royalty rates and Ericsson's licensing promises, and (b) ruling that no reasonable jury could have found the '625 Patent infringed. Ericsson appealed the PTAB decision to the Federal Circuit and also requested that the PTAB reconsider its decision, but the PTAB denied Ericsson's request for reconsideration. Accordingly, the Company reversed the accruals related to this case in the first fiscal quarter of 2015. On September 16, 2016, the Federal Circuit upheld the invalidity of certain claims of the '625 Patent, the '568 Patent, and '215 Patent, as previously determined by the PTAB. The Federal Circuit only issued one precedential written opinion, on the '215 Patent; the PTAB invalidity rulings on the '625 and '568 Patents were upheld without a written decision. Ericsson petitioned the Federal Circuit for an en banc rehearing of the appeal decision, and the present status of the case continues to be that the Company does not infringe on any valid Ericsson patent.

*Agenzia Entrate Provinciale Revenue Office 1 of Milan v. NETGEAR International, Inc.*

In November 2012, the Italian tax police began a comprehensive tax audit of NETGEAR International, Inc.'s Italian Branch. The scope of the audit initially was from 2004 through 2011 and was subsequently expanded to include 2012. The tax audit encompasses Corporate Income Tax (IRES), Regional Business Tax (IRAP) and Value-Added Tax (VAT). In December 2013, December 2014, August 2015, and December 2015 an assessment was issued by Inland Revenue Agency, Provincial Head Office No. 1 of Milan-Auditing Department (Milan Tax Office) for the 2004 tax year, the 2005 through 2007 tax years, the 2008 through 2010 tax years, and the 2011 through 2012 tax years, respectively.

In May 2014, the Company filed with the Provincial Tax Court of Milan an appeal brief, including a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2004 year. The hearing was held and decision was issued on December 19, 2014. The Tax Court decided in favor of the Company and nullified the assessment by the Inland Revenue Agency for 2004. The Inland Revenue Agency appealed the decision of the Tax Court on June 12, 2015. The Company filed its counter appeal with respect to the 2004 year during September 2015. On February 26, 2016 the Regional Tax Court conducted the appeals hearing for the 2004 year, ruling in favor of the Company. On June 13, 2016, the Inland Revenue Agency appealed the decision to the Supreme Court. The Company has filed a counter appeal.

In June, 2015, the Company filed with the Provincial Tax Court of Milan an appeal brief including a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2005 through 2007 tax years. The hearing for suspension was held and the Request for Suspension of payment was granted. The hearing for the validity of the tax assessment for 2005 and 2006 was held in December 2015 with the Provincial Tax Court issuing its decision in favor of the Company. The Inland Revenue Agency filed its appeal with the Regional Tax Court. The Company filed its counter brief on September 30, 2016.

The hearing for the validity of the tax assessment for 2007 was held on March 10, 2016 with the Provincial Tax Court who issued its decision in favor of the Company on April 7, 2016. The Inland Revenue Agency has until November 7, 2016 to file for an appeal to the Regional Tax Court with regard to the 2007 tax year.

With respect to 2008 through 2010, the Company filed its briefs with the Tax Court in October 2015 and the hearing for the validity of the tax assessments was held on April 21, 2016 and a decision favorable to the Company was issued on May 12, 2016. The Inland Revenue Agency has until December 9, 2016 to file an appeal to the Regional Tax Court.



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

With respect to 2011 through 2012, the Company has filed its appeal brief on February 26, 2016 with the Provincial Tax Court to contest this assessment. The hearing for suspension was held and the Request for Suspension of payment was granted. On October 13, 2016, the Company filed its brief with the Provincial Tax Court. The hearing was held on October 24, 2016. The Company is awaiting the decision of the Provincial Tax Court.

With regard to all tax years, it is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Via Vadis v. NETGEAR, Inc.

On August 22, 2014, the Company was sued by Via Vadis, LLC and AC Technologies, S.A. (“Via Vadis”), in the Western District of Texas. The complaint alleges that the Company’s ReadyNAS and Stora products “with built-in BitTorrent software” allegedly infringe three related patents of Via Vadis (U.S. Patent Nos. 7,904,680, RE40, 521, and 8,656,125). Via Vadis filed similar complaints against Belkin, Buffalo, Blizzard, D-Link, and Amazon.

By referring to “built-in BitTorrent software,” the Company believes that the complaint is referring to the BitTorrent Sync application, which was released by BitTorrent Inc. in spring of 2014. At a high-level, the application allows file synchronization across multiple devices by storing the underlying files on multiple local devices, rather than on a centralized server. The Company’s ReadyNAS products do not include BitTorrent software when sold. The BitTorrent application is provided as one of a multitude of potential download options, but the software itself is not included on the Company’s devices when shipped. Therefore, the only viable allegation at this point is an indirect infringement allegation.

On November 10, 2014, the Company answered the complaint denying that it infringes the patents in suit and also asserting the affirmative defenses that the patents in suit are invalid and barred by the equitable doctrines of laches, waiver, and/or estoppel.

On February 6, 2015, the Company filed its motion to transfer venue from the Western District of Texas to the Northern District of California with the Court; on February 13, 2015, Via Vadis filed its opposition to the Company’s motion to transfer; and on February 20, 2015, the Company filed its reply brief on its motion to transfer. In early April 2015, the Company received the plaintiff’s infringement contentions, and on June 12, 2015, the defendants served invalidity contentions. On July 30, 2015 the Court granted the Company’s motion to transfer venue to the Northern District of California. In addition, the Company learned that Amazon and Blizzard filed petitions for the inter partes reviews (“IPRs”) for the patents in suit. On October 30, 2015, the Company and Via Vadis filed a joint stipulation requesting that the Court vacate all deadlines and enter a stay of all proceedings in the case pending the Patent Trial and Appeal Board’s final non-appealable decision on the IPRs initiated by Amazon and Blizzard. On November 2, 2015 the Court granted the requested stay. On March 8, 2016, the Patent Trial and Appeal Board issued written decisions instituting the IPRs jointly filed by Amazon and Blizzard.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Chrimar Systems, Inc. v NETGEAR, Inc.

On July 1, 2015, the Company was sued by a non-practicing entity named Chrimar Systems, Inc., doing business as CMS Technologies and Chrimar Holding Company, LLC (collectively, “CMS”), in the Eastern District of Texas for allegedly infringing four patents-U.S. Patent Nos. 8,155,012 (the “012 Patent”), entitled “System and method for adapting a piece of terminal equipment”; 8,942,107 (the “107 Patent”), entitled “Piece of ethernet terminal equipment”;

8,902,760 (the “760 Patent”), entitled “Network system and optional tethers”; and 9,019,838 (the “838 Patent”), entitled “Central piece of network equipment” (collectively “patents-in-suit”).

The patents-in-suit relate to using or embedding an electrical DC current or signal into an existing Ethernet communication link in order to transmit additional data about the devices on the communication link, and the specifications for the patents are identical. It appears that CMS has approximately 40 active cases in the Eastern District of Texas, as well as some cases in the Northern District of California on the patents-in-suit and the parent patent to the patents-in-suit.

The Company answered the complaint on September 15, 2015. On November 24, 2015, CMS served its infringement contentions on the Company, and CMS is generally attempting to assert that the patents in suit cover the Power over Ethernet standard (802.3af and 802.3at) used by certain of the Company's products.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

On December 3, 2015, the Company filed with the Court a motion to transfer venue to the District Court for the Northern District of California and their memorandum of law in support thereof. On December 23, 2015, CMS filed its response to the Company's motion to transfer, and, on January 8, 2016, the Company filed its reply brief in support of its motion to transfer venue. On January 15, 2016, the Court granted the Company's motion to transfer venue to the District Court for the Northern District of California. The initial case management conference in the Northern District of California occurred on May 13, 2016, and on August 19, 2016, the parties exchanged preliminary claim constructions and extrinsic evidence. On August 26, 2016, the Company and three defendants in other Northern District of California CMS cases (Juniper Networks, Inc., Ruckus Wireless, Inc., and Fortinet, Inc.) submitted motions to stay their cases. The defendants in part argued that stays were appropriate pending the resolution of the currently-pending IPRs of the patents-in-suit before the Patent Trial and Appeal Board (PTAB), including four IPR Petitions filed by Juniper. On September 9, 2016, CMS submitted its opposition to the motions to stay the cases. On September 26, 2016, the Court ordered the cases stayed in their entirety, until the PTAB reaches institution decisions with respect to Juniper's four pending IPR petitions. The Court ordered that the parties provide the Court with a written update on the status of all IPR and reexamination proceedings within ten days of the PTAB's institution decisions on Juniper's four IPR petitions, at which time the Court may either lift or continue the stay of the cases.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Wi3, INC. v. NETGEAR, Inc.

On November 12, 2015, a lawsuit was filed against the Company by a company called Wi3, INC. ("Wi3") in the United States District Court, Western District of New York. The patent No. 6,108,331 (the "331 Patent") is entitled "Single Medium Wiring Scheme for Multiple Signal Distribution in Building and Access Port Therefor," and was filed in 1998, and should expire in July 2018. The complaint alleges direct and indirect infringement, and accuses the Company's MoCA Network Adapters and/or Network Extenders (including at least model MCA1001 v2) of infringing at least claims 26, 27, 29, and 30. The complaint alleges no pre-suit knowledge of the patent, but seeks enhanced damages. The patent has been asserted in three prior cases, and all three cases were resolved in the early stages.

The Company filed its answer to the Wi3 complaint on March 11, 2016. In the answer, the Company denied the infringement allegations and put forth several counterclaims. Subsequent to the Company's answer, the parties participated in some motion practice resulting in an amended answer and counterclaims being filed by the Company on April 1, 2016. Wi3 answered the Company's amended answer and counterclaims on April 13, 2016. The initial case management conference occurred on August 17, 2016. Without admitting any wrongdoing or violation of law and to avoid the distraction and expense of continued litigation and the uncertainty of a jury verdict on the merits, on August 29, 2016, the Company and Wi3 settled the lawsuit for a one-time payment from the Company to Wi3 in return for a license to the Company to the Wi3 patents and applications that are currently owned by Wi3. As part of the settlement, Wi3 also agreed not to sue the Company's customers or suppliers on the Wi3 patents and applications that are currently owned by Wi3. The Court subsequently dismissed the case. The settlement did not have a material financial impact to the Company.

Tessera v. NETGEAR, Inc.

On May 23, 2016, Tessera Technologies, Inc., Tessera, Inc., and Invensas Corp. (collectively, "Tessera") filed a complaint requesting that the U.S. International Trade Commission ("Commission") commence an investigation pursuant to Section 337 by reason of alleged infringement of certain patent claims by the Company and other respondents. On June 20, 2016, the Commission issued the related Notice of Investigation, and the Investigation was instituted on June 24, 2016.

The Tessera complaint alleges that the following “Proposed Respondents” unlawfully import into the U.S., sell for importation, and/or sell within the U.S. after importation certain semiconductor devices, semiconductor device packages, and products containing the same that infringe one or more claims of U.S. Patent Nos. 6,856,007 (the ‘007 patent), 6,849,946 (the ‘946 patent), and 6,133,136 (the ‘136 patent) (collectively, the “asserted patents”): Broadcom Limited of Singapore; Broadcom Corp. of Irvine, California; Avago Technologies Limited of Singapore; Avago Technologies U.S. Inc. of San Jose, California; Arista Networks, Inc. of Santa Clara, California; ARRIS International plc of Suwanee, Georgia; ARRIS Group, Inc. of Suwanee, Georgia; ARRIS Technology, Inc. of Horsham, Pennsylvania; ARRIS Enterprises LLC of Suwanee, Georgia; ARRIS Solutions, Inc. of Suwanee, Georgia; Pace Ltd. (formerly Pace plc) of England; Pace Americas, LLC of Boca Raton, Florida; Pace USA, LLC of Boca Raton, Florida; ASUSTeK Computer Inc. of Taiwan; ASUS Computer International of Fremont, California; Comcast Cable Communications, LLC of Philadelphia, Pennsylvania; Comcast Cable Communications Management, LLC of Philadelphia, Pennsylvania; Comcast Business Communications, LLC of Philadelphia, Pennsylvania; HTC Corp. of Taiwan; HTC America, Inc. of Bellevue, Washington;

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Technicolor S.A. of France; Technicolor USA, Inc. of Indianapolis, Indiana; Technicolor Connected Home USA LLC of Indianapolis, Indiana; and the Company.

According to the complaint, the asserted patents generally relate to semiconductor packaging technology. In particular, the '007 patent relates to a compact and economical semiconductor chip assembly that includes a packaged semiconductor chip, a chip carrier with a metallic thermal conductor, and a circuit panel with a thermal conductor mounting. The '946 patent relates to a semiconductor layout configuration and method that results in a more efficient planarization process for a semiconductor chip. Lastly, the '136 patent relates to a structure for metal interconnects used in semiconductor packaging.

In the complaint, Tessera states that the Proposed Respondents import and sell products that infringe the asserted patents. In particular, the complaint refers to multiple categories of accused semiconductor products associated with Broadcom and asserts that the remaining Proposed Respondents import and sell products that contain these infringing Broadcom semiconductor products. Tessera requested that the Commission issue a permanent limited exclusion order and a permanent cease and desist order directed at the Proposed Respondents and related entities.

The claim construction hearing for the Investigation is scheduled for December 1, 2016; the evidentiary hearing is scheduled for March 27 - 31, 2017; and the target date for completion of the Investigation is October 24, 2017.

Concurrently with the filing of the instant ITC complaint, Tessera also filed a complaint against Broadcom Corp. in the U.S. District Court for the District of Delaware alleging infringement of the asserted patents. The Company has not been sued in Delaware or any other jurisdiction other than the ITC.

Discovery in the ITC case is ongoing. The Company is considering stipulating to certain facts regarding its importation and inventory of Broadcom-based products in return for various relief from discovery, such as reduced depositions and discovery responses.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Symbology v. NETGEAR, Inc.

On June 7, 2016, the Company and numerous other companies were sued in the Eastern District of Texas by a non-practicing entity named Symbology Innovations, LLC ("Symbology"). The lawsuit alleges infringement of three patents: U.S. Patent Nos. 8,424,752 (the '752 Patent); 8,651,369 (the '369 Patent); and 8,936,190 (the '190 Patent) (collectively "Patents in Suit"). The Patents in Suit are all entitled "System and method for presenting information about an object on a portable electronic device", and the complaint targets the Company's use of QR codes. In total, Symbology has filed approximately 50 lawsuits against 50 companies alleging infringement of the Patents in Suit.

The alleged infringers Symbology is targeting are advertisers using QR codes. The plaintiff generally is alleging that the Patents in Suit cover the use of QR codes to display content from a website, such as using a mobile phone to scan the QR code, whereby the phone gets the URL from the QR code and fetches the associated web page and then displays it on the mobile phone.

The Company was served with the complaint on July 8, 2016. On August 29, 2016, the Company received Symbology's Preliminary Infringement Contentions and Disclosures. On September 12, 2016 the Company filed its Answer to the Complaint, denying the allegations of infringement and asserting numerous affirmative defenses.

On September 30, 2016, the Company received Symbology's Initial Disclosures. On October 3, 2016, the Company filed a Motion to Transfer the case from the Eastern District of Texas to the Northern District of California, and on October 10, 2016, the Company filed its Initial Disclosures and initial technical document production. Without admitting any wrongdoing or violation of law and to avoid the distraction and expense of continued litigation and the uncertainty of a jury verdict on the merits, on October 20, 2016, the Company and Symbology reached a verbal agreement in principle to settle the lawsuit for a one-time payment from the Company to Symbology in return for a license to the Company to the Symbology patents and applications that are currently owned by Symbology. If the verbally-agreed settlement is finalized and case dismissed then this litigation matter will not have a material financial impact to the Company.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

e.Digital v. NETGEAR, Inc.

On September 12, 2016, e.Digital Corporation (e.Digital) filed a lawsuit against the Company in the Northern District of California accusing the Company of infringing U.S. Patent Nos. 8,311,522 (“the ’522 patent”); 8,311,524 (“the ’524 patent”); 9,002,331 (“the ’331 patent”); and 9,178,983 (“the ’983 patent”) (collectively, the “patents-in-suit”), which purportedly cover systems and methods for the remote detection, classification, and communication of sensor data. In the Complaint, e.Digital broadly accuses the Company’s Arlo wireless camera systems, including the Arlo Wire-Free, Arlo Q, and Arlo Q Plus cameras (collectively, the “Accused Products”). The allegations are generally directed at the “remote monitoring and communication” functionality of the Accused Products. Specifically, the Complaint alleges that the Accused Products infringe the patents-in-suit by utilizing sensors-such as cameras and microphones-to collect data and perform various operations-such as send alerts, trigger video recording, or take a snapshot-in response to a classification of the collected sensor data.

Beginning with a lawsuit against Dropcam in July, 2014, e.Digital has litigated the patents-in-suit, and related portfolio, against a handful of other companies with products similar to the Arlo wireless camera systems. The previous litigation includes the lawsuit against Dropcam along with suits against ArcSoft, Inc., ShenZhen Gospell Smarhome Electronic Co., Ltd., iBaby Labs, Inc., iSmart Alarm, Inc., MivaTek International, Inc., MyFox, Inc., and Nest. Concurrent with the filing of the instant complaint against the Company, e.Digital also filed similar suits against Netatmo LLC and Y-Cam Solutions, LLC. The Company’s case is scheduled to have an initial case management conference on December, 28, 2016, with a case management statement due December 16, 2016. The Company’s Answer to the Complaint is due in early November, 2016.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

#### IP Indemnification Claims

In its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers (the “Indemnified Parties”) for any expenses or liability resulting from claimed infringements by the Company's products of patents, trademarks or copyrights of third parties that are asserted against the Indemnified Parties, subject to customary carve outs. The terms of these indemnification agreements are generally perpetual after execution of the agreement. The maximum amount of potential future indemnification is generally unlimited. From time to time, the Company receives requests for indemnity and may choose to assume the defense of such litigation asserted against the Indemnified Parties.

#### Environmental Regulation

The Company is required to comply and is currently in compliance with the European Union (“EU”) and other Directives on the Restrictions of the use of Certain Hazardous Substances in Electrical and Electronic Equipment (“RoHS”), Waste Electrical and Electronic Equipment (“WEEE”) requirements, Energy Using Product (“EuP”) requirements, the REACH Regulation, Packaging Directive and the Battery Directive.

The Company is subject to various federal, state, local, and foreign environmental laws and regulations, including those governing the use, discharge, and disposal of hazardous substances in the ordinary course of our manufacturing process. The Company believes that its current manufacturing and other operations comply in all material respects with applicable environmental laws and regulations; however, it is possible that future environmental legislation may be enacted or current environmental legislation may be interpreted to create an environmental liability with respect to its facilities, operations, or products. See further discussion of the business risks associated with environmental

legislation under the risk titled, "We are subject to, and must remain in compliance with, numerous laws and governmental regulations concerning the manufacturing, use, distribution and sale of our products, as well as any such future laws and regulations. Some of our customers also require that we comply with their own unique requirements relating to these matters. Any failure to comply with such laws, regulations and requirements, and any associated unanticipated costs, may adversely affect our business, financial condition and results of operations." within Item 1A Risk Factors of this Form 10-Q.

Note 8. Stockholders' Equity

Common Stock Repurchase Program

From time to time, the Company's Board of Directors has authorized programs under which the Company may repurchase shares of its common stock, depending on market conditions, in the open market or through privately negotiated transactions. Under the authorizations, the timing and actual number of shares subject to repurchase are at the discretion of management and



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

are contingent on a number of factors, such as levels of cash generation from operations, cash requirements for acquisitions and the price of the Company's common stock. Repurchases made by the Company pursuant to Board-authorized programs during the nine months ended October 2, 2016 and September 27, 2015 are discussed below. As of October 2, 2016, 1.6 million shares remained authorized for repurchase under the repurchase program approved by the Board in July 2015. All shares authorized under previously approved programs were fully utilized. The Company repurchased, reported based on trade date, 0.6 million shares of common stock at a cost of \$23.3 million during the nine months ended October 2, 2016. The Company repurchased, reported based on trade date, 3.4 million shares of common stock at a cost of \$105.2 million under the repurchase authorization during the nine months ended September 27, 2015.

The Company repurchased, as reported based on trade date, approximately 99,000 shares of common stock at a cost of \$4.4 million under a repurchase program to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving restricted stock units ("RSUs") during the nine months ended October 2, 2016. Similarly, during the nine months ended September 27, 2015, the Company repurchased approximately 77,000 shares of common stock at a cost of \$2.4 million under the same program to help facilitate tax withholding for RSUs.

These shares were retired upon repurchase. The purchase price for the shares of the Company's stock repurchased is reflected as a reduction to stockholders' equity. The Company's policy related to repurchases of its common stock is to charge the excess of cost over par value to retained earnings. All repurchases were made in compliance with Rule 10b-18 under the Securities Exchange Act of 1934, as amended.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Accumulated Other Comprehensive Income, Net

The following table sets forth the changes in accumulated other comprehensive income ("AOCI") by component, net of taxes, for the nine months ended October 2, 2016 and September 27, 2015 (in thousands):

	Gains and losses on available-for-sale securities	Gains and losses on derivatives	Total
Beginning balance as of December 31, 2015	\$ (40 )	\$ 43	\$3
Other comprehensive income (loss) before reclassifications	65	(684 )	(619 )
Amounts reclassified from accumulated other comprehensive income	—	858	858
Net current period other comprehensive income (loss)	65	174	239
Ending balance as of October 2, 2016	\$ 25	\$ 217	\$242
	Gains and losses on available for sale securities	Gains and losses on derivatives	Total
Beginning balance as of December 31, 2014	\$ (5 )	\$ 43	\$38
Other comprehensive income (loss) before reclassifications	21	(1,299 )	(1,278)
Amounts reclassified from accumulated other comprehensive income	—	1,197	1,197
Net current period other comprehensive income (loss)	21	(102 )	(81 )
Ending balance as of September 27, 2015	\$ 16	\$ (59 )	\$(43)

The following tables provide details about significant amounts reclassified out of each component of AOCI for the three and nine months ended October 2, 2016 and September 27, 2015 (in thousands):

	Three Months Ended October 2, 2016		Nine Months Ended October 2, 2016
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations	Amount Reclassified from AOCI
Gains and losses on cash flow hedge:			
Foreign currency forward contracts	\$(824)	Net revenue	\$(1,543)
Foreign currency forward contracts	\$4	Cost of revenue	\$4
Foreign currency forward contracts	163	Operating expenses	219
	\$(657)	Total before tax	\$(1,320)
	230	Tax impact	462
	\$(427)	Total, net of tax	\$(858 )
	Three Months Ended September 27, 2015		Nine Months Ended September 27, 2015
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations	Amount Reclassified from AOCI

Edgar Filing: NETGEAR, INC - Form 10-Q

Gains and losses on cash flow hedge:

Foreign currency forward contracts	\$ (552)	Net revenue	\$ (1,474)	Net revenue
Foreign currency forward contracts	3	Cost of revenue	7	Cost of revenue
Foreign currency forward contracts	123	Operating expenses	270	Operating expenses
	(426 )	Total before tax	(1,197 )	Total before tax
	—	Tax impact (1)	—	Tax impact (1)
	\$ (426)	Total, net of tax	\$ (1,197)	Total, net of tax

(1) Under the Company's 2015 tax structure, all hedging gains and losses from derivative contracts were ultimately borne by a legal entity in a jurisdiction with no income tax.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 9. Employee Benefit Plans

2006 Long Term Incentive Plan

The Company's 2006 Long Term Incentive Plan (the "2006 Plan") expired on April 13, 2016 by its terms. No further equity awards can be granted under the 2006 Plan. The 2006 Plan will continue to govern awards previously granted under it.

2016 Equity Incentive Plan

In April 2016, the Company's Board of Directors adopted the 2016 Equity Incentive Plan (the "2016 Plan") which was approved by the Company's stockholders at the 2016 Annual Meeting of Stockholders on June 3, 2016. The 2016 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares and performance units to eligible directors, employees and consultants of the Company. Award vesting periods for this plan are generally four years. The maximum aggregate number of shares that may be issued under the 2016 Plan is 2.5 million Shares, plus (i) any shares that were available for grant under the Company's 2006 Plan as of immediately prior to the 2006 Plan's expiration by its terms, which was 699,827 shares, plus (ii) any shares granted under the 2006 Plan that expire, are forfeited to or repurchased by the Company. As of October 2, 2016, approximately 3.1 million shares were reserved for future grants under the 2016 Plan.

Options granted under the 2016 Plan may be either incentive stock options or nonstatutory stock options. Incentive stock options ("ISO") may be granted only to Company employees (including officers and directors who are also employees). Nonstatutory stock options ("NSO") may be granted to Company employees, directors and consultants. Options may be granted for periods of up to ten years and at prices no less than the estimated fair value of the common stock on the date of grant. In addition, the exercise price of an ISO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. Options granted under the 2016 Plan generally vest over four years, the first tranche at the end of twelve months and the remaining shares underlying the option vesting monthly over the remaining three years.

Stock Appreciation Rights may be granted under the 2016 Plan subject to the terms specified by the plan administrator, provided that the term of any such right may not exceed ten (10) years from the date of grant. The exercise price may not be less than the fair market value of the Company's common stock on the date of grant. Restricted stock awards may be granted under the 2016 Plan subject to the terms specified by the plan administrator. The period over which any restricted award may fully vest is generally no less than three (3) years. Restricted stock awards are nonvested stock awards that may include grants of restricted stock or grants of restricted stock units. Restricted stock awards are rights to acquire or purchase shares that generally are subject to transferability and forfeitability restrictions for a specified period. Restricted stock has the same voting rights as other common stock and is considered to be currently issued and outstanding. Restricted stock units do not have the voting rights of common stock, and the shares underlying the restricted stock units are not considered issued and outstanding. The Company expenses the cost of the restricted stock awards, which is determined to be the fair market value of the shares at the date of grant, ratably over the period during which the restrictions lapse.

Performance units and performance shares are awards that result in a payment to a participant only if specified performance objectives or other vesting provisions are achieved during a specified performance period. Each performance unit will have an initial value established by the Administrator on or before the grant date. Each performance share will have an initial value equal to the fair market value of a share on the grant date. The plan administrator will determine the number of performance awards that will be granted and will establish the performance goals and other conditions for payment of such performance awards. The period of measuring the achievement of performance goals will be specified by an award agreement.

Other stock or cash awards may be granted under the 2016 Plan subject to the terms specified by the plan administrator.

Any shares subject to restricted stock, restricted stock units, performance units, or performance shares awarded under the 2016 Plan will be counted against the shares available for issuance under the 2016 Plan as one and fifty-eight hundredths (1.58) shares for every one share subject to such awards. Any shares of common stock subject to an award that is forfeited, settled in cash, expires or is otherwise settled without the issuance of shares shall again be available for awards under the 2016 Plan. Additionally, any shares that are tendered by a participant of the 2016 Plan or retained by the Company as full or partial payment to the Company for the purchase of an award or to satisfy tax withholding obligations in connection with an award shall no longer again be made available for issuance under the 2016 Plan.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Employee Stock Purchase Plan

The Company sponsors an Employee Stock Purchase Plan (the "ESPP"), pursuant to which eligible employees may contribute up to 10% of base compensation, subject to certain income limits, to purchase shares of the Company's common stock. Prior to February 16, 2016, employees could purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date. As the price of the shares was determined at the purchase date, the Company recognized expense based on the 15% discount at purchase. Beginning February 16, 2016, the terms of the plan include a look-back feature that enables employees to purchase stock semi-annually at a price equal to 85% of the lesser of the fair market value at the beginning of the offering period or the purchase date. The duration of each offering period is generally six-months. The fair value of the shares offered under the ESPP is estimated at grant using a Black-Scholes option valuation model. In April 2016, the Company approved an amendment to the 2003 Employee Stock Purchase plan to increase the number of shares of common stock authorized for sale under the Purchase Plan by 1.0 million shares to a total of 2.0 million shares. As of October 2, 2016, approximately 1.0 million shares were available for issuance under the ESPP.

## Option Activity

Stock option activity during the nine months ended October 2, 2016 was as follows:

	Number of shares	Weighted Average Exercise Price Per Share
	(in thousands)	(in dollars)
Outstanding at December 31, 2015	2,461	\$ 30.08
Granted	328	39.53
Exercised	(707 )	31.23
Cancelled	(15 )	34.10
Expired	(2 )	34.37
Outstanding at October 2, 2016	2,065	\$ 31.16

## RSU Activity

RSU activity during the nine months ended October 2, 2016 was as follows:

	Number of shares	Weighted Average Grant Date Fair Value Per Share
	(in thousands)	(in dollars)
Outstanding at December 31, 2015	964	\$ 31.63
RSUs granted	457	40.65
RSUs vested	(321 )	31.22
RSUs cancelled	(82 )	31.35
Outstanding at October 2, 2016	1,018	\$ 35.84

## Valuation and Expense Information

The fair value of each option award and share granted under the ESPP commencing February 16, 2016 is estimated on the date of grant using a Black-Scholes-Merton option valuation model that uses the assumptions noted in the following table. The estimated expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk free interest rate for options and ESPP shares is based on the implied yield currently available on U.S. Treasury securities with a remaining term commensurate with the estimated expected term. Expected volatility for options and ESPP shares is based on historical volatility over the most recent period commensurate with the estimated expected term.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The table below sets forth the weighted average assumptions used to estimate the fair value of option grants during the three and nine months ended October 2, 2016 and September 27, 2015 and purchase rights granted under the ESPP commencing February 16, 2016 during the three and nine months ended October 2, 2016.

	Three Months Ended			Nine Months Ended		
	ESPP	Stock Options		ESPP	Stock Options	
	October 2, 2016	October 2, 2016	September 27, 2015	October 2, 2016	October 2, 2016	September 27, 2015
Expected life (in years)	0.5	N/A	N/A	0.5	4.4	4.5
Risk-free interest rate	0.45%	N/A	N/A	0.43%	1.28%	1.44%
Expected volatility	28.6%	N/A	N/A	38.3%	35.4%	39.3%
Dividend yield	—	N/A	N/A	—	—	—

The following table sets forth the stock-based compensation expense resulting from stock options, RSUs and the ESPP included in the Company's unaudited condensed consolidated statements of operations (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Cost of revenue	\$426	\$ 358	\$1,316	\$ 1,190
Research and development	1,087	877	3,071	2,495
Sales and marketing	1,300	1,173	3,835	3,838
General and administrative	2,057	1,703	6,078	4,994
Total stock-based compensation	\$4,870	\$ 4,111	\$14,300	\$ 12,517

As of October 2, 2016, \$6.6 million of unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.7 years. \$24.8 million of unrecognized compensation cost related to unvested RSUs, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.6 years.

## Note 10. Segment Information and Operations by Geographic Area

Operating segments are components of an enterprise about which separate financial information is available and is regularly evaluated by management, namely the Chief Operating Decision Maker ("CODM") of an organization, in order to determine operating and resource allocation decisions. By this definition, the Company has identified its CEO as the CODM and operates in three specific business units: retail, commercial, and service provider. The retail business unit consists of high performance, dependable and easy-to-use home networking, home video security, storage and digital media products. The commercial business unit consists of business networking and storage solutions that bring enterprise class functionality down to the small and medium-sized business at an affordable price. The service provider business unit consists of made-to-order and retail proven, whole home networking hardware and software solutions as well as 4G LTE hotspots sold to service providers for sale to their subscribers. Each business unit contains leadership focused on the product development efforts, both from a product marketing and engineering standpoint, to service the unique needs of these customer segments. The Company believes this structure enables it to better focus its efforts on the Company's core customer segments and allows it to be more nimble and opportunistic as a company overall.

The results of the reportable segments are derived directly from the Company's management reporting system. The results are based on the Company's method of internal reporting and are not necessarily in conformity with accounting principles generally accepted in the United States. Management measures the performance of each segment based on several metrics, including contribution income. Segment contribution income includes all product line segment



revenues less the related cost of sales, research and development and sales and marketing costs. Contribution income is used, in part, to evaluate the performance of, and allocate resources to, each of the segments. Certain operating expenses are not allocated to segments because they are separately managed at the corporate level. These unallocated indirect costs include corporate costs, such as corporate research and development, corporate marketing expense and general and administrative costs, amortization of intangibles, stock-based compensation expense, restructuring and other charges, losses on inventory commitments due to restructuring, litigation reserves, net, interest income and other income (expense), net. The Company does not evaluate operating segments using discrete asset information.

Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Financial information for each reportable segment and a reconciliation of segment contribution income to income before income taxes is as follows (in thousands, except percentage data):

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Net revenue:				
Retail	\$ 194,203	\$ 164,081	\$ 522,392	\$ 416,847
Commercial	73,405	65,187	215,508	200,935
Service provider	70,850	112,625	222,469	322,050
Total net revenue	338,458	341,893	960,369	939,832
Contribution income:				
Retail	\$ 23,218	\$ 21,149	\$ 73,177	\$ 53,715
Retail contribution margin	12.0 %	12.9 %	14.0 %	12.9 %
Commercial	20,216	13,700	53,604	42,507
Commercial contribution margin	27.5 %	21.0 %	24.9 %	21.2 %
Service Provider	12,872	14,819	35,582	27,472
Service Provider contribution margin	18.2 %	13.2 %	16.0 %	8.5 %
Total segment contribution income	56,306	49,668	162,363	123,694
Corporate and unallocated costs	(17,532 )	(14,363 )	(50,666 )	(39,559 )
Amortization of intangibles (1)	(4,165 )	(4,165 )	(12,496 )	(12,804 )
Stock-based compensation expense	(4,870 )	(4,111 )	(14,300 )	(12,517 )
Restructuring and other charges	130	(1,016 )	(3,859 )	(6,384 )
Losses on inventory commitments due to restructuring	—	—	—	(407 )
Litigation reserves, net	(13 )	—	(58 )	2,690
Interest income	291	65	804	184
Other income (expense), net	116	(199 )	(582 )	(67 )
Income before income taxes	\$ 30,263	\$ 25,879	\$ 81,206	\$ 54,830

(1) Amount excludes amortization expense related to patents included in cost of revenue.

The Company conducts business across three geographic regions: Americas, Europe, Middle-East and Africa (“EMEA”) and Asia Pacific (“APAC”). Net revenue by geography comprises gross revenue less such items as end-user customer rebates and other sales incentives deemed to be a reduction of net revenue per the authoritative guidance for revenue recognition, sales returns and price protection. For reporting purposes revenue is attributed to each geographic region based on the location of the customer. The following table shows net revenue by geography for the periods indicated (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
United States (U.S.)	\$ 217,631	\$ 213,913	\$ 610,505	\$ 552,787
Americas (excluding U.S.)	7,604	5,823	19,488	13,194
EMEA	60,034	77,725	176,192	234,827
APAC	\$ 53,189	\$ 44,432	\$ 154,184	\$ 139,024
Total net revenue	\$ 338,458	\$ 341,893	\$ 960,369	\$ 939,832



Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Long-lived assets include purchased intangibles, goodwill and property and equipment. The Company's property and equipment are located in the following geographic locations (in thousands):

	As of	
	October 2, 2016	December 31, 2015
United States	\$8,992	\$ 9,832
Canada	3,131	3,586
EMEA	602	468
China	4,725	6,562
APAC (excluding China)	2,026	1,936
	\$19,476	\$ 22,384

## Note 11. Fair Value Measurements (in thousands)

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of October 2, 2016:

	As of October 2, 2016			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents—money-market funds	\$10,325	\$ 10,325	\$ —	\$ —
Available-for-sale securities—U.S. treasuries (1)	127,689	127,689	—	—
Available-for-sale securities—certificates of deposit (1)	156	156	—	—
Trading securities—mutual funds (1)	1,451	1,451	—	—
Foreign currency forward contracts (2)	1,053	—	1,053	—
Total assets measured at fair value	\$140,674	\$ 139,621	\$ 1,053	\$ —

(1) Included in short-term investments on the Company's unaudited condensed consolidated balance sheet.

(2) Included in prepaid expenses and other current assets on the Company's unaudited condensed consolidated balance sheet.

	As of October 2, 2016			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Foreign currency forward contracts (3)	\$1,285	\$ —	\$ 1,285	\$ —
Total liabilities measured at fair value	\$1,285	\$ —	\$ 1,285	\$ —

(3) Included in other accrued liabilities on the Company's unaudited condensed consolidated balance sheet.

Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of December 31, 2015:

	As of December 31, 2015			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents—money-market funds	\$10,976	\$ 10,976	\$ —	\$ —
Available-for-sale securities—U.S. treasuries (1)	94,993	94,993	—	—
Available-for-sale securities—certificates of deposit (1)	147	147	—	—
Trading securities—mutual funds (1)	1,181	1,181	—	—
Foreign currency forward contracts (2)	3,205	—	3,205	—
Total assets measured at fair value	\$110,502	\$ 107,297	\$ 3,205	\$ —

(1) Included in short-term investments on the Company's unaudited condensed consolidated balance sheet.

(2) Included in prepaid expenses and other current assets on the Company's unaudited condensed consolidated balance sheet.

	As of December 31, 2015			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Foreign currency forward contracts (3)	\$451	\$ —	\$ 451	\$ —
Total liabilities measured at fair value	\$451	\$ —	\$ 451	\$ —

(3) Included in other accrued liabilities on the Company's unaudited condensed consolidated balance sheet.

The Company's investments in cash equivalents and available-for-sale securities are classified within Level 1 of the fair value hierarchy because they are valued based on quoted market prices in active markets. The Company enters into foreign currency forward contracts with only those counterparties that have long-term credit ratings of A-/A3 or higher. The Company's foreign currency forward contracts are classified within Level 2 of the fair value hierarchy as they are valued using pricing models that take into account the contract terms as well as currency rates and counterparty credit rates. The Company verifies the reasonableness of these pricing models using observable market data for related inputs into such models. Additionally, the Company includes an adjustment for non-performance risk in the recognized measure of fair value of derivative instruments. At October 2, 2016 and December 31, 2015, the adjustment for non-performance risk did not have a material impact on the fair value of the Company's foreign currency forward contracts. The carrying value of non-financial assets and liabilities measured at fair value in the financial statements on a recurring basis, including accounts receivable and accounts payable, approximate fair value due to their short maturities.

## Note 12. Shipping and Handling Fees and Costs

The Company includes shipping and handling fees billed to customers in net revenue. Shipping and handling costs associated with inbound freight are included in cost of revenue and ending inventory. Shipping and handling costs associated with outbound freight are included in sales and marketing expenses and totaled \$2.2 million and \$7.0 million for the three and nine months ended October 2, 2016, respectively, and \$2.3 million and \$7.9 million for the

three and nine months ended September 27, 2015, respectively.

Note 13. Restructuring and Other Charges

No significant restructuring and other charges or benefits were recognized during the three months ended October 2, 2016. During the nine months ended October 2, 2016, restructuring and other charges of \$3.9 million was recognized. Restructuring and other charges recognized in the second quarter of 2016 related primarily to severance as headcount reductions occurred within our commercial business unit. The headcount reductions were implemented in line with channel shift and changing buying behaviors being experienced for our commercial business unit products. Restructuring and other charges recognized in the first quarter of 2016, and the first and second quarter of 2015 respectively related to actions to resize our service provider business unit and supporting functions. The actions were taken to match the reduced revenue outlook and to concentrate resources on LTE Advanced

Table of Contents

NETGEAR, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

and long-term and profitable accounts. Charges incurred in these periods primarily related to severance, other one-time termination benefits and other associated costs attributable to the restructuring actions announced in February 2015 and January 2016, respectively. The two restructuring actions executed in the first half of 2016 were completed and the Company does not expect to incur any additional material associated charges.

Accrued restructuring and other charges are classified within other accrued liabilities in the unaudited condensed consolidated balance sheets. Amounts attributable to lease contract termination charges will be paid over the remaining lease term until January 2022.

The following table provides a summary of the activity related to accrued restructuring and other charges for the nine months ended October 2, 2016 (in thousands):

	Accrued Restructuring and Other Charges at December 31, 2015	Additions (1)	Cash Payments	Adjustments	Accrued Restructuring and Other Charges at October 2, 2016
Restructuring					
Employee termination charges	\$ 13	\$ 3,128	\$ (2,898 )	\$ (194 )	\$ 49
Lease contract termination and other charges	1,253	607	(384 )	—	1,476
Total Restructuring and other charges	\$ 1,266	\$ 3,735	\$ (3,282 )	\$ (194 )	\$ 1,525

(1) Total restructuring and other charges recognized in the Company's unaudited condensed consolidated statement of operations for the nine months ended October 2, 2016 includes non-cash charges and adjustments, net of \$0.3 million. These amounts have been excluded from the table above.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

## Forward-looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended and the Private Securities Litigation Reform Act of 1995. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, the words "believes," "anticipates," "plans," "expects," "intends," "could," "may," "will," and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a discrepancy include, but are not limited to, those discussed in "Part II—Item 1A—Risk Factors" and "Liquidity and Capital Resources" below. All forward-looking statements in this document are based on information available to us as of the date hereof and we assume no obligation to update any such forward-looking statements. The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and the accompanying notes contained in this quarterly report. Unless expressly stated or the context otherwise requires, the terms "we," "our," "us" and "NETGEAR" refer to NETGEAR, Inc. and our subsidiaries.

## Business and Executive Overview

We are a global networking company that delivers innovative products to consumers, businesses and service providers. Our products are built on a variety of proven technologies such as wireless (WiFi and LTE), Ethernet and powerline, with a focus on reliability and ease-of-use. Our product line consists of wired and wireless devices that enable networking, broadband access and network connectivity. These products are available in multiple configurations to address the needs of our end-users in each geographic region in which our products are sold.

We operate in three specific business segments: retail, commercial, and service provider. We believe this structure enables us to better focus our efforts on our core customer segments and allows us to be more nimble and opportunistic as a company overall. Each business unit contains leadership focused on the product development efforts, both from a product marketing and engineering standpoint, to service the unique needs of these customer segments. The retail business unit is focused on individual consumers and consists of high performance, dependable and easy-to-use home networking, home video security, storage and digital media products. The commercial business unit is focused on small and medium-sized businesses and consists of business networking and storage solutions that bring enterprise class functionality at an affordable price. The service provider business unit is focused on the service provider market and consists of made-to-order and retail-proven whole home networking hardware and



## Table of Contents

software solutions, as well as 4G LTE hotspots sold to service providers for sale to their subscribers. We conduct business across three geographic regions: Americas; Europe, Middle-East and Africa (“EMEA”) and Asia Pacific (“APAC”).

The retail, commercial business, and service provider markets are intensely competitive and subject to rapid technological change. We believe that the principal competitive factors in the retail, commercial, and service provider markets for networking products include product breadth, size and scope of the sales channel, brand name, timeliness of new product introductions, product availability, performance, features, functionality and reliability, ease-of-installation, maintenance and use, and customer service and support. To remain competitive, we believe we must continue to aggressively invest resources in developing new products and enhancing our current products while continuing to expand our channels and maintaining customer satisfaction worldwide.

We sell our products through multiple sales channels worldwide, including traditional retailers, online retailers, wholesale distributors, direct market resellers (“DMRs”), value-added resellers (“VARs”), and broadband service providers. Our retail channel includes traditional retail locations domestically and internationally, such as Best Buy, Costco, Fry’s Electronics, Staples, Target, Wal-Mart, Argos (U.K.), Dixons (U.K.), PC World (U.K.), MediaMarkt (Europe), Darty (France), JB HiFi (Australia), Elkjop (Norway) and Sunning and Guomei (China). Online retailers include Amazon.com worldwide, Newegg.com (US), JD.com and Alibaba (China), as well as NBB.com (Germany) and Coolblue.com (Netherlands). Our DMRs include CDW Corporation, Insight Corporation and PC Connection in domestic markets and Misco throughout Europe. In addition, we also sell our products through broadband service providers, such as multiple system operators (“MSOs”), xDSL, and other broadband technology operators domestically and internationally. Some of these retailers and broadband service providers purchase directly from us, while others are fulfilled through wholesale distributors around the world. A substantial portion of our net revenue to date has been derived from a limited number of wholesale distributors and retailers. We expect that these wholesale distributors and retailers will continue to contribute a significant percentage of our net revenue for the foreseeable future.

During the third quarter of 2016, we experienced a 1.0% decrease in net revenue compared to the third quarter of 2015, driven by an anticipated decrease in service provider net revenue, which was almost completely offset by increases in retail net revenue and, to a lesser extent, commercial business unit net revenue. Retail net revenue in the third quarter of 2016 increased 18% compared to the prior year period due to an increase in gross shipments of home security camera products, broadband gateways and home wireless products. We continue to see strong demand for our retail products, including the Nighthawk family and Arlo Smart Home cameras. Commercial net revenue in the third quarter of 2016 increased compared to the prior year period due to an increase in gross shipments of switches, partially offset by a reduction in gross shipment of network storage products. Service provider net revenue in the third quarter of 2016 decreased compared to the prior year period due primarily to a reduction in gross shipments of broadband gateways, home wireless and mobile products. As previously announced, in 2015 we began to execute on our plans to resize our service provider business for higher profitability by focusing on higher margin products and accounts while reducing the cost structure of this business unit. In line with this objective, we made further restructuring efforts in the first quarter of 2016.

On a geographic basis, net revenue increased in the Americas and APAC, offset by a decline in EMEA. The increase in Americas was driven primarily by an increase in gross shipments of our home security camera products and broadband gateways, partially offset by a decrease in gross shipments of our mobile products. The increase in APAC was driven by an increase in gross shipments of broadband gateways, switches, home wireless and home security camera products, partially offset by a reduction in gross shipments of our mobile products. The decrease in EMEA was driven primarily by a reduction in gross shipments of broadband gateways, partially offset by an increase in gross shipments of home security camera products and switches.

Looking forward, we expect growth in our retail business unit mainly driven by increasing demand for home security camera products, cable products sold in retail, WiFi high end router products and home WiFi systems. We expect growth in our commercial business unit driven by the sales of our 10Gig switches, 11 ac WLAN products and web-managed PoE. We also expect approximately \$55 million per quarter revenue run rate for the service provider business unit for the fourth quarter of 2016 and subsequent quarters as we continue to remain focused on improving profitability.

Table of Contents

## Results of Operations

The following table sets forth the unaudited condensed consolidated statements of operations for the three and nine months ended October 2, 2016, with the comparable reporting period in the preceding year.

	Three Months Ended				Nine Months Ended			
	October 2, 2016		September 27, 2015		October 2, 2016		September 27, 2015	
	(In thousands, except percentage data)							
Net revenue	\$338,458	100.0 %	\$341,893	100.0 %	\$960,369	100.0 %	\$939,832	100.0 %
Cost of revenue	235,336	69.5 %	245,566	71.8 %	658,894	68.6 %	677,569	72.1 %
Gross profit	103,122	30.5 %	96,327	28.2 %	301,475	31.4 %	262,263	27.9 %
Operating expenses:								
Research and development	21,935	6.5 %	21,572	6.3 %	65,876	6.9 %	63,126	6.7 %
Sales and marketing	37,337	11.0 %	35,923	10.5 %	110,703	11.5 %	107,538	11.5 %
General and administrative	14,111	4.2 %	11,803	3.5 %	39,995	4.2 %	33,192	3.5 %
Restructuring and other charges	(130)	0.0 %	1,016	0.3 %	3,859	0.4 %	6,384	0.7 %
Litigation reserves, net	13	0.0 %	—	— %	58	0.0 %	(2,690)	(0.3) %
Total operating expenses	73,266	21.7 %	70,314	20.6 %	220,491	23.0 %	207,550	22.1 %
Income from operations	29,856	8.8 %	26,013	7.6 %	80,984	8.4 %	54,713	5.8 %
Interest income	291	0.1 %	65	0.1 %	804	0.2 %	184	0.0 %
Other income (expense), net	116	0.0 %	(199)	(0.1) %	(582)	(0.1) %	(67)	(0.0) %
Income before income taxes	30,263	8.9 %	25,879	7.6 %	81,206	8.5 %	54,830	5.8 %
Provision for income taxes	9,144	2.7 %	10,780	3.2 %	27,464	2.9 %	28,053	3.0 %
Net income	\$21,119	6.2 %	\$15,099	4.4 %	\$53,742	5.6 %	\$26,777	2.8 %

## Net Revenue by Geographic Segment

Our net revenue consists of gross product shipments, less allowances for estimated returns for stock rotation and warranty, price protection, end-user customer rebates and other sales incentives deemed to be a reduction of net revenue per the authoritative guidance for revenue recognition, and net changes in deferred revenue.

We conduct business across three geographic regions: Americas, EMEA and APAC. For reporting purposes revenue is attributed to each geographic region based upon the location of the customer.

	Three Months Ended			Nine Months Ended		
	October 2, 2016	% Change	September 27, 2015	October 2, 2016	% Change	September 27, 2015
	(In thousands, except percentage data)					
Americas	\$225,235	2.5 %	\$219,736	\$629,993	11.3 %	\$565,981
Percentage of net revenue	66.6 %		64.3 %	65.6 %		60.2 %
EMEA	\$60,034	(22.8) %	\$77,725	\$176,192	(25.0) %	\$234,827
Percentage of net revenue	17.7 %		22.7 %	18.3 %		25.0 %
APAC	\$53,189	19.7 %	\$44,432	\$154,184	10.9 %	\$139,024
Percentage of net revenue	15.7 %		13.0 %	16.1 %		14.8 %
Total net revenue	\$338,458	(1.0) %	\$341,893	\$960,369	2.2 %	\$939,832

## Americas

The increase in America's net revenue for the three months ended October 2, 2016 compared to the prior year period was attributable to increases in gross shipments of our home security cameras, broadband gateways and switch

products. The increase was partially offset by decreases in mobile and home wireless product sales to service provider business unit customers. The increase in Americas net revenue for the nine months ended October 2, 2016 compared to the prior year period was driven primarily by an increase in gross shipments of our home security cameras, broadband gateways and switch products, partially offset by a decrease in gross shipments of our mobile products. The increase was primarily due to continued growth in the retail business unit

Table of Contents

driven by strong demand for our products, including the Nighthawk family and Arlo Smart Home cameras. The increase was partially offset by a reduction in service provider net revenues. Service provider net revenue fell versus the prior year period as we continue to prioritize profitability with respect to service provider business opportunities.

## EMEA

The decrease in EMEA net revenue for the three and nine months ended October 2, 2016 compared to the prior year periods was primarily attributable to the performance of our service provider business unit. The steps taken to restructure the service provider business unit in the first and second quarter of 2015 and again in the first quarter of 2016 was primarily responsible for the fall, resulting in a reduction of gross shipments of broadband gateways. By contrast, in the three and nine months ended October 2, 2016 the fall in service provider net revenue was partially offset by growth in both our retail and commercial business units which saw an increase in gross shipments of home security camera products and switches.

## APAC

The increase in APAC net revenue for the three and nine months ended October 2, 2016 compared to the prior year periods was driven primarily by an increase in gross shipments of broadband gateways, switches, home wireless and home security camera products, partially offset by a reduction in gross shipments of our mobile products. The increased net revenue in the three months ended October 2, 2016 was due to improved performance across all three business units with the majority of growth derived from our service provider business unit. The increase in net revenue during the nine months ended October 2, 2016 compared to the prior year period was driven by improved performance in our service provider and commercial business units, partially offset by a slight reduction in our retail business unit.

## Cost of Revenue and Gross Margin

Cost of revenue consists primarily of the following: the cost of finished products from our third party contract manufacturers; overhead costs, including purchasing, product planning, inventory control, warehousing and distribution logistics; third-party software licensing fees; inbound freight and duty; warranty costs associated with returned goods; write-downs for excess and obsolete inventory; amortization expense of certain acquired intangibles and restructuring accounting adjustments to inventory.

We outsource our manufacturing, warehousing and distribution logistics. We believe this outsourcing strategy allows us to better manage our product costs and gross margin. Our gross margin can be affected by a number of factors, including fluctuation in foreign exchange rates, sales returns, changes in average selling prices, end-user customer rebates and other sales incentives, changes in our cost of goods sold due to fluctuations in prices paid for components, net of vendor rebates, warranty and overhead costs, inbound freight and duty, conversion costs, charges for excess or obsolete inventory and amortization of acquired intangible assets. The following table presents costs of revenue and gross margin, for the periods indicated:

	Three Months Ended		Nine Months Ended				
	October 2,	%	September 27,	October 2,	%	September 27,	
	2016	Change	2015	2016	Change	2015	
	(In thousands, except percentage data)						
Cost of revenue	\$235,336	(4.2 )%	\$ 245,566	\$658,894	(2.8 )%	\$ 677,569	
Gross margin percentage	30.5	%	28.2	%	31.4	%	27.9

## Cost of Revenue

Cost of revenue fell in the three and nine months ended October 2, 2016 compared to the prior year periods. The fall in cost of revenue is primarily attributable to the shift in net revenue away from our service provider business unit toward the retail business unit. Cost of revenue associated with retail business unit products represents a lower proportion of net revenue than service provider business unit products. In the three months ended October 2, 2016 this net revenue shift was further assisted by improved gross margin performance of the commercial business unit.

#### Gross Margin

Our gross margin increased for the three and nine months ended October 2, 2016 compared to the prior year periods. In the three months ended October 2, 2016 higher gross margin yield and higher net revenue performance in the commercial business unit along with a shift in revenue mix from service provider to retail drove improved gross margin achievement compared to the prior year period. For the nine month period ended October 2, 2016 the change in business unit net revenue mix from service provider to retail is the primary driver of improved gross margin performance compared to the prior year period. Additionally,

Table of Contents

gross margins for the nine months ended October 2, 2016 were positively impacted by the reversal in first quarter 2016 of a \$3.3 million charge recorded previously against net revenue. The charge was originally recorded in the second quarter of 2015 and related to an anticipated credit to a customer to resolve a disputed quality issue. We no longer believe there to be a quality issue after obtaining two independent party reports, and consequently the full amount of this charge was reversed in the three months ended April 3, 2016.

We expect gross margin achievement will increase versus the prior year for the remainder of 2016. Forecasting future gross margin percentages is difficult, and there are a number of risks related to our ability to maintain or improve our current gross margin levels. Our cost of revenues as a percentage of revenues can vary significantly based upon a number of factors such as the following: uncertainties surrounding revenue levels, including future pricing and/or potential discounts as a result of the economy or in response to the strengthening of the U.S. dollar in our international markets, and related production level variances; competition; changes in technology; changes in product mix; variability of stock-based compensation costs; royalties to third parties; fluctuations in freight, duty and repair costs; manufacturing and purchase price variances; changes in prices on commodity components; warranty costs; and the timing of sales, particularly to service providers.

## Operating Expenses

## Research and Development

Research and development expenses consist primarily of personnel expenses, payments to suppliers for design services, safety and regulatory testing, product certification expenditures to qualify our products for sale into specific markets, prototypes and other consulting fees. Research and development expenses are recognized as they are incurred. We have invested in building our research and development organization to enhance our ability to introduce innovative and easy-to-use products. The following table presents research and development expense, for the periods indicated:

	Three Months Ended		Nine Months Ended		
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015	
	%	Change	%	Change	
Research and development expense	\$21,935	1.7 %	\$ 21,572	\$65,876	4.4 %
				\$ 63,126	

(In thousands, except percentage data)

Research and development for the three months ended October 2, 2016 slightly increased year over year. The increase was attributable to increased personnel-related expense of \$0.4 million driven by additional headcount and increased variable compensation of \$0.3 million offset by lower outside engineering services of \$0.5 million. Outside engineering expenses in the three months ended October 2, 2016 decreased as a result of reduced revenue expectations for our service provider business unit on a year over year basis.

Research and development expense increased for the nine months ended October 2, 2016 compared to the prior year period due primarily to increases in variable compensation of \$3.2 million and personnel-related expense of \$1.1 million driven by additional headcount. The increase was partially offset primarily by a \$1.4 million reduction in outside engineering services mainly associated with our service provider business unit.

We believe that innovation and technological leadership is critical to our future success, and we are committed to continuing a significant level of research and development to develop new technologies and products to combat competitive pressures. We continue to invest in research and development to expand our cloud platform capabilities, grow our home security camera and home automation device portfolio, and develop innovative WiFi and LTE Advanced coverage solutions. For the remainder of 2016, we expect research and development expenses to grow in absolute dollars as we are allocating resources in the key areas that we expect will drive future growth and profitability. Research and development expenses will fluctuate depending on the timing and number of development activities in any given quarter and could vary significantly as a percentage of revenue, depending on actual revenues achieved in any given quarter.

## Sales and Marketing

Sales and marketing expenses consist primarily of advertising, trade shows, corporate communications and other marketing expenses, product marketing expenses, outbound freight costs, amortization expenses, personnel expenses for sales and marketing staff and technical support expenses. The following table presents sales and marketing expense, for the periods indicated:

36

---



Table of Contents

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
	%	Change	%	Change
	(In thousands, except percentage data)			
Sales and marketing expense	\$37,337	3.9 %	\$ 35,923	\$ 110,703 2.9 % \$ 107,538

Sales and marketing expense increased for the three months ended October 2, 2016 compared to the prior year period. The increase was attributable to an increase in product marketing expense of \$2.7 million relating to marketing campaigns to enhance consumer knowledge of our brand and product offerings, partially offset by a decrease in outside service of \$1.5 million mainly as a result of lower call center costs.

Sales and marketing expense increased for the nine months ended October 2, 2016 compared to the prior year period. The increase was mainly attributable to increases in product marketing expense of \$2.7 million, variable compensation of \$1.4 million and personnel-related costs of \$1.1 million, partially offset by a reduction in outside service of \$1.5 million mainly as a result of lower call center costs.

We expect our sales and marketing expense for the remainder of 2016 to remain relatively flat as a percentage of net revenue while we continue to adjust our sales coverage to better align with our 2016 net revenue outlook. Expenses may fluctuate depending on revenue levels achieved as certain expenses, such as commissions, are determined based upon the revenues achieved. Forecasting sales and marketing expenses as a percentage of revenues is highly dependent on expected revenue levels and could vary significantly depending on actual revenues achieved in any given quarter. Marketing expenses will also fluctuate depending upon the timing, extent and nature of marketing programs.

## General and Administrative

General and administrative expenses consist of salaries and related expenses for executives, finance and accounting, human resources, information technology, professional fees, including legal costs associated with defending claims against us, allowance for doubtful accounts and other general corporate expenses. The following table presents general and administrative expense, for the periods indicated:

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
	%	Change	%	Change
	(In thousands, except percentage data)			
General and administrative expense	\$14,111	19.6 %	\$ 11,803	\$39,995 20.5 % \$ 33,192

General and administrative expense increased for the three months ended October 2, 2016 compared to the prior year period mainly due to increases in personnel related expense of \$0.8 million, variable compensation costs of \$0.6 million and outside professional service of \$0.6 million.

General and administrative expense increased for the nine months ended October 2, 2016 compared to the prior year period mainly due to increases in variable compensation costs of \$2.7 million, personnel related expense of \$2.0 million and outside professional service of \$1.0 million.

We expect our general and administrative expenses to remain flat as a percentage of net revenue in the remainder of 2016 but they could fluctuate depending on a number of factors, including the level and timing of expenditures associated with litigation defense costs in connection with the litigation described in Note 7, Commitments and Contingencies, in the notes to unaudited condensed consolidated financial statements. Future general and administrative expense increases or decreases in absolute dollars are difficult to predict due to the lack of visibility of certain costs, including legal costs associated with defending claims against us, as well as legal costs associated with asserting and enforcing our intellectual property portfolio and other factors.

## Restructuring and Other Charges

Edgar Filing: NETGEAR, INC - Form 10-Q

	Three Months Ended		Nine Months Ended	
	October 2, 2016	% Change	September 27, 2015	October 2, 2016
				Change
				2015
	(In thousands, except percentage data)			
Restructuring and other charges	\$ (130)	**	\$ 1,016	\$ 3,859 (39.6)%
				\$ 6,384

\*\*Percentage change not meaningful.

Table of Contents

No significant restructuring and other charges or benefits were recognized during the three months ended October 2, 2016. During the nine months ended October 2, 2016, restructuring and other charges of \$3.9 million was recognized. Restructuring and other charges recognized in the second quarter of 2016 related primarily to severance as headcount reductions occurred within our commercial business unit. The headcount reductions were implemented in line with channel shift and changing buying behaviors being experienced for our commercial business unit products. Restructuring and other charges recognized in the first quarter of 2016, and the first and second quarter of 2015 respectively related to actions to resize our service provider business unit and supporting functions. The actions were taken to match the reduced revenue outlook and to concentrate resources on LTE Advanced and long-term and profitable accounts. Charges incurred in these periods primarily related to severance, other one-time termination benefits and other associated costs attributable to the restructuring actions announced in February 2015 and January 2016, respectively.

The two restructuring actions executed in the first half of 2016 were completed and management does not expect to incur any additional material associated charges. Restructuring actions are subject to significant risks, including delays in implementing expense control programs or workforce reductions and the failure to meet operational targets due to the loss of employees, all of which would impair our ability to achieve anticipated cost reductions. If we do not achieve anticipated cost reductions, our financial results could be negatively impacted.

For further discussion of restructuring and other charges, refer to Note 13, Restructuring and Other Charges, of the notes to unaudited condensed consolidated financial statements.

## Litigation Reserves, Net

	Three Months Ended		Nine Months Ended	
	October 2, 2016 % Change	September 27, 2015	October 2, 2016 % Change	September 27, 2015
	(In thousands, except percentage data)			
Litigation reserves, net	\$ 13 **	\$	—\$58 **	\$ (2,690 )

\*\*Percentage change not meaningful.

No significant litigation reserves or benefits were recognized during the three and nine months ended October 2, 2016. By contrast, we recognized a benefit of \$2.7 million during the nine months ended September 27, 2015 resulting from adjustments recorded to release accrued litigation reserves associated with the Ericsson patent litigation matter.

For a detailed discussion of our litigation matters, refer to Note 7, Commitments and Contingencies, in the notes to unaudited condensed consolidated financial statements.

## Interest Income and Other Income (Expense), Net

Interest income represents amounts earned on our cash, cash equivalents and short-term investments. Other income (expense), net primarily represents gains and losses on transactions denominated in foreign currencies and other miscellaneous income and expenses. The following table presents interest income and other income (expense), net, for the periods indicated:

	Three Months Ended		Nine Months Ended	
	October 2, 2016 % Change	September 27, 2015	October 2, 2016 Change	September 27, 2015
	(In thousands, except percentage data)			
Interest income	\$291 **	\$ 65	\$804 **	\$ 184
Other income (expense), net	116 **	(199 )	(582 ) **	(67 )
Total interest income and other income (expense), net	\$407 **	\$ (134 )	\$222 89.7 %	\$ 117

\*\*Percentage change not meaningful.

Interest income increased for the three and nine months ended October 2, 2016 compared to the prior year periods due to increases in both short term investment average balances and yields obtained on such balances being more favorable than the prior year periods.

No significant other income (expense) was recognized during the three months ended October 2, 2016 and the three and nine months ended September 27, 2015. The expense in the nine months ended October 2, 2016 primarily related to impairment of a receivable from sale of cost method investment. Our foreign currency hedging program effectively reduced volatility associated

38

---

Table of Contents

with hedged currency exchange rate movements during the three and nine months ended October 2, 2016. For a detailed discussion of our hedging program and related foreign currency contracts, refer to Note 4, Derivative Financial Instruments, in the notes to unaudited condensed consolidated financial statements.

## Provision for Income Taxes

	Three Months Ended			Nine Months Ended		
	October 2, 2016	September 27, 2015	Change	October 2, 2016	September 27, 2015	Change
	(In thousands, except percentage data)					
Provision for income taxes	\$9,144	\$ 10,780	(15.2)%	\$27,464	\$ 28,053	(2.1)%
Effective tax rate	30.2 %	41.7 %		33.8 %	51.2 %	

The decrease in the effective tax rate for the three and nine months ended October 2, 2016 compared to the three and nine months ended September 3, 2015 was partly due to changes in earnings incurred in a jurisdiction where a loss was not tax benefited for the three and nine months ended September 3, 2015. For the three and nine months ended September 3, 2015, the forecasted loss from this jurisdiction was excluded from the determination of tax expense. For the three and nine months ended October 2, 2016, we did not exclude any jurisdictions from the determination of tax expense. The decrease was also due to a \$1.8 million non-recurring tax benefit related to a change in estimate during the three and nine months ended October 2, 2016. We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Our future foreign tax rate could be affected by changes in the composition in earnings in countries with tax rates differing from the U.S. federal rate. We are under examination in various U.S. and foreign jurisdictions.

## Segment Information

A description of our products and services, as well as segment financial data, for each segment and a reconciliation of segment contribution income to income before income taxes can be found in Note 10, Segment Information and Operations by Geographic Area, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

## Retail

	Three Months Ended			Nine Months Ended		
	October 2, 2016	September 27, 2015	Change	October 2, 2016	September 27, 2015	Change
	(in thousands, except percentage data)					
Net revenue	\$194,203	\$ 164,081	18.4 %	\$522,392	\$ 416,847	25.3 %
Percentage of net revenue	57.4 %	48.0 %		54.4 %	44.3 %	
Contribution income	\$23,218	\$ 21,149	9.8 %	\$73,177	\$ 53,715	36.2 %
Contribution margin	12.0 %	12.9 %		14.0 %	12.9 %	

Retail net revenue increased for the three and nine months ended October 2, 2016 compared to the prior year periods primarily due to an increase in gross shipments of home security camera products, broadband gateways and home wireless products. Geographically, retail business unit net revenue grew across all three regions for the three months ended October 2 2016 while in the nine months ended October 2, 2016 both the Americas and EMEA regions grew while the APAC region net revenue fell slightly. End user demand for our premium range of retail products such as Arlo Smart Home cameras and Nighthawk series continues to be robust.

Contribution income increased for the three and nine months ended October 2, 2016 compared to the prior year periods primarily due to growth in net revenue. Contribution margin for the three months ended October 2, 2016 decreased slightly compared to the prior year period mainly due to increased investment in research and development of \$2.2 million, sales and marketing expenditure of \$2.3 million mainly relating to marketing campaigns to enhance consumer knowledge of our brand and product offerings, partially offset by a reduction in air freight costs incurred of

\$2.5 million. Contribution margin for the nine months ended October 2, 2016 increased compared to the prior year period as our strategy of pursuing higher average selling prices resulted in higher gross margins and profitability for the retail business unit.

Table of Contents

## Commercial

	Three Months Ended			Nine Months Ended			
	October 2, 2016	% Change	September 27, 2015	October 2, 2016	% Change	September 27, 2015	
	(in thousands, except percentage data)						
Net revenue	\$73,405	12.6 %	\$ 65,187	\$215,508	7.3 %	\$ 200,935	
Percentage of net revenue	21.7 %		19.1 %	22.4 %		21.4 %	
Contribution income	\$20,216	47.6 %	\$ 13,700	\$53,604	26.1 %	\$ 42,507	
Contribution margin	27.5 %		21.0 %	24.9 %		21.2 %	

Commercial net revenue increased for the three and nine months ended October 2, 2016 compared to the prior year periods due to increased gross shipments of switches, partially offset by a reduction in gross shipments of network storage products. Geographically, we experienced growth in all three regions.

Contribution income increased for the three and nine months ended October 2, 2016 compared to the prior year periods as growth in both net revenue and gross margin yield improved profitability versus the prior year periods. In addition, the growth in net revenue did not require corresponding investment in operating expense resulting in greater contribution income return.

## Service Provider

	Three Months Ended			Nine Months Ended			
	October 2, 2016	% Change	September 27, 2015	October 2, 2016	% Change	September 27, 2015	
	(in thousands, except percentage data)						
Net revenue	\$70,850	(37.1)%	\$ 112,625	\$222,469	(30.9)%	\$ 322,050	
Percentage of net revenue	20.9 %		32.9 %	23.2 %		34.3 %	
Contribution income	\$12,872	(13.1)%	\$ 14,819	\$35,582	29.5 %	\$ 27,472	
Contribution margin	18.2 %		13.2 %	16.0 %		8.5 %	

Service provider net revenue decreased for the three and nine months ended October 2, 2016 compared to the prior year periods due primarily to a reduction in gross shipments of broadband gateways, home wireless and mobile products. Geographically, we experienced a reduction in service provider net revenue in EMEA and the Americas. The reduction was partially offset by growth in APAC. As previously announced, we took steps to restructure the service provider business unit in the first and second quarter of 2015 and again in the first quarter of 2016. The actions were taken to match the reduced revenue outlook and to concentrate resources on LTE Advanced and long-term and profitable accounts.

Contribution margin increased for the three and nine months ended October 2, 2016 compared to the prior year periods as restructuring efforts taken yielded additional contribution income through reductions in operating expenses combined with higher gross margin achievement. On a year over year basis, operating expenses decreased approximately 45% as a result of headcount reduction. In addition the continued focus on higher margin products and accounts resulted in higher gross margin yield assisting in higher contribution income performance. Contribution income for the nine months ended October 2, 2016 was further positively impacted by the reversal of the \$3.3 million charge recorded against net revenue in the second quarter of 2015. The charge related to an anticipated credit to a customer to resolve a disputed quality issue. We no longer believe there to be a quality issue after obtaining two independent party reports, and consequently the full amount of this charge was reversed in the first quarter of 2016.

## Liquidity and Capital Resources

Our cash and cash equivalents balance increased from \$181.9 million as of December 31, 2015 to \$273.7 million as of October 2, 2016. Our short-term investments, which represent the investment of funds available for current operations, increased from \$96.3 million as of December 31, 2015 to \$129.3 million as of October 2, 2016 as we increased purchases of Treasuries. Operating activities during the nine months ended October 2, 2016 provided cash of \$131.0

million, compared to \$115.7 million provided in the nine months ended September 27, 2015, resulting from the increased net income, partially offset by changes in working capital. Cash used in investing activities increased by \$83.4 million mainly due to more purchase of short-term investments along with less proceeds from sales and maturities of short-term investments. Cash used in financing activities decreased by \$98.6



Table of Contents

million primarily due to less repurchases of common stock along with higher proceeds from the issuance of common stock upon exercise of stock options.

Our days sales outstanding ("DSO") was 63 days as of October 2, 2016, which decreased from 77 days as of December 31, 2015. DSO as of December 31, 2015 was higher due to seasonal payment terms extended to our larger retail customers. As of October 2, 2016 we have returned to a more normal range of DSO as these extended terms are no longer applicable. Additionally, the reduction in service provider net revenue contributed to DSO improvement as the standard payment terms with service provider customers is significantly longer than our standard payment terms for our other customers.

Our accounts payable increased from \$90.5 million at December 31, 2015 to \$96.0 million at October 2, 2016. The increase was primarily attributable to timing of payments.

Inventory increased from \$213.1 million at December 31, 2015 to \$217.6 million at October 2, 2016. In the three months ended October 2, 2016, we experienced annualized ending inventory turns of approximately 4.3, down from 4.8 turns in the three months ended December 31, 2015.

We enter into foreign currency forward-exchange contracts, which typically mature in two to nine months, to hedge a portion of our exposure to foreign currency fluctuations of foreign currency-denominated revenue, costs of revenue, certain operating expenses, receivables, payables, and cash balances. We record, in the unaudited condensed consolidated balance sheet at each reporting period, the fair value of our forward-exchange contracts and record any fair value adjustments in our unaudited condensed consolidated statements of operations and in our unaudited condensed consolidated balance sheet. Gains and losses associated with currency rate changes on hedge contracts that are non-designated under the authoritative guidance for derivatives and hedging are recorded within other income (expense), net, offsetting foreign exchange gains and losses on our monetary assets and liabilities. Gains and losses associated with currency rate changes on hedge contracts that are cash flow hedges under the authoritative guidance for derivatives and hedging are recorded within accumulated other comprehensive income until the related revenue, costs of revenue, or expenses are recognized.

From time to time, our Board of Directors has authorized programs under which we may repurchase shares of our common stock, depending on market conditions, in the open market or through privately negotiated transactions. Under these authorizations, the timing and actual number of shares subject to repurchase are at the discretion of management and are contingent on a number of factors, such as levels of cash generation from operations, cash requirements for acquisitions and the price of our common stock. During the nine months ended October 2, 2016, we repurchased and retired, reported based on trade date, approximately 0.6 million shares of common stock at a cost of \$23.3 million. During the nine months ended September 27, 2015, we repurchased and retired, reported based on trade date, 3.4 million shares of common stock at a cost of \$105.2 million. As of October 2, 2016, 1.6 million shares remained authorized for repurchase under the repurchase program approved by the Board in July 2015. All shares authorized under previously approved programs were fully utilized. We plan to continue to repurchase shares opportunistically.

We repurchased, as reported based on trade date, approximately 99,000 shares of common stock at a cost of \$4.4 million under a repurchase program to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving restricted stock units ("RSUs") during the nine months ended October 2, 2016. Similarly, during the nine months ended September 27, 2015, we repurchased approximately 77,000 shares of our common stock at a cost of \$2.4 million under the same program to help facilitate tax withholding for RSUs. These shares were retired upon repurchase.

Based on our current plans and market conditions, we believe that our existing cash, cash equivalents and short-term investments will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months. However, we may require or desire additional funds to support our operating expenses and capital requirements or for other purposes, such as acquisitions, and may seek to raise such additional funds through public or private equity

financing or from other sources. We cannot assure you that additional financing will be available at all or that, if available, such financing would be obtainable on terms favorable to us and would not be dilutive. Our future liquidity and cash requirements will depend on numerous factors, including the introduction of new products and potential acquisitions of related businesses or technology.

#### Contractual Obligations

There have been no material changes during the nine months ended October 2, 2016 to the contractual obligations disclosed in Part II, Item 7, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

We lease office space, cars and equipment under non-cancelable operating leases with various expiration dates through December 2026. The terms of certain of our facility leases provide for rental payments on a graduated scale. We recognize rent expense on a straight-line basis over the lease period and have accrued for rent expense incurred but not paid.

## Table of Contents

We enter into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of the orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31 to 45 days prior to the expected shipment date. Orders are non-cancelable within 30 days prior to the expected shipment date. As of October 2, 2016, we had approximately \$161 million in non-cancelable purchase commitments with suppliers. We establish a loss liability for all products we do not expect to sell for which we have committed purchases from suppliers. Such losses have not been material to date. From time to time our suppliers procure unique complex components on our behalf. If these components do not meet specified technical criteria or are defective, we should not be obligated to purchase the materials. However, disputes may arise as a result and significant resources may be spent resolving such disputes.

As of October 2, 2016, we had \$15.6 million of total gross unrecognized tax benefits and related interest. The timing of any payments that could result from these unrecognized tax benefits will depend upon a number of factors. The possible reduction in liabilities for uncertain tax positions in multiple jurisdictions that may impact the statement of operations in the next 12 months is approximately \$0.7 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

### Off-Balance Sheet Arrangements

As of October 2, 2016, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

### Critical Accounting Policies and Estimates

For a complete description of what we believe to be the critical accounting policies and estimates used in the preparation of our unaudited condensed consolidated financial statements, refer to our Annual Report on Form 10-K for the year ended December 31, 2015. There have been no changes to our critical accounting policies and estimates during the nine months ended October 2, 2016.

### Recent Accounting Pronouncements

See Note 2, Summary of Significant Accounting Policies, in Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Report on Form 10-Q, for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on financial condition and results of operations, which are hereby incorporated by reference.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

During the nine months ended October 2, 2016, there were no material changes to our market risk disclosures as set forth in Part II Item 7A "Quantitative and Qualitative Disclosures About Market Risk" in our Annual Report on Form 10-K for the year ended December 31, 2015.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

Based on an evaluation under the supervision and with the participation of our management (including our Chief Executive Officer and Chief Financial Officer), our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), were effective as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to management, including our Chief Executive Officer and our Chief Financial

Officer, as appropriate to allow timely decisions regarding required disclosures.

42

---

Table of Contents

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially effect, our internal control over financial reporting. It should be noted that any system of controls, however well designed and operated, can provide only reasonable assurance, and not absolute assurance, that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals in all future circumstances.

Table of Contents

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

The information set forth under Note 7, Commitments and Contingencies, in Item 1 of Part I of this Quarterly Report on Form 10-Q, is incorporated herein by reference. For an additional discussion of certain risks associated with legal proceedings, see the section entitled "Risk Factors" in Part II, Item 1A of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

Investing in our common stock involves a high degree of risk. The risks described below are not exhaustive of the risks that might affect our business. Other risks, including those we currently deem immaterial, may also impact our business. Any of the following risks could materially adversely affect our business operations, results of operations and financial condition and could result in a significant decline in our stock price. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the unaudited condensed consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q

We have marked with an asterisk (\*) those risks described below that reflect substantive changes from the risks described under Part I, Item 1A "Risk Factors" included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 19, 2016.

\* We expect our operating results to fluctuate on a quarterly and annual basis, which could cause our stock price to fluctuate or decline.

Our operating results are difficult to predict and may fluctuate substantially from quarter-to-quarter or year-to-year for a variety of reasons, many of which are beyond our control. If our actual results were to fall below our estimates or the expectations of public market analysts or investors, our quarterly and annual results would be negatively impacted and the price of our stock could decline. Other factors that could affect our quarterly and annual operating results include those listed in the risk factors section of this report and others such as:

• changes in the pricing policies of or the introduction of new products by us or our competitors;

• slow or negative growth in the networking product, personal computer, Internet infrastructure, Smart Home, home electronics and related technology markets, as well as decreased demand for Internet access;

• seasonal shifts in end market demand for our products, particularly in our retail business;

• delays in the introduction of new products by us or market acceptance of these products;

• shift in overall product mix sales from higher to lower margin products, or from one business unit to another, that would adversely impact our margins;

• component supply constraints from our vendors;

• unanticipated increase in costs, including air freight, associated with shipping and delivery of our products;

• delay or failure of our service provider customers to purchase at the volumes that they forecast;

foreign currency exchange rate fluctuations in the jurisdictions where we transact sales and expenditures in local currency;

unfavorable level of inventory and turns;

changes in or consolidation of our sales channels and wholesale distributor relationships or failure to manage our sales channel inventory and warehousing requirements;

delay or failure to fulfill orders for our products on a timely basis;

Table of Contents

- changes in international trade policy that adversely affect customs, tax or duty rates, including consequences of the recent "Brexit" referendum in the United Kingdom;
- operational disruptions, such as transportation delays or failure of our order processing system, particularly if they occur at the end of a fiscal quarter;
- disruptions or delays related to our financial and enterprise resource planning systems;
- our inability to accurately forecast product demand, particularly from our service provider sales channel, resulting in increased inventory exposure;
- the inability to maintain stable operations by our suppliers and other parties with which we have commercial relationships;
- allowance for bad debts exposure with our existing customers and new customers, particularly as we expand into new international markets;
- unanticipated shift or decline in profit by geographical region that would adversely impact our tax rate;
- geopolitical disruption leading to delay or even stoppage of our operations in manufacturing, transportation, technical support and research and development;
- terms of our contracts with customers or suppliers that cause us to incur additional expenses or assume additional liabilities;
- an increase in price protection claims, redemptions of marketing rebates, product warranty and stock rotation returns or allowance for doubtful accounts;
- litigation involving alleged patent infringement;
- epidemic or widespread product failure, or unanticipated safety issues, in one or more of our products;
- challenges associated with integrating acquisitions that we make, or with realizing value from our strategic investments in other companies;
- failure to effectively manage our third party customer support partners, which may result in customer complaints and/or harm to the NETGEAR brand;
- our inability to monitor and ensure compliance with our anti-corruption compliance program and domestic and international anti-corruption laws and regulations, whether in relation to our employees or with our suppliers or customers;
- labor unrest at facilities managed by our third-party manufacturers;
- our failure to implement and maintain the appropriate internal controls over financial reporting which may result in restatements of our financial statements; and
- any changes in accounting rules.



As a result, period-to-period comparisons of our operating results may not be meaningful, and you should not rely on them as an indication of our future performance.

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 securities of technology and other companies, which may be unrelated to the financial performance of these companies. These broad market fluctuations may negatively affect the market price of our common stock.

Table of Contents

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 our competitors' operating results;
- actual or anticipated changes in the growth rate of the general networking sector, our growth rates or our competitors' growth rates;
- conditions in the financial markets in general or changes in general economic conditions, including government efforts to stabilize currencies;
- interest rate or currency exchange rate fluctuations;
- our ability to forecast or report accurate financial results; and
- changes in stock market analyst recommendations regarding our common stock, other comparable companies or our industry generally.

\* If we fail to continue to introduce or acquire new products that achieve broad market acceptance on a timely basis, we will not be able to compete effectively and we will be unable to increase or maintain net revenue and gross margins.

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop or acquire, and introduce new products that achieve broad market acceptance. Our future success will depend in large part upon our ability to identify demand trends in the commercial business, retail, and service provider markets and quickly develop or acquire, and manufacture and sell products that satisfy these demands in a cost effective manner. In order to differentiate our products from our competitors' products, we must continue to increase our focus and capital investment in research and development, including software development. For example, we have committed a substantial amount of resources to the development, manufacture and sale of our Nighthawk series and Arlo Smart Home camera products and to introducing additional and improved models in these lines, as well as the recent introduction of our Orbi products. If these products do not achieve or continue to achieve widespread market acceptance, or if we are unsuccessful in capitalizing on other Smart Home market opportunities, our future growth may be slowed and our financial results could be harmed. Successfully predicting demand trends is difficult, and it is very difficult to predict the effect that introducing a new product will have on existing product sales. We will also need to respond effectively to new product announcements by our competitors by quickly introducing competitive products.

In addition, we have acquired companies and technologies in the past and as a result, have introduced new product lines in new markets. We may not be able to successfully manage integration of the new product lines with our existing products. Selling new product lines in new markets will require our management to learn different strategies in order to be successful. We may be unsuccessful in launching a newly acquired product line in new markets which requires management of new suppliers, potential new customers and new business models. Our management may not have the experience of selling in these new markets and we may not be able to grow our business as planned. For example, in April 2013, we completed the acquisition of the AirCard product line from Sierra Wireless. Similarly, we acquired certain technology and intellectual property in connection with our acquisition of AVAAK, Inc. in July 2012 that has been key to the development of our Arlo Smart Home camera products. If we are unable to effectively and successfully further develop these new product lines, we may not be able to increase or maintain our sales and our gross margins may be adversely affected.

We have experienced delays and quality issues in releasing new products in the past, which resulted in lower quarterly net revenue than expected. In addition, we have experienced, and may in the future experience, product introductions that fall short of our projected rates of market adoption. Online Internet reviews of our products are increasingly becoming a significant factor in the success of our new product launches, especially in the retail business unit. If we are unable to quickly respond to negative reviews, including end user reviews posted on various prominent online retailers, our ability to sell these products will be harmed. Any future delays in product development and introduction, or product introductions that do not meet broad market acceptance, or unsuccessful launches of new product lines could result in:

- loss of or delay in revenue and loss of market share;
- negative publicity and damage to our reputation and brand;
- a decline in the average selling price of our products;

Table of Contents

adverse reactions in our sales channels, such as reduced shelf space, reduced online product visibility, or loss of sales channel; and

increased levels of product returns.

Throughout the past few years, we have significantly increased the rate of our new product introductions. If we cannot sustain that pace of product introductions, either through rapid innovation or acquisition of new products or product lines, we may not be able to maintain or increase the market share of our products. In addition, if we are unable to successfully introduce or acquire new products with higher gross margins, our net revenue and overall gross margin would likely decline.

\* We rely on a limited number of traditional and online retailers, wholesale distributors and service provider customers for a substantial portion of our sales, and our net revenue could decline if they refuse to pay our requested prices or reduce their level of purchases or if there is significant consolidation in our customer base which results in fewer customers for our products.

We sell a substantial portion of our products through traditional and online retailers, including Best Buy Co., Inc., Amazon.com, Inc. and their affiliates, wholesale distributors, including Ingram Micro, Inc. and Tech Data Corporation, and service providers, such as AT&T. We expect that a significant portion of our net revenue will continue to come from sales to a small number of customers for the foreseeable future. In addition, because our accounts receivable are often concentrated with a small group of purchasers, the failure of any of them to pay on a timely basis, or at all, would reduce our cash flow. We are also exposed to increased credit risk if any one of these limited numbers of customers fails or becomes insolvent. We generally have no minimum purchase commitments or long-term contracts with any of these customers. These purchasers could decide at any time to discontinue, decrease or delay their purchases of our products. If our customers increase the size of their product orders without sufficient lead-time for us to process the order, our ability to fulfill product demands would be compromised. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. Accordingly, the prices that they pay for our products are subject to negotiation and could change at any time. Our ability to maintain strong relationships with our principal customers is essential to our future performance. If any of our major customers reduce their level of purchases or refuse to pay the prices that we set for our products, our net revenue and operating results could be harmed. Our traditional retail customers have faced increased and significant competition from online retailers, and some of these traditional retail customers have increasingly become a smaller portion of our business. If key retail customers continue to reduce their level of purchases, our business could be harmed.

Additionally, consolidation among our customer base may allow certain customers to command increased leverage in negotiating prices and other terms of sale, which could adversely affect our profitability. In addition, if, as a result of increased leverage, customer pressures require us to reduce our pricing such that our gross margins are diminished, we could decide not to sell our products to a particular customer, which could result in a decrease in our revenue. Consolidation among our customer base may also lead to reduced demand for our products, elimination of sales opportunities, replacement of our products with those of our competitors and cancellations of orders, each of which would harm our operating results. Consolidation among our service provider customers worldwide may also make it more difficult to grow our service provider business, given the fierce competition for the already limited number of service providers worldwide and the long sales cycles to close deals. For example, in June 2013, Liberty Global, a service provider with operations worldwide, completed its acquisition of Virgin Media Limited, one of our significant historical customers. Because we have not conducted business with Liberty Global in the past, it directed Virgin Media to develop relationships and business with other Liberty Global vendors, many of which are our competitors. This situation has contributed to a substantial reduction in purchases of our products by Virgin Media Limited in

2016. In addition, in May 2016, Charter Communications completed its acquisitions of Time Warner Cable and Bright House Networks. If consolidation among our customer base becomes more prevalent, our operating results may be harmed.

If we fail to overcome the challenges associated with managing our broadband service provider sales channel, our net revenue and gross profit will be negatively impacted.

We sell a substantial portion of our products through broadband service providers worldwide. Our service provider business unit accounted for a significant portion of our growth in recent years and became a larger proportion of our business, especially after our acquisition of the Sierra Wireless AirCard business. However, the service provider business is challenging and exceptionally competitive. In the first quarter of 2015, we undertook a reorganization of our service provider business unit to reduce the cost structure of the unit and supporting functions in order to match a reduced revenue outlook. In the first quarter of 2016, we took additional steps to re-size the cost structure of this unit and to redeploy certain resources internally to focus on other initiatives. These reorganization efforts also sought to concentrate our resources on long-term and profitable accounts. The reorganization may not be successful in meeting these goals or the other challenges posed by the service provider channel. Difficulties and challenges in selling to service providers include a longer sales cycle, more stringent product testing and validation

## Table of Contents

requirements, a higher level of customization demands, requirements that suppliers take on a larger share of the risk with respect to contractual business terms, competition from established suppliers, pricing pressure resulting in lower gross margins, and irregular and unpredictable ordering habits. For example, rigorous service provider certification processes may delay our sale of new products, or our products ultimately may fail these tests. In either event, we may lose some or all of the amounts we expended in trying to obtain business from the service provider, as well as lose the business opportunity altogether. In addition, even if we have a product which a service provider customer may wish to purchase, we may choose not to supply products to the potential service provider customer if the contract requirements, such as service level requirements, penalties, and liability provisions, are too onerous. Accordingly, our business may be harmed and our revenues may be reduced. We have, in exceptional limited circumstances, while still in contract negotiations, shipped products in advance of and subject to agreement on a definitive contract. We do not record revenue from these shipments until a definitive contract exists. There is risk that we do not ultimately close and sign a definitive contract. If this occurs, the timing of revenue recognition is uncertain and our business would be harmed. In addition, we often commence building custom-made products prior to execution of a contract in order to meet the customer's contemplated launch dates and requirements. Service provider products are generally custom-made for a specific customer and may not be salable to other customers or in other channels. If we have pre-built custom-made products but do not come to agreement on a definitive contract, we may be forced to scrap the custom-made products or re-work them at substantial cost and our business would be harmed.

Further, successful engagements with service provider customers requires a constant analysis of technology trends. If we are unable to anticipate technology trends and service provider customer product needs, and to allocate research and development resources to the right projects, we may not be successful in continuing to sell products to service provider customers. In addition, because our service provider customers command significant resources, including for software support, and demand extremely competitive pricing, certain ODMs have declined to develop service provider products on an ODM basis. Accordingly, as our ODMs increasingly limit development of our service provider products, our service provider business will be harmed if we cannot replace this capability with alternative ODMs or in-house development.

Orders from service providers generally tend to be large but sporadic, which causes our revenues from them to fluctuate and challenges our ability to accurately forecast demand from them. In particular, managing inventory and production of our products for our service provider customers is a challenge. Many of our service provider customers have irregular purchasing requirements. These customers may decide to cancel orders for customized products specific to that customer, and we may not be able to reconfigure and sell those products in other channels. These cancellations could lead to substantial write-offs. In addition, these customers may issue unforecasted orders for products which we may not be able to produce in a timely manner and as such, we may not be able to accept and deliver on such unforecasted orders. In certain cases, we may commit to fixed-price, long term purchase orders, with such orders priced in foreign currencies which could lose value over time in the event of adverse changes in foreign exchange rates. Even if we are selected as a supplier, typically a service provider will also designate a second source supplier, which over time will reduce the aggregate orders that we receive from that service provider. Further, as the technology underlying our products deployed by broadband service providers matures and more competitors offer alternative products with similar technology, we anticipate competing in an extremely price sensitive market and our margins may be affected. If we are unable to introduce new products with sufficiently advanced technology to attract service provider interest in a timely manner, our service provider customers may then require us to lower our prices, or they may choose to purchase products from our competitors. If this occurs, our business would be harmed and our revenues would be reduced.

If we were to lose a service provider customer for any reason, we may experience a material and immediate reduction in forecasted revenue that may cause us to be below our net revenue and operating margin expectations for a particular period of time and therefore adversely affect our stock price. For example, many of our competitors in the service provider space aggressively price their products in order to gain market share. We may not be able to match the lower

prices offered by our competitors. Many of the service provider customers will seek to purchase from the lowest cost provider, notwithstanding that our products may be higher quality or that our products were previously validated for use on their proprietary network. Accordingly, we may lose customers who have lower, more aggressive pricing and our revenues may be reduced. These particular challenges are a significant reason for the reduced service provider business unit revenue outlook that we announced in the first quarter of 2015 and that we further reduced in 2016. In addition, service providers may choose to prioritize the implementation of other technologies or the roll out of other services than home networking. Weakness in orders from this industry could have a material adverse effect on our business, operating results, and financial condition. We have seen slowdowns in capital expenditures by certain of our service provider customers in the past, and believe there may be potential for similar slowdowns in the future. Any slowdown in the general economy, over supply, consolidation among service providers, regulatory developments and constraint on capital expenditures could result in reduced demand from service providers and therefore adversely affect our sales to them. If we do not successfully overcome these challenges, we will not be able to profitably manage our service provider sales channel and our financial results will be harmed.

## Table of Contents

We depend on large, recurring purchases from certain significant customers, and a loss, cancellation or delay in purchases by these customers could negatively affect our revenue.

The loss of recurring orders from any of our more significant customers could cause our revenue and profitability to suffer. Our ability to attract new customers will depend on a variety of factors, including the cost-effectiveness, reliability, scalability, breadth and depth of our products. In addition, a change in the mix of our customers, or a change in the mix of direct and indirect sales, could adversely affect our revenue and gross margins.

Although our financial performance may depend on large, recurring orders from certain customers and resellers, we do not generally have binding commitments from them. For example:

- our reseller agreements generally do not require substantial minimum purchases;
- our customers can stop purchasing and our resellers can stop marketing our products at any time; and
- our reseller agreements generally are not exclusive.

Further, our revenue may be impacted by significant one-time purchases which are not contemplated to be repeatable. While such purchases are reflected in our financial statements, we do not rely on and do not forecast for continued significant one-time purchases. As a result, lack of repeatable one-time purchases will adversely affect our revenue.

Because our expenses are based on our revenue forecasts, a substantial reduction or delay in sales of our products to, or unexpected returns from, customers and resellers, or the loss of any significant customer or reseller, could harm or otherwise have a negative impact to our operating results. Although our largest customers may vary from period to period, we anticipate that our operating results for any given period will continue to depend on large orders from a small number of customers.

\* We obtain several key components from limited or sole sources, and if these sources fail to satisfy our supply requirements or we are unable to properly manage our supply requirements with our third-party manufacturers, we may lose sales and experience increased component costs.

Any shortage or delay in the supply of key product components would harm our ability to meet scheduled product deliveries. Many of the semiconductors used in our products are specifically designed for use in our products and are obtained from sole source suppliers on a purchase order basis. In addition, some components that are used in all our products are obtained from limited sources. These components include connector jacks, plastic casings and physical layer transceivers. We also obtain switching fabric semiconductors, which are used in our Ethernet switches and Internet gateway products, and wireless local area network chipsets, which are used in all of our wireless products, from a limited number of suppliers. Semiconductor suppliers have experienced and continue to experience component shortages themselves, such as with substrates used in manufacturing chipsets, which in turn adversely impact our ability to procure semiconductors from them. Our third-party manufacturers generally purchase these components on our behalf on a purchase order basis, and we do not have any contractual commitments or guaranteed supply arrangements with our suppliers. If demand for a specific component increases, we may not be able to obtain an adequate number of that component in a timely manner. In addition, if worldwide demand for the components increases significantly, the availability of these components could be limited. Further, our suppliers may experience financial or other difficulties as a result of uncertain and weak worldwide economic conditions. Other factors which may affect our suppliers' ability or willingness to supply components to us include internal management or reorganizational issues, such as roll-out of new equipment which may delay or disrupt supply of previously forecasted components, or industry consolidation and divestitures, which may result in changed business and product priorities among certain suppliers. It could be difficult, costly and time consuming to obtain alternative sources for these



components, or to change product designs to make use of alternative components. In addition, difficulties in transitioning from an existing supplier to a new supplier could create delays in component availability that would have a significant impact on our ability to fulfill orders for our products.

We provide our third-party manufacturers with a rolling forecast of demand, which they use to determine our material and component requirements. Lead times for ordering materials and components vary significantly and depend on various factors, such as the specific supplier, contract terms and demand and supply for a component at a given time. Some of our components have long lead times, such as wireless local area network chipsets, switching fabric chips, physical layer transceivers, connector jacks and metal and plastic enclosures. If our forecasts are not timely provided or are less than our actual requirements, our third-party manufacturers may be unable to manufacture products in a timely manner. For example, in the first quarter of 2013, our third-party manufacturers were not able to manufacture sufficient quantities of our new line of ReadyNAS products in order to meet demand, adversely affecting our profitability for the quarter. If our forecasts are too high, our third-party manufacturers will be unable to use the components they have purchased on our behalf. The cost of the components used in our products tends to

## Table of Contents

drop rapidly as volumes increase and the technologies mature. Therefore, if our third-party manufacturers are unable to promptly use components purchased on our behalf, our cost of producing products may be higher than our competitors due to an oversupply of higher-priced components. Moreover, if they are unable to use components ordered at our direction, we will need to reimburse them for any losses they incur.

If we are unable to obtain a sufficient supply of components, or if we experience any interruption in the supply of components, our product shipments could be reduced or delayed or our cost of obtaining these components may increase. Component shortages and delays affect our ability to meet scheduled product deliveries, damage our brand and reputation in the market, and cause us to lose sales and market share. For example, component shortages and disruptions in supply in the past have limited our ability to supply all the worldwide demand for our products, and our revenue was affected. At times we have elected to use more expensive transportation methods, such as air freight, to make up for manufacturing delays caused by component shortages, which reduces our margins. In addition, at times sole suppliers of highly specialized components have provided components that were either defective or did not meet the criteria required by our customers, resulting in delays, lost revenue opportunities and potentially substantial write-offs.

Another example relates to the record flooding in Thailand in the third quarter of 2011. Many major manufacturers of hard disk drives and their component suppliers maintain significant operations in Thailand in areas affected by the flooding. These include most, if not all, of our direct and indirect suppliers of hard disk drives for our ReadyNAS product line. All of our major direct and indirect suppliers of hard disk drives informed us that our supply chain would be constrained for an indefinite amount of time, in some cases up to six months. Some therefore declared a force majeure event and have stated that, in addition to and because of the supply constraints, pricing for hard disk drives would increase significantly until they were able to stabilize the situation. As a result, we experienced increased prices in the cost of hard disk drives and ceased accepting any additional orders containing ReadyNAS products with hard disk drives at then current prices and all shipments of ReadyNAS products with hard disk drives were placed on hold. In addition, all sales and marketing promotions involving ReadyNAS products were terminated temporarily. Further, we declared the existence of a force majeure event under our contracts with certain customers. Accordingly, our business was harmed. Certain events or natural disasters that occur in the future may harm our business as well.

Some of our competitors have substantially greater resources than we do, and to be competitive we may be required to lower our prices or increase our sales and marketing expenses, which could result in reduced margins and loss of market share.

We compete in a rapidly evolving and fiercely competitive market, and we expect competition to continue to be intense, including price competition. Our principal competitors in the home market for networking and Smart Home devices include Apple, ASUS, Belkin/Linksys, Devolo, D-Link, Eero, Google, Logitech, Nest Labs (owned by Google), Ring, Samsung, Swann, Synology, TP-Link and Western Digital. Our principal competitors in the commercial business market include Allied Telesys, Barracuda, Buffalo, Cisco Systems, Dell, D-Link, Fortinet, Hewlett-Packard, Huawei, QNAP Systems, Seagate Technology, Synology, TP-Link, Ubiquity, WatchGuard and Western Digital. Our principal competitors in the broadband service provider market include Actiontec, Arcadyan, ARRIS, AVM, Compal Broadband, D-Link, Hitron, Huawei, Novatel Wireless, Sagem, Scientific Atlanta (a Cisco Systems company), Sercomm, SMC Networks, TechniColor, TP-Link, Ubee, ZTE and ZyXEL. Other competitors include numerous local vendors such as Xiaomi in China, and Buffalo in Japan. In addition, these local vendors may target markets outside of their local regions and may increasingly compete with us in other regions worldwide. Our potential competitors also include other consumer electronics vendors, including LG Electronics, Microsoft, Panasonic, Sony, Toshiba and Vizio, who could integrate networking and streaming capabilities into their line of products, such as televisions, set top boxes and gaming consoles, and our channel customers who may decide to offer self-branded networking products. We also face competition from service providers who may bundle a free networking device with their broadband service offering, which would reduce our sales if we are not the supplier of

choice to those service providers. In the service provider space, we are also facing significant and increased competition from original design manufacturers, or ODMs, and contract manufacturers who are selling and attempting to sell their products directly to service providers around the world.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers, and exert more influence on sales channels than we can. In addition, certain competitors may have different business models, such as integrated manufacturing capabilities, that may allow them to achieve cost savings and to compete on the basis of price. Other competitors may have fewer resources, but may be more nimble in developing new or disruptive technology or in entering new markets. We anticipate that current and potential competitors will also intensify their efforts to penetrate our target markets. For example, price competition is intense in our industry in certain geographical regions and product categories. Many of our competitors in the service provider and retail spaces price their products significantly below our product costs in order to gain market share. Average sales prices have declined in the past and may again decline in the future. These competitors may have

## Table of Contents

more advanced technology, more extensive distribution channels, stronger brand names, greater access to shelf space in retail locations, bigger promotional budgets and larger customer bases than we do. In addition, many of these competitors leverage a broader product portfolio and offer lower pricing as part of a more comprehensive end-to-end solution which we may not have. These companies could devote more capital resources to develop, manufacture and market competing products than we could. Our competitors may also acquire other companies in the market and leverage combined resources to gain market share. For example, in March 2013, Belkin completed its acquisition of the Linksys division from Cisco. Belkin and Linksys are two of our significant competitors. The combined company may have synergies which increase opportunities for Belkin to gain market share, especially in North America. If any of these companies are successful in competing against us, our sales could decline, our margins could be negatively impacted and we could lose market share, any of which could seriously harm our business and results of operations.

We depend on a limited number of third-party manufacturers for substantially all of our manufacturing needs. If these third-party manufacturers experience any delay, disruption or quality control problems in their operations, we could lose market share and our brand may suffer.

All of our products are manufactured, assembled, tested and generally packaged by a limited number of third-party manufacturers, including original design manufacturers, or ODMs, and original equipment manufacturers, as well as contract manufacturers. In most cases, we rely on these manufacturers to procure components and, in some cases, subcontract engineering work. Some of our products are manufactured by a single manufacturer. For example, we currently rely on a single manufacturer for our Arlo Smart Home cameras. We do not have any long-term contracts with any of our third-party manufacturers. Some of these third-party manufacturers produce products for our competitors. Due to changing economic conditions, the viability of some of these third-party manufacturers may be at risk. Our ODMs are increasingly refusing to work with us on certain projects, such as projects for manufacturing products for our service provider customers. Because our service provider customers command significant resources, including for software support, and demand extremely competitive pricing, our ODMs are starting to refuse to engage on service provider terms. The loss of the services of any of our primary third-party manufacturers could cause a significant disruption in operations and delays in product shipments. Qualifying a new manufacturer and commencing volume production is expensive and time consuming. Ensuring that a contract manufacturer is qualified to manufacture our products to our standards is time consuming. In addition, there is no assurance that a contract manufacturer can scale its production of our products at the volumes and in the quality that we require. If a contract manufacturer is unable to do these things, we may have to move production for the products to a new or existing third party manufacturer which would take significant effort and our business may be harmed. In addition, as we contemplate moving manufacturing into different jurisdictions, we will be subject to additional significant challenges in ensuring that quality, processes and costs, among other issues, are consistent with our expectations. For example, while we expect our manufacturers to be responsible for penalties assessed on us because of excessive failures of the products, there is no assurance that we will be able to collect such reimbursements from these manufacturers, which causes us to take on additional risk for potential failures of our products.

Our reliance on third-party manufacturers also exposes us to the following risks over which we have limited control:

- unexpected increases in manufacturing and repair costs;
- inability to control the quality and reliability of finished products;
- inability to control delivery schedules;
- potential liability for expenses incurred by third-party manufacturers in reliance on our forecasts that later prove to be inaccurate;

potential lack of adequate capacity to manufacture all or a part of the products we require; and

potential labor unrest affecting the ability of the third-party manufacturers to produce our products.

All of our products must satisfy safety and regulatory standards and some of our products must also receive government certifications. Our third party manufacturers are primarily responsible for obtaining most regulatory approvals for our products. If our third party manufacturers fail to obtain timely domestic or foreign regulatory approvals or certificates, we would be unable to sell our products and our sales and profitability could be reduced, our relationships with our sales channel could be harmed, and our reputation and brand would suffer.

Specifically, substantially all of our manufacturing occurs in the Asia Pacific region and any disruptions from natural disasters, health epidemics and political, social and economic instability would affect the ability of our third party manufacturers to

Table of Contents

manufacture our products. In addition, our third party manufacturers in China have continued to increase our costs of production, particularly in the past couple of years. If these costs continue to increase, it may affect our margins and ability to lower prices for our products to stay competitive. Labor unrest in China may also affect our third party manufacturers as workers may strike and cause production delays. If our third party manufacturers fail to maintain good relations with their employees or contractors, and production and manufacturing of our products is affected, then we may be subject to shortages of products and quality of products delivered may be affected. Further, if our manufacturers or warehousing facilities are disrupted or destroyed, we would have no other readily available alternatives for manufacturing our products and our business would be significantly harmed.

As we continue to work with more third party manufacturers on a contract manufacturing basis, we are also exposed to additional risks not inherent in a typical ODM arrangement. Such risks may include our inability to properly source and qualify components for the products, lack of software expertise resulting in increased software defects, and lack of resources to properly monitor the manufacturing process. In our typical ODM arrangement, our ODMs are generally responsible for sourcing the components of the products and warranting that the products will work against a product's specification, including any software specifications. In a contract manufacturing arrangement, we would take on much more, if not all, of the responsibility around these areas. If we are unable to properly manage these risks, our products may be more susceptible to defects and our business would be harmed.

We are exposed to adverse currency exchange rate fluctuations in jurisdictions where we transact in local currency, which could harm our financial results and cash flows.

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our results of operations, financial position and cash flows. Although a portion of our international sales are currently invoiced in United States dollars, we have implemented and continue to implement for certain countries and customers both invoicing and payment in foreign currencies. Our primary exposure to movements in foreign currency exchange rates relates to non-U.S. dollar denominated sales in Europe, Japan and Australia as well as our global operations, and non-U.S. dollar denominated operating expenses and certain assets and liabilities. In addition, weaknesses in foreign currencies for U.S. dollar denominated sales could adversely affect demand for our products. Conversely, a strengthening in foreign currencies against the U.S. dollar could increase foreign currency denominated costs. As a result we may attempt to renegotiate pricing of existing contracts or request payment to be made in U.S. dollars. We cannot be sure that our customers would agree to renegotiate along these lines. This could result in customers eventually terminating contracts with us or in our decision to terminate certain contracts, which would adversely affect our sales.

We hedge our exposure to fluctuations in foreign currency exchange rates as a response to the risk of changes in the value of foreign currency-denominated assets and liabilities. We may enter into foreign currency forward contracts or other instruments, the majority of which mature within approximately five months. Our foreign currency forward contracts reduce, but do not eliminate, the impact of currency exchange rate movements. For example, we do not execute forward contracts in all currencies in which we conduct business. In addition, we hedge to reduce the impact of volatile exchange rates on net revenue, gross profit and operating profit for limited periods of time. However, the use of these hedging activities may only offset a portion of the adverse financial effect resulting from unfavorable movements in foreign exchange rates.

If we do not effectively manage our sales channel inventory and product mix, we may incur costs associated with excess inventory, or lose sales from having too few products.

If we are unable to properly monitor, control and manage our sales channel inventory and maintain an appropriate level and mix of products with our wholesale distributors and within our sales channels, we may incur increased and

unexpected costs associated with this inventory. We generally allow wholesale distributors and traditional retailers to return a limited amount of our products in exchange for other products. Under our price protection policy, if we reduce the list price of a product, we are often required to issue a credit in an amount equal to the reduction for each of the products held in inventory by our wholesale distributors and retailers. If our wholesale distributors and retailers are unable to sell their inventory in a timely manner, we might lower the price of the products, or these parties may exchange the products for newer products. Also, during the transition from an existing product to a new replacement product, we must accurately predict the demand for the existing and the new product. For example, in the first quarter of 2013, while transitioning from our existing ReadyNAS product line to our new line of ReadyNAS products, we were not able to execute on the launch of the new product. This led to our inability to have sufficient quantities of the existing line of ReadyNAS products as we had ramped down supply anticipating the transition, which adversely affected our profitability for the quarter.

We determine production levels based on our forecasts of demand for our products. Actual demand for our products depends on many factors, which makes it difficult to forecast. We have experienced differences between our actual and our forecasted

Table of Contents

demand in the past and expect differences to arise in the future. If we improperly forecast demand for our products we could end up with too many products and be unable to sell the excess inventory in a timely manner, if at all, or, alternatively we could end up with too few products and not be able to satisfy demand. This problem is exacerbated because we attempt to closely match inventory levels with product demand leaving limited margin for error. If these events occur, we could incur increased expenses associated with writing off excessive or obsolete inventory, lose sales, incur penalties for late delivery or have to ship products by air freight to meet immediate demand incurring incremental freight costs above the sea freight costs, a preferred method, and suffering a corresponding decline in gross margins.

The average selling prices of our products typically decrease rapidly over the sales cycle of the product, which may negatively affect our net revenue and gross margins.

Our products typically experience price erosion, a fairly rapid reduction in the average unit selling prices over their respective sales cycles. In order to sell products that have a falling average unit selling price and maintain margins at the same time, we need to continually reduce product and manufacturing costs. To manage manufacturing costs, we must collaborate with our third-party manufacturers to engineer the most cost-effective design for our products. In addition, we must carefully manage the price paid for components used in our products. We must also successfully manage our freight and inventory costs to reduce overall product costs. We also need to continually introduce new products with higher sales prices and gross margins in order to maintain our overall gross margins. If we are unable to manage the cost of older products or successfully introduce new products with higher gross margins, our net revenue and overall gross margin would likely decline.

We depend substantially on our sales channels, and our failure to maintain and expand our sales channels would result in lower sales and reduced net revenue.

To maintain and grow our market share, net revenue and brand, we must maintain and expand our sales channels. Our sales channels consist of traditional retailers, online retailers, DMRs, VARs, and broadband service providers. Some of these entities purchase our products through our wholesale distributor customers. We generally have no minimum purchase commitments or long-term contracts with any of these third parties.

Traditional retailers have limited shelf space and promotional budgets, and competition is intense for these resources. If the networking sector does not experience sufficient growth, retailers may choose to allocate more shelf space to other consumer product sectors. A competitor with more extensive product lines and stronger brand identity may have greater bargaining power with these retailers. Any reduction in available shelf space or increased competition for such shelf space would require us to increase our marketing expenditures simply to maintain current levels of retail shelf space, which would harm our operating margin. Our traditional retail customers have faced increased and significant competition from online retailers. If we cannot effectively manage our business amongst our online customers and traditional retail customers, our business would be harmed. The recent trend in the consolidation of online retailers and DMR channels has resulted in intensified competition for preferred product placement, such as product placement on an online retailer's Internet home page. Expanding our presence in the VAR channel may be difficult and expensive. We compete with established companies that have longer operating histories and longstanding relationships with VARs that we would find highly desirable as sales channel partners. In addition, our efforts to realign or consolidate our sales channels may cause temporary disruptions in our product sales and revenue, and these changes may not result in the expected longer-term benefits.

We also sell products to broadband service providers. Competition for selling to broadband service providers is fierce and intense. Penetrating service provider accounts typically involves a long sales cycle and the challenge of displacing incumbent suppliers with established relationships and field-deployed products. If we are unable to maintain and expand our sales channels, our growth would be limited and our business would be harmed.



We must also continuously monitor and evaluate emerging sales channels. If we fail to establish a presence in an important developing sales channel, our business could be harmed.

If we lose the services of our Chairman and Chief Executive Officer, Patrick C.S. Lo, or our other key personnel, we may not be able to execute our business strategy effectively.

Our future success depends in large part upon the continued services of our key technical, sales, marketing, finance and senior management personnel. In particular, the services of Patrick C.S. Lo, our Chairman and Chief Executive Officer, who has led our company since its inception, are very important to our business. We do not maintain any key person life insurance policies. Our business model requires extremely skilled and experienced senior management who are able to withstand the rigorous requirements and expectations of our business. Our success depends on senior management being able to execute at a very high level. The loss of any of our senior management or other key research, development, sales or marketing personnel, particularly if

## Table of Contents

lost to competitors, could harm our ability to implement our business strategy and respond to the rapidly changing needs of our business. While we have adopted an emergency succession plan for the short term, we have not formally adopted a long term succession plan. As a result, if we suffer the loss of services of any key executive, our long term business results may be harmed. While we believe that we have mitigated some of the business execution and business continuity risk with our reorganization into three business units, the loss of any key personnel would still be disruptive and harm our business, especially given that our business is leanly staffed and relies on the expertise and high performance of our key personnel. In addition, because we do not have a formal long term succession plan, we may not be able to have the proper personnel in place to effectively execute our long term business strategy if Mr. Lo or other key personnel retire, resign or are otherwise terminated.

\* System security risks, data protection breaches and cyber-attacks could disrupt our internal operations, information technology systems, products or services, and any such disruption could reduce our expected revenue, increase our expenses, damage our reputation and adversely affect our stock price.

Maintaining the security of our computer information systems and communication systems is a critical issue for us and our customers. Malicious actors may develop and deploy viruses and other advanced persistent threats that are designed to attack our systems, including our internal network, or those of our vendors or customers. Additionally, outside parties may attempt to fraudulently induce our employees to disclose sensitive information in order to gain access to our information technology systems, our data or our customers' data. We have established a crisis management plan and business continuity program. While we regularly test the plan and the program, there can be no assurance that the plan and program can withstand an actual or serious disruption in our business, including a data protection breach or cyber-attack. While we have established infrastructure and geographic redundancy for our critical systems, our ability to utilize these redundant systems requires further testing and we cannot be assured that such systems are fully functional. For example, much of our order fulfillment process is automated and the order information is stored on our servers. A significant business interruption could result in losses or damages and harm our business. If our computer systems and servers go down at the end of a fiscal quarter, our ability to recognize revenue may be delayed until we are able to utilize back-up systems and continue to process and ship our orders. This could cause our stock price to decline significantly.

We devote considerable internal and external resources to network security, data encryption and other security measures to protect our systems and customer data, but these security measures cannot provide absolute security. Potential breaches of our security measures and the accidental loss, inadvertent disclosure or unapproved dissemination of proprietary information or sensitive or confidential data about us, our employees or our customers, including the potential loss or disclosure of such information or data as a result of hacking, fraud, social engineering or other forms of deception, could expose us, our customers or the individuals affected to a risk of loss or misuse of this information, result in litigation and potential liability for us, damage our brand and reputation or otherwise harm our business. In addition, the cost and operational consequences of implementing further data protection measures could be significant.

Our products and services may contain unknown security vulnerabilities. For example, the firmware, software and open source software that we or our manufacturing partners have installed on our products may be susceptible to hacking or misuse. In addition, we offer a comprehensive online cloud management service paired with our Arlo Smart Home cameras. If malicious actors compromise this cloud service, or if customer confidential information is accessed without authorization, our business will be harmed. Operating an online cloud service is a relatively new business for us and we may not have the expertise to properly manage risks related to data security and systems security. We rely on third-party providers for a number of critical aspects of our cloud services and customer support, including web hosting services, billing and payment processing, and consequently we do not maintain direct control over the security or stability of the associated systems. If we or our third-party providers are unable to successfully prevent breaches of security relating to our products, services or customer private information, including customer

videos and customer personal identification information, or if these third-party systems failed for other reasons, our management would need to spend increasing amounts of time and effort in this area, we would incur substantial expenses, and our business would be harmed.

\* Global economic conditions could materially adversely affect our revenue and results of operations.

Our business has been and may continue to be affected by a number of factors that are beyond our control, such as general geopolitical, economic and business conditions, conditions in the financial markets, and changes in the overall demand for networking and Smart Home products. A severe and/or prolonged economic downturn could adversely affect our customers' financial condition and the levels of business activity of our customers. Weakness in, and uncertainty about, global economic conditions may cause businesses to postpone spending in response to tighter credit, negative financial news and/or declines in income or asset values, which could have a material negative effect on the demand for networking products.

In the recent past, slow economic growth throughout various regions worldwide, especially in Europe, presented significant challenges to our business. For example, we believe that decreased demand in Europe adversely impacted our net revenue in all

Table of Contents

three of our business units beginning in fiscal 2013. In addition, current economic challenges in China, including any global economic ramifications of these challenges, may continue to put negative pressure on global economic conditions. If conditions in the global economy, including Europe, China, Australia and the United States, or other key vertical or geographic markets remain uncertain or deteriorate further, such conditions could have a material adverse impact on our business, operating results and financial condition. If we are unable to successfully anticipate changing economic and political conditions, we may be unable to effectively plan for and respond to those changes, which could materially adversely affect our business and results of operations.

In addition, the economic problems affecting the financial markets and the uncertainty in global economic conditions resulted in a number of adverse effects including a low level of liquidity in many financial markets, extreme volatility in credit, equity, currency and fixed income markets, instability in the stock market and high unemployment. For example, the challenges faced by the European Union to stabilize some of its member economies, such as Greece, Portugal, Spain, Hungary and even Italy, have had international implications affecting the stability of global financial markets and hindering economies worldwide. Many member nations in the European Union have been addressing the issues with controversial austerity measures. In addition, the potential consequences of the recent "Brexit" referendum in the United Kingdom have led to significant uncertainty in the region. Should the European Union monetary policy measures be insufficient to restore confidence and stability to the financial markets, or should the United Kingdom's "Brexit" decision lead to additional economic or political instability, the recovery of the global economy, including the U.S. and European Union economies where we have a significant presence, could be hindered or reversed, which could have a material adverse effect on us. There could also be a number of other follow-on effects from these economic developments and negative economic trends on our business, including the inability of customers to obtain credit to finance purchases of our products; customer insolvencies; decreased customer confidence to make purchasing decisions; decreased customer demand; and decreased customer ability to pay their trade obligations.

\* Changes in tax rates, adverse changes in tax laws or exposure to additional income tax liabilities could affect our future profitability.

Factors that could materially affect our future effective tax rates include but are not limited to:

- changes in the regulatory environment;
- changes in accounting and tax standards or practices;
- changes in the composition of operating income by tax jurisdiction; and
- our operating results before taxes.

We are subject to income taxes in the United States and numerous foreign jurisdictions. Our effective tax rate has fluctuated in the past and may fluctuate in the future. Future effective tax rates could be affected by changes in the composition of earnings in countries with differing tax rates, changes in deferred tax assets and liabilities, or changes in tax laws. Numerous foreign jurisdictions have been influenced by the OECD's (Organization of Economic Cooperation and Development) issuance of its Base Erosion and Profit Shifting (BEPS) Report that is comprised of 15 comprehensive actions intended to address tax base erosion and jurisdictional profit shifting within multinational corporations. The OECD has encouraged all countries to adopt minimum standards that would result in more transparency and consistency in intercompany transactions. Many countries continue to evaluate and modify their tax laws in light of BEPS as well as increase the volume of tax audits of multinational corporations. Changes in tax laws could affect the distribution of our earnings, result in double taxation and adversely affect our results.

We have been under examination by the Italian Tax Authority (ITA) for the 2004 through 2012 tax years. The ITA examination included an audit of income, gross receipts and value-added taxes. Currently, we are in litigation with the ITA for the 2004 through 2012 years. If we are unsuccessful in defending our tax positions, our profitability will be reduced.

We are also subject to examination by the Internal Revenue Service, or IRS, and other tax authorities, including state revenue agencies and other foreign governments. We were recently notified by the IRS that they will conduct an audit of the tax year ended December 31, 2014. While we regularly assess the likelihood of favorable or unfavorable outcomes resulting from examinations by the IRS and other tax authorities to determine the adequacy of our provision for income taxes, there can be no assurance that the actual outcome resulting from these examinations will not materially adversely affect our financial condition and operating results. Additionally, the IRS and several foreign tax authorities have increasingly focused attention on intercompany transfer pricing with respect to sales of products and services and the use of intangibles. Tax authorities could disagree with our intercompany charges, cross-jurisdictional transfer pricing or other matters and assess additional taxes. If we do not prevail in any such disagreements, our profitability may be affected.

Table of Contents

We must comply with indirect tax laws in multiple foreign jurisdictions. Audits of our compliance with these rules may result in additional liabilities for tax, interest and penalties related to our international operations which would reduce our profitability.

Our international operations are routinely subject to audit by tax authorities in various countries. Many countries have indirect tax systems where the sale and purchase of goods and services are subject to tax based on the transaction value. These taxes are commonly referred to as value-added tax (VAT) or goods and services tax (GST). Failure to comply with these systems can result in the assessment of additional tax, interest and penalties. While we believe we are in compliance with local laws, there is no assurance that foreign tax authorities agree with our reporting positions and upon audit may assess us additional tax, interest and penalties. If this occurs and we cannot successfully defend our position, our profitability will be reduced.

\* Our sales and operations in international markets expose us to operational, financial and regulatory risks.

International sales comprise a significant amount of our overall net revenue. International sales were approximately 36% of overall net revenue in the third quarter of 2016 and approximately 40% in fiscal year 2015. We continue to be committed to growing our international sales and while we have committed resources to expanding our international operations and sales channels, these efforts may not be successful. International operations are subject to a number of other risks, including:

• exchange rate fluctuations;

• political and economic instability, international terrorism and anti-American sentiment, particularly in emerging markets;

• potential for violations of anti-corruption laws and regulations, such as those related to bribery and fraud;

• preference for locally branded products, and laws and business practices favoring local competition;

• potential consequences of, and uncertainty related to, the recent "Brexit" referendum in the United Kingdom, which could lead to additional expense and complexity in doing business there;

• increased difficulty in managing inventory;

• delayed revenue recognition;

• less effective protection of intellectual property;

• stringent consumer protection and product compliance regulations, including but not limited to the Restriction of Hazardous Substances directive, the Waste Electrical and Electronic Equipment directive and the European Ecodesign directive, or EuP, that are costly to comply with and may vary from country to country;

• difficulties and costs of staffing and managing foreign operations;

• business difficulties, including potential bankruptcy or liquidation, of any of our worldwide third party logistics providers; and

• changes in local tax laws or changes in the enforcement, application or interpretation of such laws.

While we believe we generally have good relations with our employees, employees in certain jurisdictions have rights which give them certain collective rights. If management must expend significant resources and effort to address and comply with these rights, our business may be harmed. We are also required to comply with local environmental legislation and our customers rely on this compliance in order to sell our products. If our customers do not agree with our interpretations and requirements of new legislation, they may cease to order our products and our revenue would be harmed.

If our products contain defects or errors, we could incur significant unexpected expenses, experience product returns and lost sales, experience product recalls, suffer damage to our brand and reputation, and be subject to product liability or other claims.

Our products are complex and may contain defects, errors or failures, particularly when first introduced or when new versions are released. The industry standards upon which many of our products are based are also complex, experience change over time

Table of Contents

and may be interpreted in different manners. Some errors and defects may be discovered only after a product has been installed and used by the end-user.

In addition, epidemic failure clauses are found in certain of our customer contracts, especially contracts with service providers. If invoked, these clauses may entitle the customer to return for replacement or obtain credits for products and inventory, as well as assess liquidated damage penalties and terminate an existing contract and cancel future or then current purchase orders. In such instances, we may also be obligated to cover significant costs incurred by the customer associated with the consequences of such epidemic failure, including freight and transportation required for product replacement and out-of-pocket costs for truck rolls to end user sites to collect the defective products. Costs or payments we make in connection with an epidemic failure may materially adversely affect our results of operations and financial condition. If our products contain defects or errors, or are found to be noncompliant with industry standards, we could experience decreased sales and increased product returns, loss of customers and market share, and increased service, warranty and insurance costs. In addition, defects in, or misuse of, certain of our products could cause safety concerns, including the risk of property damage or personal injury. If any of these events occurred, our reputation and brand could be damaged, and we could face product liability or other claims regarding our products, resulting in unexpected expenses and adversely impacting our operating results. For instance, if a third party were able to successfully overcome the security measures in our products, such a person or entity could misappropriate customer data, third party data stored by our customers and other information, including intellectual property. In addition, the operations of our end-user customers may be interrupted. If that happens, affected end-users or others may file actions against us alleging product liability, tort, or breach of warranty claims.

We have been and will be investing increased additional in-house resources on software research and development, which could disrupt our ongoing business and present distinct risks from our historically hardware-centric business.

We plan to continue to evolve our historically hardware-centric business model towards a model that includes more sophisticated software offerings. As such, we will further evolve the focus of our organization towards the delivery of more integrated hardware and software solutions for our customers. While we have invested in software development in the past, we will be expending additional resources in this area in the future. Such endeavors may involve significant risks and uncertainties, including distraction of management from current operations, insufficient revenue to offset liabilities assumed and expenses associated with the strategy, inadequate return on capital, and unidentified issues not discovered in our due diligence. Software development is inherently risky for a company such as ours with a historically hardware-centric business model, and accordingly, our efforts in software development may not be successful. Any increased investment in software research and development may materially adversely affect our financial condition and operating results.

We may spend a proportionately greater amount on software research and development in the future. If we cannot proportionately decrease our cost structure in response to competitive price pressures, our gross margin and, therefore, our profitability could be adversely affected. In addition, if our software solutions, pricing and other factors are not sufficiently competitive, or if there is an adverse reaction to our product decisions, we may lose market share in certain areas, which could adversely affect our revenue and prospects.

Software research and development is complex. We must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect customer demand for our products and services. We must accurately forecast mixes of software solutions and configurations that meet customer requirements, and we may not succeed at doing so within a given product's life cycle or at all. Any delay in the development, production or marketing of a new software solution could result in us not being among the first to market, which could further harm our competitive position. In addition, our regular testing and quality control efforts may not be effective in controlling or detecting all quality issues and defects. We may be unable to determine the cause, find an appropriate solution or offer a temporary fix to address defects. Finding



solutions to quality issues or defects can be expensive and may result in additional warranty, replacement and other costs, adversely affecting our profits. If new or existing customers have difficulty with our software solutions or are dissatisfied with our services, our operating margins could be adversely affected, and we could face possible claims if we fail to meet our customers' expectations. In addition, quality issues can impair our relationships with new or existing customers and adversely affect our brand and reputation, which could adversely affect our operating results.

As part of growing our business, we have made and expect to continue to make acquisitions. If we fail to successfully select, execute or integrate our acquisitions, then our business and operating results could be harmed and our stock price could decline.

From time to time, we will undertake acquisitions to add new product lines and technologies, gain new sales channels or enter into new sales territories. For example, in June 2012 and June 2013 we acquired select assets of two separate engineering operations in India to enhance our wireless product offerings in our commercial business unit. Additionally in July 2012, we closed

Table of Contents

the acquisition of privately held AVAAK, Inc., creators of the VueZone® home security camera system, and in April 2013, we closed the acquisition of the AirCard business of Sierra Wireless, Inc. The AirCard acquisition represents our largest acquisition, both in terms of consideration and headcount. Acquisitions involve numerous risks and challenges, including but not limited to the following:

- integrating the companies, assets, systems, products, sales channels and personnel that we acquire;
- higher than anticipated acquisition and integration costs and expenses;
- reliance on third parties to provide transition services for a period of time after closing to ensure an orderly transition of the business;
- growing or maintaining revenues to justify the purchase price and the increased expenses associated with acquisitions;
- entering into territories or markets with which we have limited or no prior experience;
- establishing or maintaining business relationships with customers, vendors and suppliers who may be new to us;
- overcoming the employee, customer, vendor and supplier turnover that may occur as a result of the acquisition;
- disruption of, and demands on, our ongoing business as a result of integration activities including diversion of management's time and attention from running the day to day operations of our business;
- inability to implement uniform standards, disclosure controls and procedures, internal controls over financial reporting and other procedures and policies in a timely manner;
- inability to realize the anticipated benefits of or successfully integrate with our existing business the businesses, products, technologies or personnel that we acquire; and
- potential post-closing disputes.

As part of undertaking an acquisition, we may also significantly revise our capital structure or operational budget, such as issuing common stock that would dilute the ownership percentage of our stockholders, assuming liabilities or debt, utilizing a substantial portion of our cash resources to pay for the acquisition or significantly increasing operating expenses. Our acquisitions have resulted and may in the future result in charges being taken in an individual quarter as well as future periods, which results in variability in our quarterly earnings. In addition, our effective tax rate in any particular quarter may also be impacted by acquisitions. Following the closing of an acquisition, we may also have disputes with the seller regarding contractual requirements and covenants. Any such disputes may be time consuming and distract management from other aspects of our business. In addition, if we continue to increase the pace or size of acquisitions, as we have done since mid-2012, we will have to expend significant management time and effort into the transactions and the integrations and we may not have the proper human resources bandwidth to ensure successful integrations and accordingly, our business could be harmed.

As part of the terms of acquisition, we may commit to pay additional contingent consideration if certain revenue or other performance milestones are met. We are required to evaluate the fair value of such commitments at each reporting date and adjust the amount recorded if there are changes to the fair value.

We cannot ensure that we will be successful in selecting, executing and integrating acquisitions. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. In addition, if stock

market analysts or our stockholders do not support or believe in the value of the acquisitions that we choose to undertake, our stock price may decline.

Table of Contents

\* We are subject to, and must remain in compliance with, numerous laws and governmental regulations concerning the manufacturing, use, distribution and sale of our products, as well as any such future laws and regulations. Some of our customers also require that we comply with their own unique requirements relating to these matters. Any failure to comply with such laws, regulations and requirements, and any associated unanticipated costs, may adversely affect our business, financial condition and results of operations.

We manufacture and sell products which contain electronic components, and such components may contain materials that are subject to government regulation in both the locations that we manufacture and assemble our products, as well as the locations where we sell our products. For example, certain regulations limit the use of lead in electronic components. To our knowledge, we maintain compliance with all applicable current government regulations concerning the materials utilized in our products, for all the locations in which we operate. Since we operate on a global basis, this is a complex process which requires continual monitoring of regulations and an ongoing compliance process to ensure that we and our suppliers are in compliance with all existing regulations. There are areas where new regulations have been enacted which could increase our cost of the components that we utilize or require us to expend additional resources to ensure compliance. For example, the SEC passed final rules in August 2012 regarding investigation and disclosure of the use of certain “conflict minerals” in our products. These rules apply to our business, and we are expending significant resources to ensure compliance. The implementation of these requirements by government regulators and our partners and/or customers could adversely affect the sourcing, availability, and pricing of minerals used in the manufacture of certain components used in our products. In addition, the supply-chain due diligence investigation required by the conflict minerals rules will require expenditures of resources and management attention regardless of the results of the investigation. If there is an unanticipated new regulation which significantly impacts our use of various components or requires more expensive components, that regulation would have a material adverse impact on our business, financial condition and results of operations.

One area which has a large number of regulations is the environmental compliance. Management of environmental pollution and climate change has produced significant legislative and regulatory efforts on a global basis, and we believe this will continue both in scope and the number of countries participating. These changes could directly increase the cost of energy which may have an impact on the way we manufacture products or utilize energy to produce our products. In addition, any new regulations or laws in the environmental area might increase the cost of raw materials we use in our products. Environmental regulations require us to reduce product energy usage, monitor and exclude an expanding list of restricted substances and to participate in required recover and recycling of our products. While future changes in regulations are certain, we are currently unable to predict how any such changes will impact us and if such impacts will be material to our business. If there is a new law or regulation that significantly increases our costs of manufacturing or causes us to significantly alter the way that we manufacture our products, this would have a material adverse effect on our business, financial condition and results of operations.

Our selling and distribution practices are also regulated in large part by U.S. federal and state as well as foreign antitrust and competition laws and regulations. In general, the objective of these laws is to promote and maintain free competition by prohibiting certain forms of conduct that tend to restrict production, raise prices, or otherwise control the market for goods or services to the detriment of consumers of those goods and services. Potentially prohibited activities under these laws may include unilateral conduct, or conduct undertaken as the result of an agreement with one or more of our suppliers, competitors, or customers. The potential for liability under these laws can be difficult to predict as it often depends on a finding that the challenged conduct resulted in harm to competition, such as higher prices, restricted supply, or a reduction in the quality or variety of products available to consumers. We utilize a number of different distribution channels to deliver our products to the end consumer, and regularly enter agreements with resellers of our products at various levels in the distribution chain that could be subject to scrutiny under these laws in the event of private litigation or an investigation by a governmental competition authority. In addition, many of our products are sold to consumers via the Internet. Many of the competition-related laws that govern these Internet sales were adopted prior to the advent of the Internet, and, as a result, do not contemplate or address the unique issues

raised by online sales. New interpretations of existing laws and regulations, whether by courts or by the state, federal or foreign governmental authorities charged with the enforcement of those laws and regulations, may also impact our business in ways we are currently unable to predict. Any failure on our part or on the part of our employees, agents, distributors or other business partners to comply with the laws and regulations governing competition can result in negative publicity and diversion of management time and effort and may subject us to significant litigation liabilities and other penalties.

In addition to government regulations, many of our customers require us to comply with their own requirements regarding manufacturing, health and safety matters, corporate social responsibility, employee treatment, anti-corruption, use of materials and environmental concerns. Some customers may require us to periodically report on compliance with their unique requirements, and some customers reserve the right to audit our business for compliance. We are increasingly subject to requests for compliance with these customer requirements. For example, there has been significant focus from our customers as well as the press regarding corporate social responsibility policies. Recently, a number of jurisdictions have adopted public disclosure requirements on related topics, including labor practices and policies within companies' supply chains. We regularly audit our manufacturers; however,

Table of Contents

any deficiencies in compliance by our manufacturers may harm our business and our brand. In addition, we may not have the resources to maintain compliance with these customer requirements and failure to comply may result in decreased sales to these customers, which may have a material adverse effect on our business, financial condition and results of operations.

We are currently involved in numerous litigation matters and may in the future become involved in additional litigation, including litigation regarding intellectual property rights, which could be costly and subject us to significant liability.

The networking industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding infringement of patents, trade secrets and other intellectual property rights. In particular, leading companies in the data communications markets, some of which are our competitors, have extensive patent portfolios with respect to networking technology. From time to time, third parties, including these leading companies, have asserted and may continue to assert exclusive patent, copyright, trademark and other intellectual property rights against us demanding license or royalty payments or seeking payment for damages, injunctive relief and other available legal remedies through litigation. These also include third-party non-practicing entities who claim to own patents or other intellectual property that cover industry standards that our products comply with. If we are unable to resolve these matters or obtain licenses on acceptable or commercially reasonable terms, we could be sued or we may be forced to initiate litigation to protect our rights. The cost of any necessary licenses could significantly harm our business, operating results and financial condition. We may also choose to join defensive patent aggregation services in order to prevent or settle litigation against such non-practicing entities and avoid the associated significant costs and uncertainties of litigation. These patent aggregation services may obtain, or have previously obtained, licenses for the alleged patent infringement claims against us and other patent assets that could be used offensively against us. The costs of such defensive patent aggregation services, while potentially lower than the costs of litigation, may be significant as well. At any time, any of these non-practicing entities, or any other third-party could initiate litigation against us, or we may be forced to initiate litigation against them, which could divert management attention, be costly to defend or prosecute, prevent us from using or selling the challenged technology, require us to design around the challenged technology and cause the price of our stock to decline. In addition, third parties, some of whom are potential competitors, have initiated and may continue to initiate litigation against our manufacturers, suppliers, members of our sales channels or our service provider customers or even end user customers, alleging infringement of their proprietary rights with respect to existing or future products. In the event successful claims of infringement are brought by third parties, and we are unable to obtain licenses or independently develop alternative technology on a timely basis, we may be subject to indemnification obligations, be unable to offer competitive products, or be subject to increased expenses. Finally, consumer class-action lawsuits related to the marketing and performance of our home networking products have been asserted and may in the future be asserted against us. For additional information regarding certain of the lawsuits in which we are involved, see the information set forth under Note 7, Commitments and Contingencies, in notes to the consolidated financial statements in Item 1 of Part I of this Quarterly Report on Form 10-Q. If we do not resolve these claims on a favorable basis, our business, operating results and financial condition could be significantly harmed.

\* If our goodwill or intangible assets become impaired we may be required to record a significant charge to earnings.

Under generally accepted accounting principles, we review our intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered when determining if the carrying value of our goodwill or intangible assets may not be recoverable include a significant decline in our expected future cash flows or a sustained, significant decline in our stock price and market capitalization.

As a result of our acquisitions, we have significant goodwill and intangible assets recorded on our balance sheet. In addition, significant negative industry or economic trends, such as those that have occurred as a result of the recent economic downturn, including reduced estimates of future cash flows or disruptions to our business could indicate that goodwill or intangible assets might be impaired. If, in any period our stock price decreases to the point where our market capitalization is less than our book value, this too could indicate a potential impairment and we may be required to record an impairment charge in that period. Our valuation methodology for assessing impairment requires management to make judgments and assumptions based on projections of future operating performance. The estimates used to calculate the fair value of a reporting unit change from year to year based on operating results and market conditions. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit. We operate in highly competitive environments and projections of future operating results and cash flows may vary significantly from actual results. As a result, we may incur substantial impairment charges to earnings in our financial statements should an impairment of our goodwill or intangible assets be determined resulting in an adverse impact on our results of operations.

Table of Contents

We are required to evaluate our internal controls under Section 404 of the Sarbanes-Oxley Act of 2002 and any adverse results from such evaluation, including restatements of our issued financial statements, could impact investor confidence in the reliability of our internal controls over financial reporting.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to furnish a report by our management on our internal control over financial reporting. Such report must contain among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. From time to time, we conduct internal investigations as a result of whistleblower complaints. In some instances, the whistleblower complaint may implicate potential areas of weakness in our internal controls. Although all known material weaknesses have been remediated, we cannot be certain that the measures we have taken ensure that restatements will not occur in the future. Execution of restatements create a significant strain on our internal resources and could cause delays in our filing of quarterly or annual financial results, increase our costs and cause management distraction. Restatements may also significantly affect our stock price in an adverse manner.

Continued performance of the system and process documentation and evaluation needed to comply with Section 404 is both costly and challenging. During this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we will be unable to assert such internal control is effective. If we are unable to assert that our internal control over financial reporting is effective as of the end of a fiscal year or if our independent registered public accounting firm is unable to express an opinion on the effectiveness of our internal control over financial reporting, we could lose investor confidence in the accuracy and completeness of our financial reports, which may have an adverse effect on our stock price.

The marketability of our AirCard products may suffer if wireless telecommunications operators do not deliver acceptable wireless services.

The success of the AirCard product line depends, in part, on the capacity, affordability, reliability and prevalence of wireless data networks provided by wireless telecommunications operators and on which our AirCard products operate. Currently, various wireless telecommunications operators, either individually or jointly with us, sell our products in connection with the sale of their wireless data services to their customers. Growth in demand for wireless data access may be limited if, for example, wireless telecommunications operators cease or materially curtail operations, fail to offer services that customers consider valuable at acceptable prices, fail to maintain sufficient capacity to meet demand for wireless data access, delay the expansion of their wireless networks and services, fail to offer and maintain reliable wireless network services or fail to market their services effectively.

In addition, the future growth of our AirCard product line depends on the successful deployment of next generation wireless data networks provided by third parties, including those networks for which we are currently developing products. If these next generation networks are not deployed or widely accepted, or if deployment is delayed, there will be no market for the AirCard products we are developing to operate on these networks. If any of these events occurs, or if for any other reason the demand for wireless data access fails to grow, sales of our products will decline or remain stagnant and our business could be harmed.

If disruptions in our transportation network occur or our shipping costs substantially increase, we may be unable to sell or timely deliver our products, and our operating expenses could increase.

We are highly dependent upon the transportation systems we use to ship our products, including surface and air freight. Our attempts to closely match our inventory levels to our product demand intensify the need for our transportation systems to function effectively and without delay. On a quarterly basis, our shipping volume also tends to steadily increase as the quarter progresses, which means that any disruption in our transportation network in the latter half of a quarter will likely have a more material effect on our business than at the beginning of a quarter.



The transportation network is subject to disruption or congestion from a variety of causes, including labor disputes or port strikes, acts of war or terrorism, natural disasters and congestion resulting from higher shipping volumes. For example, in June 2013, a ship carrying containers of our products among its cargo sank, and the shipment was lost. Although covered by insurance, this loss led to delays in delivery and our receipt of payment. Labor disputes among freight carriers and at ports of entry are common, particularly in Europe, and we expect labor unrest and its effects on shipping our products to be a continuing challenge for us. A port worker strike, work slow-down or other transportation disruption in Long Beach, California, where we have a significant distribution center, could significantly disrupt our business. For example, a series of work stoppages and slow-downs arising from labor disputes at the Long Beach port and other West Coast ports, particularly in the first quarter of 2015, negatively impacted our ability to timely deliver certain product shipments to the United States and resulted in additional transportation expense. Our international freight is regularly subjected to inspection by governmental entities. If our delivery times increase unexpectedly for these or any other reasons, our ability to deliver products on time would be materially adversely affected and

Table of Contents

result in delayed or lost revenue as well as customer imposed penalties. In addition, if increases in fuel prices occur, our transportation costs would likely increase. Moreover, the cost of shipping our products by air freight is greater than other methods. From time to time in the past, we have shipped products using extensive air freight to meet unexpected spikes in demand, shifts in demand between product categories, to bring new product introductions to market quickly and to timely ship products previously ordered. If we rely more heavily upon air freight to deliver our products, our overall shipping costs will increase. A prolonged transportation disruption or a significant increase in the cost of freight could severely disrupt our business and harm our operating results.

We are exposed to the credit risk of some of our customers and to credit exposures in weakened markets, which could result in material losses.

A substantial portion of our sales are on an open credit basis, with typical payment terms of 30 to 60 days in the United States and, because of local customs or conditions, longer in some markets outside the United States. We monitor individual customer financial viability in granting such open credit arrangements, seek to limit such open credit to amounts we believe the customers can pay, and maintain reserves we believe are adequate to cover exposure for doubtful accounts.

In the past, there have been bankruptcies amongst our customer base, and certain of our customers' businesses face financial challenges that put them at risk of future bankruptcies. For example, our customer RadioShack Corp. filed for Chapter 11 bankruptcy protection in 2015. Although any resulting loss has not been material to date, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition. To the degree that turmoil in the credit markets makes it more difficult for some customers to obtain financing, our customers' ability to pay could be adversely impacted, which in turn could have a material adverse impact on our business, operating results, and financial condition.

We have expanded our operations and infrastructure, which may strain our operations and increase our operating expenses.

We have expanded our operations and are pursuing market opportunities both domestically and internationally in order to grow our sales. As a result of the acquisition of the AirCard business of Sierra Wireless in 2013, we added two new locations with over 80 personnel housed at each site, one in Carlsbad, California, and one in Richmond, British Columbia. This expansion required enhancements to our existing management information systems, and operational and financial controls. In addition, if we continue to grow, our expenditures will likely be significantly higher than our historical costs. We may not be able to install adequate controls in an efficient and timely manner as our business grows, and our current systems may not be adequate to support our future operations. The difficulties associated with installing and implementing new systems, procedures and controls may place a significant burden on our management, operational and financial resources. In addition, if we grow internationally, we will have to expand and enhance our communications infrastructure. If we fail to continue to improve our management information systems, procedures and financial controls or encounter unexpected difficulties during expansion and reorganization, our business could be harmed.

For example, we have invested, and will continue to invest, significant capital and human resources in the design and enhancement of our financial and enterprise resource planning systems, which may be disruptive to our underlying business. We depend on these systems in order to timely and accurately process and report key components of our results of operations, financial position and cash flows. If the systems fail to operate appropriately or we experience any disruptions or delays in enhancing their functionality to meet current business requirements, our ability to fulfill customer orders, bill and track our customers, fulfill contractual obligations, accurately report our financials and otherwise run our business could be adversely affected. Even if we do not encounter these adverse effects, the enhancement of systems may be much more costly than we anticipated. If we are unable to continue to enhance our

information technology systems as planned, our financial position, results of operations and cash flows could be negatively impacted.

We invest in companies for both strategic and financial reasons, but may not realize a return on our investments.

We have made, and continue to seek to make, investments in companies around the world to further our strategic objectives and support our key business initiatives. These investments may include equity or debt instruments of public or private companies, and may be non-marketable at the time of our initial investment. We do not restrict the types of companies in which we seek to invest. These companies may range from early-stage companies that are often still defining their strategic direction to more mature companies with established revenue streams and business models. If any company in which we invest fails, we could lose all or part of our investment in that company. If we determine that an other-than-temporary decline in the fair value exists for an equity or debt investment in a public or private company in which we have invested, we will have to write down the investment to its fair value and recognize the related write-down as an investment loss. The performance of any of these investments could result in significant impairment charges and gains (losses) on other equity investments. We must also analyze accounting and legal issues when making these investments. If we do not structure these investments properly, we may be subject to certain adverse accounting issues, such as potential consolidation of financial results.

Table of Contents

Furthermore, if the strategic objectives of an investment have been achieved, or if the investment or business diverges from our strategic objectives, we may seek to dispose of the investment. Our non-marketable equity investments in private companies are not liquid, and we may not be able to dispose of these investments on favorable terms or at all. The occurrence of any of these events could harm our results. Gains or losses from equity securities could vary from expectations depending on gains or losses realized on the sale or exchange of securities and impairment charges related to debt instruments as well as equity and other investments.

We rely upon third parties for technology that is critical to our products, and if we are unable to continue to use this technology and future technology, our ability to develop, sell, maintain and support technologically innovative products would be limited.

We rely on third parties to obtain non-exclusive patented hardware and software license rights in technologies that are incorporated into and necessary for the operation and functionality of most of our products. In these cases, because the intellectual property we license is available from third parties, barriers to entry into certain markets may be lower for potential or existing competitors than if we owned exclusive rights to the technology that we license and use. Moreover, if a competitor or potential competitor enters into an exclusive arrangement with any of our key third-party technology providers, or if any of these providers unilaterally decide not to do business with us for any reason, our ability to develop and sell products containing that technology would be severely limited. If we are shipping products that contain third-party technology that we subsequently lose the right to license, then we will not be able to continue to offer or support those products. In addition, these licenses often require royalty payments or other consideration to the third party licensor. Our success will depend, in part, on our continued ability to access these technologies, and we do not know whether these third-party technologies will continue to be licensed to us on commercially acceptable terms, if at all. If we are unable to license the necessary technology, we may be forced to acquire or develop alternative technology of lower quality or performance standards, which would limit and delay our ability to offer new or competitive products and increase our costs of production. As a result, our margins, market share, and operating results could be significantly harmed.

We also utilize third-party software development companies to develop, customize, maintain and support software that is incorporated into our products. If these companies fail to timely deliver or continuously maintain and support the software, as we require of them, we may experience delays in releasing new products or difficulties with supporting existing products and customers. In addition, if these third-party licensors fail or experience instability, then we may be unable to continue to sell products that incorporate the licensed technologies in addition to being unable to continue to maintain and support these products. We do require escrow arrangements with respect to certain third-party software which entitle us to certain limited rights to the source code, in the event of certain failures by the third party, in order to maintain and support such software. However, there is no guarantee that we would be able to understand and use the source code, as we may not have the expertise to do so. We are increasingly exposed to these risks as we continue to develop and market more products containing third-party software, such as our TV connectivity, security and network attached storage products.

If we are unable to secure and protect our intellectual property rights, our ability to compete could be harmed.

We rely upon third parties for a substantial portion of the intellectual property that we use in our products. At the same time, we rely on a combination of copyright, trademark, patent and trade secret laws, nondisclosure agreements with employees, consultants and suppliers and other contractual provisions to establish, maintain and protect our intellectual property rights. Despite efforts to protect our intellectual property, unauthorized third parties may attempt to design around, copy aspects of our product design or obtain and use technology or other intellectual property associated with our products. For example, one of our primary intellectual property assets is the NETGEAR name, trademark and logo. We may be unable to stop third parties from adopting similar names, trademarks and logos,

particularly in those international markets where our intellectual property rights may be less protected. Furthermore, our competitors may independently develop similar technology or design around our intellectual property. Our inability to secure and protect our intellectual property rights could significantly harm our brand and business, operating results and financial condition.

\* Political events, war, terrorism, public health issues, natural disasters and other circumstances could materially adversely affect us.

Our corporate headquarters are located in Northern California and one of our warehouses is located in Southern California, both of which are regions known for seismic activity. Substantially all of our critical enterprise-wide information technology systems, including our main servers, are currently housed in colocation facilities in Mesa, Arizona. While our critical information technology systems are located at colocation facilities in a different geographic region in the United States, our headquarters and warehouses remain susceptible to seismic activity so long as they are located in California. In addition, substantially all of our manufacturing occurs in two geographically concentrated areas in mainland China, where disruptions from natural disasters, health

Table of Contents

epidemics and political, social and economic instability may affect the region. If our manufacturers or warehousing facilities are disrupted or destroyed, we would be unable to distribute our products on a timely basis, which could harm our business.

In addition, war, terrorism, geopolitical uncertainties, public health issues, and other business interruptions have caused and could cause damage or disruption to international commerce and the global economy, and thus could have a strong negative effect on us, our suppliers, logistics providers, manufacturing vendors and customers. Our business operations are subject to interruption by natural disasters, fire, power shortages, terrorist attacks, and other hostile acts, labor disputes, public health issues, and other events beyond our control. For example, labor disputes at manufacturing facilities in China have led to workers going on strike, and labor unrest could materially affect our third-party manufacturers' abilities to manufacture our products. In addition, all of our major direct and indirect suppliers of hard disk drives were affected by record flooding in Thailand in 2011, leading to significant supply constraints, increased prices and disruption of our ReadyNAS product business. Furthermore, earthquakes and resultant nuclear threats and tsunamis in Japan in 2011 also caused disruption to our supply of raw materials and components for our products and impacted our operating results in Japan.

Such events could decrease demand for our products, make it difficult or impossible for us to make and deliver products to our customers or to receive components from our suppliers, and create delays and inefficiencies in our supply chain. Should major public health issues, including pandemics, arise, we could be negatively affected by more stringent employee travel restrictions, additional limitations in freight services, governmental actions limiting the movement of products between regions, delays in production ramps of new products, and disruptions in the operations of our manufacturing vendors and component suppliers.

Governmental regulations of imports or exports affecting Internet security could affect our net revenue.

Any additional governmental regulation of imports or exports or failure to obtain required export approval of our encryption technologies could adversely affect our international and domestic sales. The United States and various foreign governments have imposed controls, export license requirements, and restrictions on the import or export of some technologies, particularly encryption technology. In addition, from time to time, governmental agencies have proposed additional regulation of encryption technology, such as requiring the escrow and governmental recovery of private encryption keys. In response to terrorist activity, governments could enact additional regulation or restriction on the use, import, or export of encryption technology. This additional regulation of encryption technology could delay or prevent the acceptance and use of encryption products and public networks for secure communications, resulting in decreased demand for our products and services. In addition, some foreign competitors are subject to less stringent controls on exporting their encryption technologies. As a result, they may be able to compete more effectively than we can in the United States and the international Internet security market.

We are exposed to credit risk and fluctuations in the market values of our investment portfolio.

Although we have not recognized any material losses on our cash equivalents and short-term investments, future declines in their market values could have a material adverse effect on our financial condition and operating results. Given the global nature of our business, we have investments with both domestic and international financial institutions. Accordingly, we face exposure to fluctuations in interest rates, which may limit our investment income. If these financial institutions default on their obligations or their credit ratings are negatively impacted by liquidity issues, credit deterioration or losses, financial results, or other factors, the value of our cash equivalents and short-term investments could decline and result in a material impairment, which could have a material adverse effect on our financial condition and operating results.



Table of Contents

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) None.

## (c) Repurchase of Equity Securities by the Company

Period	Total Number of Shares Purchased (2)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 04, 2016 - July 31, 2016	2,221	\$ 51.43	—	1,634,956
August 01, 2016 - August 28, 2016	—	\$ —	—	1,634,956
August 29, 2016 - October 2, 2016	5,576	\$ 60.02	—	1,634,956
Total	7,797	\$ 57.57	—	

From time to time, our Board of Directors has authorized programs under which we may repurchase shares of its common stock, depending on market conditions, in the open market or through privately negotiated transactions.

1. Under these authorizations, the timing and actual number of shares subject to repurchase are at the discretion of management and are contingent on a number of factors, such as levels of cash generation from operations, cash requirements for acquisitions and the price of our common stock. During the three months ended October 2, 2016, we didn't repurchase or retire any common stock.

2. We repurchased, as reported based on trade date, approximately 8,000 shares of common stock at a cost of approximately \$0.4 million to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving RSUs during the three months ended October 2, 2016.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

## Item 6. Exhibits

See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.





Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NETGEAR, INC.

Registrant

/s/ CHRISTINE M. GORJANC

Christine M. Gorjanc

Chief Financial Officer

(Principal Financial and Accounting Officer)

Date: November 4, 2016

66

---

Table of Contents

## Exhibit Index

Exhibit Number	Exhibit Description	Incorporated by Reference		Number	Filed Herewith
		Form	Date		
3.1	Amended and Restated Certificate of Incorporation of the registrant	S-1	7/30/2003	3.3	
3.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation of the registrant	10-Q	7/31/2015	3.2	
3.3	Amended and Restated Bylaws of the registrant	8-K	4/20/2016	3.2	
4.1	Form of registrant's common stock certificate	S-1	7/30/2003	4.1	
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer				X
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer				X
32.1#	Section 1350 Certification of Principal Executive Officer				X
32.2#	Section 1350 Certification of Principal Financial Officer				X
101.INS	XBRL Instance Document				X
101.SCH	XBRL Taxonomy Extension Schema Document				X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document				X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document				X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document				X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document				X

# This certification is deemed to accompany this Form 10-Q and will not be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") or otherwise subject to the liabilities of that section. This certification will not be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.