

NETGEAR, INC  
Form 10-Q  
November 06, 2012  
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 September 30, 2012.

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 38,272,676 as of October 30, 2012.

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>33</u>
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>45</u>
Item 4.	<u>Controls and Procedures</u>	<u>45</u>

PART II: OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	<u>46</u>
Item 1A.	<u>Risk Factors</u>	<u>46</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>66</u>
Item 5.	<u>Other Information</u>	<u>66</u>
Item 6.	<u>Exhibits</u>	<u>67</u>
	<u>Signatures</u>	<u>68</u>

Table of Contents

## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

## NETGEAR, INC.

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 134,601	\$ 208,898
Short-term investments	227,819	144,797
Accounts receivable, net	248,862	261,307
Inventories	178,916	163,724
Deferred income taxes	22,705	23,088
Prepaid expenses and other current assets	38,173	32,415
Total current assets	851,076	834,229
Property and equipment, net	18,927	15,884
Intangibles, net	27,701	20,956
Goodwill	100,880	85,944
Other non-current assets	20,053	14,357
Total assets	\$ 1,018,637	\$ 971,370
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 91,070	\$ 117,285
Accrued employee compensation	21,116	26,896
Other accrued liabilities	120,829	120,480
Deferred revenue	28,205	40,093
Income taxes payable	1,829	4,207
Total current liabilities	263,049	308,961
Non-current income taxes payable	17,525	18,657
Other non-current liabilities	5,286	4,995
Total liabilities	285,860	332,613
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Common stock	38	38
Additional paid-in capital	388,812	364,243
Cumulative other comprehensive (loss) income	(171	) 23
Retained earnings	344,098	274,453
Total stockholders' equity	732,777	638,757
Total liabilities and stockholders' equity	\$ 1,018,637	\$ 971,370

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	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
Net revenue	\$315,210	\$301,800	\$961,485	\$871,863
Cost of revenue	217,522	205,490	669,310	597,390
Gross profit	97,688	96,310	292,175	274,473
Operating expenses:				
Research and development	17,399	12,738	46,277	35,102
Sales and marketing	37,600	39,600	114,247	115,284
General and administrative	11,888	10,851	33,520	31,044
Restructuring and other charges	—	—	—	2,094
Litigation reserves, net	269	44	420	(234)
Total operating expenses	67,156	63,233	194,464	183,290
Income from operations	30,532	33,077	97,711	91,183
Interest income	109	115	344	350
Other income (expense), net	3,070	(267)	2,823	(938)
Income before income taxes	33,711	32,925	100,878	90,595
Provision for income taxes	9,920	6,178	30,418	22,062
Net income	\$23,791	\$26,747	\$70,460	\$68,533
Net income per share:				
Basic	\$0.62	\$0.71	\$1.86	\$1.85
Diluted	\$0.61	\$0.70	\$1.82	\$1.81
Weighted average shares outstanding used to compute net income per share:				
Basic	38,162	37,483	37,978	36,967
Diluted	38,802	38,080	38,682	37,812

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	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
Net income	\$23,791	\$26,747	\$70,460	\$68,533
Other comprehensive loss, before tax:				
Unrealized loss on derivative instruments	(303	) (70	) (187	) (317
Unrealized gain (loss) on available-for-sale securities	23	(5	) (12	) 34
Other comprehensive loss, before tax	(280	) (75	) (199	) (283
Tax (expense) benefit related to items of other comprehensive income	(7	) (2	) 5	(12
Other comprehensive loss, net of tax	(287	) (77	) (194	) (295
Comprehensive income	\$23,504	\$26,670	\$70,266	\$68,238

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	
	September 30, 2012	October 2, 2011
Cash flows from operating activities:		
Net income	\$70,460	\$68,533
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,125	11,068
Purchase premium amortization on investments	2,018	467
Non-cash stock-based compensation	10,806	10,334
Income tax benefit associated with stock option exercises	926	3,269
Gain on sale of cost method investment	(3,126)	) —
Excess tax benefit from stock-based compensation	(1,374)	) (3,426)
Deferred income taxes	(1,602)	) (1,516)
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	12,469	8,078
Inventories	(14,603)	) (2,279)
Prepaid expenses and other assets	74	(5,813)
Accounts payable	(26,855)	) (13,484)
Accrued employee compensation	(6,005)	) (940)
Other accrued liabilities	(2,126)	) (3,013)
Deferred revenue	(12,120)	) (3,604)
Income taxes payable	(3,507)	) (4,521)
Net cash provided by operating activities	37,560	63,153
Cash flows from investing activities:		
Purchases of short-term investments	(308,787)	) (188,329)
Proceeds from maturities of short-term investments	223,733	185,680
Purchase of property and equipment	(11,492)	) (5,816)
Payments made in connection with business acquisitions, net of cash acquired	(28,625)	) (37,509)
Net cash used in investing activities	(125,171)	) (45,974)
Cash flows from financing activities:		
Purchase and retirement of treasury stock	(815)	) (899)
Proceeds from exercise of stock options	10,757	26,647
Proceeds from issuance of common stock under employee stock purchase plan	1,998	1,752
Excess tax benefit from stock-based compensation	1,374	3,426
Net cash provided by financing activities	13,314	30,926
Net (decrease) increase in cash and cash equivalents	(74,297)	) 48,105
Cash and cash equivalents, at beginning of period	208,898	126,173
Cash and cash equivalents, at end of period	\$134,601	\$174,278

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. For consumers, the Company makes high performance, dependable and easy-to-use home networking, storage and digital media products to connect people with the Internet and their content and devices. For businesses, the Company provides networking, storage and security solutions without the cost and complexity of Big IT. The Company also supplies leading service providers with made-to-order and retail proven, whole home networking solutions for sale to their customers. The Company's products are built on a variety of proven technologies such as wireless, Ethernet and powerline, with a focus on reliability and ease-of-use. The Company sells products primarily through a global sales channel network, which includes traditional retailers, online retailers, wholesale distributors, direct market resellers ("DMRs"), value added resellers ("VARs"), and broadband service providers.

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, 2011, has been derived from audited financial statements at such date. 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, 2011.

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 revenues and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

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, 2011. The Company's significant accounting policies have not materially changed during the nine months ended September 30, 2012.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs", which amends current fair value measurement and disclosure guidance to converge with International Financial Reporting Standards ("IFRS") and provides increased transparency around valuation inputs and investment categorization. ASU 2011-04 became effective prospectively for the Company in the first quarter of fiscal 2012. The

Company's adoption of ASU 2011-04 did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income." ASU 2011-05 eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. ASU 2011-05 allows two presentation alternatives: present items of net income and other comprehensive income (1) in one continuous statement, referred to as the statement of comprehensive income or (2) in two separate, but consecutive, statements of net income and other comprehensive income. ASU 2011-05 is effective retrospectively starting in the first quarter of fiscal 2012. In December 2011, the FASB issued ASU 2011-12, which defers the ASU 2011-05 requirement to present components of reclassifications of other comprehensive income on the face of the income statement. The amendments in ASU 2011-12 are effective at the same time as the amendments in ASU 2011-05. All other requirements of ASU 2011-05 are not affected by ASU 2011-12. Since the adoption of the authoritative guidance only required additional disclosures, the adoption did not impact the Company's consolidated financial

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

position, results of operations or cash flows.

In July 2012, the FASB issued ASU 2012-02, "Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment". The guidance in ASU 2012-02 provides the option to first assess qualitative factors to determine whether it is necessary to perform a quantitative impairment test. Calculation of the fair value of an indefinite-lived intangible asset would not be required unless it is determined, based on the qualitative assessment, that it is not more likely than not, the indefinite-lived intangible asset is impaired. ASU 2012-02 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after September 15, 2012. Early adoption of ASU 2012-02 is permitted. The Company will adopt ASU 2012-02 in the fourth quarter of 2012 and it does not anticipate that the adoption will have a significant impact on its financial position, results of operations or cash flows.

**3. Business Acquisitions****AVAAK, Inc.**

On July 2, 2012, the Company acquired 100% of the voting equity interests of AVAAK, Inc. ("AVAAK"), a privately-held company that developed wire-free video networking products for a total purchase consideration of \$24.0 million in cash. The Company believes the acquisition will bolster its retail business unit product offerings and expand its presence into the smart home market. The Company paid \$21.6 million of the aggregate purchase price in the third quarter of 2012, and expects to pay the remaining \$2.4 million, less amounts used to satisfy certain claims, twelve months after the closing of the acquisition.

The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting. The results of AVAAK have been included in the consolidated financial statements since the date of acquisition. Pro forma results of operations for the acquisition are not presented as the financial impact to the Company's consolidated results of operations is not material.

The allocation of the purchase price was as follows (in thousands):

Net tangible assets acquired (liabilities assumed)	\$ 172
Deferred tax assets, net	5,937
Intangible assets, net	6,000
Goodwill	11,895
Total consideration	\$ 24,004

The estimation of fair values for tangible assets and intangible assets acquired and liabilities assumed was subject to estimates, assumptions and other uncertainties, and it is possible that the allocation of the purchase consideration reflected in the foregoing table may change.

None of the goodwill recognized related to AVAAK is deductible for income tax purposes. The goodwill recognized, which was assigned to the Company's retail business unit, is primarily attributable to expected synergies resulting from the acquisition.

In connection with the acquisition, the Company recorded \$5.9 million of deferred tax assets net of deferred tax liabilities. The deferred tax assets arise from the tax benefit of the estimated net operating losses as of the date of the acquisition after consideration of limitations on the use under U.S. Internal Revenue Code section 382. The deferred tax assets are reduced by deferred tax liabilities recorded for the book basis in intangible assets and in-process research and development ("IPR&D") for which the Company has no tax basis.

The Company designated \$2.3 million of the acquired intangible assets as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 14.0%. The acquired existing technology is being amortized over its estimated useful life of five years.

The Company designated \$0.3 million of the acquired intangible assets as customer relationships. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations

attributable to existing customer relationships and discounted at 14.0%. The acquired customer relationships are being amortized over an estimated useful life of five years.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The Company designated \$1.4 million of the acquired intangible assets as trade name and trademarks. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to existing trade name and trademarks and discounted at 16.0%. The acquired trade name and trademarks are being amortized over an estimated useful life of five years.

In addition, \$2.0 million of the consideration paid represents the fair value of acquired IPR&D projects. The IPR&D acquired is considered indefinite lived intangible assets until research and development efforts associated with the projects are completed or abandoned. The most significant of the acquired IPR&D projects relate to camera technology and applications.

Firetide, Inc.

On June 4, 2012, the Company acquired certain intellectual property of Firetide, Inc. ("Firetide") for an aggregate purchase price of \$7.2 million in cash. The acquisition included intangible assets that existed at the closing date, including IP contracts, technology assets, business technology, and goodwill. The Company believes the acquisition will bolster its wireless product offerings in its commercial business unit and strengthen its market position in the small to medium size campus wireless LAN market. The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting.

The Company paid \$6.6 million of the aggregate purchase price in the second quarter of 2012, and expects to pay the remaining \$0.6 million, less amounts used to satisfy certain claims, twelve months after the closing of the acquisition. The ongoing costs of developing these assets subsequent to the date of acquisition have been included in the consolidated financial statements since the date of acquisition. The historical results of operations related to the acquired assets prior to the acquisition were not material to the Company's results of operations.

The allocation of the purchase price was as follows (in thousands):

Intangible assets, net	\$4,159
Goodwill	3,041
Total consideration	\$7,200

The estimation of fair values for intangible assets acquired was subject to estimates, assumptions and other uncertainties, and it is possible that the allocation of the purchase consideration reflected in the foregoing table may change.

Of the \$3.0 million of goodwill recorded on the acquisition of Firetide, approximately \$1.7 million and \$3.0 million is deductible for U.S. federal and state income tax purposes, respectively. The goodwill recognized, which was assigned to the Company's commercial business unit, is primarily attributable to expected synergies and the assembled workforce of Firetide.

The Company designated the \$4.2 million in acquired intangible assets as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 22.0%. The acquired existing technology is being amortized over its estimated useful life of five years.

Customer Networking Solutions Division of Westell Technologies, Inc.

On April 15, 2011, the Company completed the acquisition of certain intellectual property and other assets of the Customer Networking Solutions division ("CNS") of Westell Technologies, Inc. ("Westell") at a purchase price of \$37.0 million in cash. The acquisition included inventories, property and equipment, intangible assets, and liabilities that existed at the closing date, including employee bonuses and product warranties. The acquisition qualifies as a business combination and was accounted for using the acquisition method of accounting. The Company believes the acquisition will bolster its service provider revenue growth and strengthen its market position among U.S. telecommunications operators.

The results of CNS's operations have been included in the consolidated financial statements since the date of acquisition. The historical results of operations of CNS prior to the acquisition were not material to the Company's

results of operations.

9

---

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The allocation of the purchase price was as follows (in thousands):

Net tangible assets acquired (liabilities assumed)	\$5,763
Intangible assets, net	19,500
Goodwill	11,746
Total consideration	\$37,009

Of the \$11.7 million of goodwill recorded on the acquisition of CNS, approximately \$10.4 million and \$11.6 million was deductible for U.S. federal and state income tax purposes, respectively. The goodwill recognized, which was assigned to the Company's service provider business unit, is primarily attributable to expected synergies and the assembled workforce of CNS.

A total of \$15.7 million of the \$19.5 million in acquired intangible assets was designated as customer contracts and related relationships. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to existing customer contracts and related relationships and discounted at 19.0%. This \$15.7 million is being amortized over its estimated useful life of eight years.

A total of \$3.7 million of the \$19.5 million in acquired intangible assets was designated as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the core technology and discounted at 16.0%. This \$3.7 million is being amortized over its estimated useful life of four years.

A total of \$0.1 million of the \$19.5 million in acquired intangible assets was designated as order backlog. The value was calculated based on an estimate of order backlog using the expected cash flow for the orders and discounted at 3.3%. This \$0.1 million was fully amortized in the third quarter of 2011.

## Leaf Networks, LLC

On January 15, 2010, the Company completed the acquisition of certain intellectual property and other assets of Leaf Networks, LLC ("Leaf"), a developer of virtual networking software. The acquisition qualified as a business acquisition and was accounted for using the purchase method of accounting. The Company believes the acquisition will accelerate the Company's continuing networking technology research and development initiatives. The aggregate purchase price was \$2.1 million, of which \$2.0 million was paid in cash in the first quarter of 2010 and \$0.1 million was paid in the first quarter of 2011.

Additionally, the acquisition agreement specified that Leaf shareholders may receive a total additional payout of up to \$0.9 million in cash over the three years following the closing of the acquisition if developed products pass certain acceptance criteria. During the first quarter of 2010, the Company initially determined that the present value of the \$0.9 million potential additional payout was approximately \$0.8 million. For each subsequent reporting period, the Company remeasured fair value of the potential payout and recorded a liability. The Company paid \$0.4 million for the first portion of this additional payout in the first quarter of 2011 and the remaining \$0.5 million in the first quarter of 2012.

The results of Leaf's operations have been included in the consolidated financial statements since the date of acquisition. The historical results of operations of Leaf prior to the acquisition were not material to the Company's results of operations.

In accordance with the acquisition method of accounting for business combinations, the Company allocated the total purchase price to identifiable intangible assets based on each element's estimated fair value. Acquisition costs were expensed as incurred, and were immaterial for this transaction. Purchased intangibles, representing the existing technology acquired from Leaf, will be amortized on a straight-line basis over their respective estimated useful lives. Goodwill was recorded based on the residual purchase price after allocating the purchase price to the fair market value of intangible assets acquired. Goodwill arose as a result of the \$0.8 million present valuation of the \$0.9 million potential additional payout, plus \$0.1 million in additional payment consideration.



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The allocation of the purchase price was as follows (in thousands):

Intangible assets, net	\$2,000
Goodwill	900
Total purchase price allocation	\$2,900

Of the \$0.9 million of goodwill recorded on the acquisition of Leaf, approximately \$0.5 million and \$0.9 million was deductible for federal and state income tax purposes, respectively. The goodwill recognized, is primarily attributable to expected synergies and the assembled workforce of Leaf.

The \$2.0 million in acquired intangible assets was designated as technology. The value was calculated based on the present value of the future estimated cash flows derived from projections of future revenue attributable to existing technology. This \$2.0 million is being amortized over its estimated useful life of seven years.

## 4. Balance Sheet Components (in thousands)

## Short-Term Investments

	As of September 30, 2012				December 31, 2011			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. Treasuries	\$225,019	\$17	\$(1 )	\$225,035	\$144,673	\$34	\$(4 )	\$144,703
Certificates of Deposits	2,784	—	—	2,784	94	—	—	94
Total	\$227,803	\$17	\$(1 )	\$227,819	\$144,767	\$34	\$(4 )	\$144,797

All of the Company's marketable securities 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 short-term investments have unrealized losses greater than 12 months.

## Cost Method Investments

As of September 30, 2012 and December 31, 2011, the carrying value of the Company's cost method investments was \$1.3 million and \$3.0 million respectively. These investments are included in other non-current assets in the consolidated balance sheets and are carried at cost, adjusted for any impairment, because the Company does not have a controlling interest and does not have the ability to exercise significant influence over these companies. The Company monitors these investments for impairment on a quarterly basis, and adjusts carrying value for any impairment charges recognized. There were no impairments recognized in the three and nine months ended September 30, 2012 and October 2, 2011. Realized gains and losses on these investments are reported in other income (expense), net in the consolidated statements of operations. In the third fiscal quarter of 2012 the Company recognized a gain of \$3.1 million on the partial sale of one of its cost method investments.

## Accounts receivable, net

As of	
September 30,	December 31,
2012	2011

Edgar Filing: NETGEAR, INC - Form 10-Q

Gross accounts receivable	\$268,819	\$279,932
Allowance for doubtful accounts	(1,256)	) (1,335)
Allowance for sales returns	(15,465)	) (13,360)
Allowance for price protection	(3,236)	) (3,930)
Total allowances	(19,957)	) (18,625)
Total accounts receivable, net	\$248,862	\$261,307

11

---

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Inventories

	As of	
	September 30, 2012	December 31, 2011
Raw materials	\$4,352	\$4,676
Finished goods	174,564	159,048
Total inventories	\$178,916	\$163,724

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.

## Property and equipment, net

	As of	
	September 30, 2012	December 31, 2011
Computer equipment	\$7,154	\$7,109
Furniture, fixtures and leasehold improvements	12,415	9,757
Software	21,326	19,974
Machinery and equipment	28,533	21,797
Construction in progress	952	662
Total property and equipment, gross	70,380	59,299
Accumulated depreciation and amortization	(51,453	) (43,415
Total property and equipment, net	\$18,927	\$15,884

Depreciation expense was \$3.2 million and \$8.7 million for the three and nine months ended September 30, 2012, respectively, and \$2.5 million and \$7.4 million for the three and nine months ended October 2, 2011, respectively.

## Intangibles, net

The following tables present details of the Company's purchased intangible assets:

	Gross	Accumulated Amortization	Net
September 30, 2012			
Technology	\$32,059	\$(21,340	) \$10,719
Customer contracts and relationships	16,000	(2,795	) 13,205
Other	5,470	(2,893	) 2,577
Finite-lived intangibles, net	53,529	(27,028	) 26,501
Indefinite-lived intangible assets	1,200	—	1,200
Total purchased intangible assets, net	54,729	(27,028	) 27,701



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

	Gross	Accumulated Amortization	Net
December 31, 2011			
Technology	\$24,800	\$(19,905)	) \$4,895
Customer contracts and relationships	15,700	(1,308)	) 14,392
Other	4,070	(2,401)	) 1,669
Total purchased intangible assets, net	\$44,570	\$(23,614)	) \$20,956

In the third quarter of 2012, the Company purchased finite-lived intangible assets of \$4.0 million and indefinite-lived assets of \$2.0 million, as a result of its acquisition of AVAAK. For further discussion regarding the AVAAK acquisition, see Note 3, Business Acquisitions.

As of September 30, 2012, the Company had \$1.2 million in unamortized intangible assets related to IPR&D. All of the IPR&D assets were acquired in connection with the Company's acquisition of AVAAK. IPR&D assets represent IPR&D projects that have not reached technical feasibility and are required to be classified as indefinite-lived assets until the successful completion or abandonment of the associated research and development efforts. Accordingly, during the development period after the date of acquisition, these assets will not be amortized. When the asset reaches technical feasibility, the Company will determine the useful life of the asset, reclassify the asset out of IPR&D, and begin amortization. Development costs incurred after acquisition on acquired IPR&D projects are expensed as incurred. Estimated future cost to complete these IPR&D projects is \$0.4 million. As of September 30, 2012, \$0.8 million of the IPR&D had reached technical feasibility and as a result, was reclassified from IPR&D to technology.

Amortization of purchased intangible assets was \$1.4 million and \$3.4 million for the three and nine months ended September 30, 2012, respectively, and \$1.2 million, and \$3.7 million for the three and nine months ended October 2, 2011, respectively. No impairment charges were recorded in the three and nine months ended September 30, 2012, and October 2, 2011.

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

Year Ending December 31	Amount
2012 (remaining three months)	\$1,437
2013	5,458
2014	5,133
2015	4,517
2016	4,158
Thereafter	5,798
Total expected amortization expense	\$26,501

## Goodwill

The changes in the carrying amount of goodwill during the nine months ended September 30, 2012 are as follows:

	Retail	Commercial	Service Provider	Total
Goodwill at December 31, 2011	\$33,546	\$32,043	\$20,355	\$85,944
Goodwill acquired during the period	11,895	3,041	—	14,936
Goodwill at September 30, 2012	\$45,441	\$35,084	\$20,355	\$100,880

During the nine months ended September 30, 2012, the Company recorded goodwill of \$11.9 million and \$3.0 million, related to its acquisition of AVAAK, and certain intellectual property of Firetide, respectively. For further discussion, see Note 3, Business Acquisitions. There were no impairments to goodwill during the three and nine months ended September 30, 2012 and October 2, 2011.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Other accrued liabilities

	As of	
	September 30, 2012	December 31, 2011
Sales and marketing programs	\$39,973	\$44,394
Warranty obligation	44,393	44,846
Freight	5,733	7,940
Other	30,730	23,300
Total other accrued liabilities	\$120,829	\$120,480

## 5. Product Warranties

The Company provides for estimated future warranty obligations at the time revenue is recognized. The Company's standard warranty obligation to its direct customers generally provides for a right of return of any product for a full refund in the event that such product is not merchantable or is found to be damaged or defective. At the time revenue is recognized, an estimate of future warranty returns is recorded to reduce revenue in the amount of the expected credit or refund to be provided to its direct customers. At the time the Company records the reduction to revenue related to warranty returns, the Company includes within cost of revenue a write-down to reduce the carrying value of such products to net realizable value.

The Company's standard warranty obligation to its end-users provides for replacement of a defective product for one or more years. Factors that affect the warranty obligation include product failure rates, material usage and service delivery costs incurred in correcting product failures. The estimated cost associated with fulfilling the Company's warranty obligation to end-users is recorded in cost of revenue. Because the Company's products are manufactured by third party manufacturers, in certain cases the Company has recourse to the third party manufacturer for replacement or credit for the defective products. The Company gives consideration to amounts recoverable from its third party manufacturers in determining its warranty liability.

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

	Nine Months Ended	
	September 30, 2012	October 2, 2011
Balance as of beginning of the period	\$44,846	\$40,513
Provision for warranty liability made during the period	44,451	42,961
Settlements made during the period	(44,904	) (42,898
Balance at end of period	\$44,393	\$40,576

## 6. 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, 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 and limits the amount of credit exposure to any one counter-party. In addition, the derivative contracts typically mature in less than six 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

Table of Contents

NETGEAR, INC.

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

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, immateriality, 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 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.

The fair values of the Company's derivative instruments and the line items on the unaudited condensed consolidated balance sheet to which they were recorded as of September 30, 2012, and December 31, 2011, are summarized as follows (in thousands):

Derivative Assets	Balance Sheet Location	Fair Value at September 30, 2012	Balance Sheet Location	Fair Value at December 31, 2011
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	\$ 558	Prepaid expenses and other current assets	\$ 1,196
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	62	Prepaid expenses and other current assets	41
Total		\$ 620		\$ 1,237
Derivative Liabilities	Balance Sheet Location	Fair Value at September 30, 2012	Balance Sheet Location	Fair Value at December 31, 2011
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	\$(859)	Other accrued liabilities	\$(654)
Derivative liabilities designated as hedging instruments	Other accrued liabilities	(245)	Other accrued liabilities	(69)
Total		\$(1,104)		\$(723)

For details of the Company's fair value measurements, see Note 13, Fair Value of Financial Instruments.

## 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 five months. The Company enters into about five forward contracts per quarter with an average size of about \$6 million USD equivalent related to its cash flow hedging program.

The Company expects to reclassify to earnings all of the amounts recorded in other comprehensive income ("OCI") associated with its cash flow hedges over the next 12 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.

Table of Contents

NETGEAR, INC.

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

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 other comprehensive income associated 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 on discontinued cash flow hedges during the three and nine months ended September 30, 2012, and October 2, 2011.

The effects of the Company's derivative instruments on OCI and the unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2012, and October 2, 2011, are summarized as follows (in thousands):

Derivatives Designated as Hedging Instruments	Three Months Ended September 30, 2012				
	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	\$ (411 )	Net revenue	\$ (253 )	Other income (expense), net	\$ (26 )
Foreign currency forward contracts	—	Cost of revenue	5	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	140	Other income (expense), net	—
Total	\$ (411 )		\$ (108 )		\$ (26 )

Derivatives Designated as Hedging Instruments	Nine Months Ended September 30, 2012				
	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	\$ 142	Net revenue	\$ 431	Other income (expense), net	\$ (134 )
Foreign currency forward contracts	—	Cost of revenue	(2 )	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(100 )	Other income (expense), net	—
Total	\$ 142		\$ 329		\$ (134 )



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Derivatives Designated as Hedging Instruments	Three Months Ended October 2, 2011				
	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	190	Net revenue	280	Other income (expense), net	(94 )
Foreign currency forward contracts	—	Cost of revenue	—	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(20 )	Other income (expense), net	—
Total	190		260		(94 )

Derivatives Designated as Hedging Instruments	Nine Months Ended October 2, 2011				
	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	\$ 174	Net revenue	\$ 511	Other income (expense), net	\$ (222 )
Foreign currency forward contracts	—	Cost of revenue	(2 )	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(18 )	Other income (expense), net	—
Total	\$ 174		\$ 491		\$ (222 )

(a) Refer to Note 10, Stockholders' Equity, which summarizes the cumulative other comprehensive income activity related to derivatives.

The Company did not recognize any net gain or loss related to the ineffective portion of cash flow hedges during the three and nine months ended September 30, 2012, and October 2, 2011.

## 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 12 non-designated derivatives per quarter. The average size of its non-designated hedges is about \$2 million USD equivalent and these hedges range from one to five months in duration.

Table of Contents

NETGEAR, INC.

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

The effects of the Company's derivatives not designated as hedging instruments in other income (expense), net in the unaudited condensed consolidated statements of operations for the three and nine months ended September 30, 2012 and October 2, 2011, are as follows (in thousands):

Derivatives Not Designated as Hedging Instruments	Location of Gains or (Losses) Recognized in Income on Derivative	Amount of Gains or (Losses) Recognized in Income on Derivative	
		Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Foreign currency forward contracts	Other income (expense), net	\$ (564	) \$ (515

Derivatives Not Designated as Hedging Instruments	Location of Gains or (Losses) Recognized in Income on Derivative	Amount of Gains or (Losses) Recognized in Income on Derivative	
		Three Months Ended October 2, 2011	Nine Months Ended October 2, 2011
Foreign currency forward contracts	Other income (expense), net	\$ 1,602	\$(1,294

## 7. 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.

Net income per share for the three and nine months ended September 30, 2012, and October 2, 2011, are as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
Net income	\$23,791	\$26,747	\$70,460	\$68,533
Weighted average shares outstanding:				
Basic	38,162	37,483	37,978	36,967
Dilutive potential common shares	640	597	704	845
Total diluted	38,802	38,080	38,682	37,812
Basic net income per share	\$0.62	\$0.71	\$1.86	\$1.85
Diluted net income per share	\$0.61	\$0.70	\$1.82	\$1.81

Weighted average stock options and unvested restricted stock awards to purchase 2.6 million shares and 1.9 million shares of the Company's stock for the three months ended September 30, 2012, and October 2, 2011, respectively, and 2.7 million and 1.9 million shares for the nine months ended September 30, 2012, and October 2, 2011, respectively,

were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

8. Income Taxes

The income tax provision for the three and nine months ended September 30, 2012 was \$9.9 million or an effective tax rate of 29.4% and \$30.4 million or an effective tax rate of 30.2%, respectively. The income tax provision for the three and nine months ended October 2, 2011 was \$6.2 million or an effective tax rate of 18.8% and \$22.1 million or an effective tax rate of 24.4%, respectively. The increase in the effective tax rate for the three and nine month periods ended September 30, 2012, compared to the same period in the prior year was primarily caused by an increase in the mix of forecasted earnings from countries with relatively higher statutory tax rates. Additionally, the expiration of the federal research tax credit as of December 31, 2011 contributed to the increased effective tax rate for the respective periods. These increases were partially offset by a reduction in accruals for uncertain tax positions that were remeasured during the three month period ended September 30, 2012.

The Company has recorded the portion of its liability for uncertain tax positions that are not expected to be paid over the next 12 months as part of its long-term liability. The existing tax positions of the Company continue to generate an increase in the liability for uncertain tax positions. The Company is under examination in various US and foreign jurisdictions including by the U.S. Internal Revenue Service. The examination by the Internal Revenue Service includes the 2008 and 2009 calendar years. 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 uncertain tax positions in multiple jurisdictions that may impact the statement of operations in the next 12 months is approximately \$1.9 million, excluding interest, penalties and the effect of any related deferred tax assets or liabilities.

9. 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.

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 September 30, 2012, the Company had approximately \$177 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.

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 these indemnification agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2012.

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 September 30, 2012.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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 stock options 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 stock options.

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 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 12 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.

OptimumPath, L.L.C. v. NETGEAR

In January 2008, a lawsuit was filed against the Company by OptimumPath, L.L.C. ("OptimumPath"), a patent-holding company existing under the laws of the State of South Carolina, in the U.S. District Court, District of South Carolina. OptimumPath claims that certain of the Company's wireless networking products infringe on OptimumPath's U.S. Patent No. 7,035,281 ("the '281 Patent"). OptimumPath also sued six other technology companies alleging similar claims of patent infringement. The Company filed its answer to the lawsuit in the second quarter of 2008. Several defendants, including the Company, jointly filed a request for inter partes reexamination of the OptimumPath patent with the United States Patent and Trademark Office (the "USPTO") on October 13, 2008. On January 12, 2009, a reexamination was ordered with respect to claims 1-3 and 8-10 of the patent, but denied with respect to claims 4-7 and 11-32 of the patent. On February 4, 2009, the defendants jointly filed a petition to challenge the denial of reexamination of claims 4-7 and 11-32. On March 26, 2009, the USPTO confirmed the patentability of claims 1-3 and 8-10 without amendment. Shortly thereafter, in March 2009, the District Court granted defendants' motion to transfer the case to the U.S. District Court, Northern District of California. In July 2009, the defendants' petition to challenge the denial of reexamination of claims 4-7 and 11-32 was denied by the USPTO. Since the petition and prosecution were closed, the USPTO issued a Right of Appeal Notice on July 31, 2009, and the defendants chose to appeal the confirmation of claims 1-3 and 8-10 by filing a notice of appeal on August 31, 2009. The Company and OptimumPath attended a Court-ordered mediation on September 22, 2009 but were unable to make progress towards settlement. The Company and other defendants filed a combined claim construction/summary judgment brief on December 23, 2010. OptimumPath responded on January 20, 2011, and the defendants replied on February 3, 2011. The oral arguments on claim construction and the summary judgment motion were made on February 17, 2011. An oral hearing was held on March 9, 2011 in the USPTO and a decision by the USPTO was issued on March 30, 2011 confirming the patentability of claims 1-3 and 8-10. On April 12, 2011, the District Court granted defendants' motion for summary

judgment on OptimumPath's claim for literal infringement and defendants' motion to preclude OptimumPath's infringement claims based on the doctrine of equivalents. The Court also found that the accused devices did not infringe under the doctrine of equivalents. The Court also granted defendants' motion for summary judgment that asserted claims 1, 2, 6, and 9 through 13 of the '281 Patent were invalidated by various prior art. The pretrial conference and trial dates were vacated. OptimumPath filed its notice of appeal to the Federal Circuit of the District Court's rulings on May 18, 2011. On May 23, 2011, the District Court entered the defendants' joint request for costs in the amount of \$103,000, which have not yet been collected or recognized. On June 29, 2011, the Federal Circuit docketed the appeal. In addition, the defendants appealed the USPTO's ruling confirming the patentability of claims 1-3 and 8-10 to the Federal Circuit by filing a Reexamination Notice of Appeal to the Federal Circuit on October 18, 2011. The parties argued OptimumPath's appeal of the District Court's summary judgment rulings before the Federal Circuit on March 5, 2011. On March 7, 2012, the Federal Circuit affirmed the District Court's summary judgment rulings in favor of the defendants. OptimumPath did not appeal the Federal Circuit's ruling upholding the District Court's summary judgment rulings, and on June 20, 2012 the Federal Circuit issued its mandate, meaning that the litigation proceedings are terminated. On June 5, 2012, the parties argued the defendants' appeal of the USPTO rulings before the Federal Circuit, but the outcome of this argument will have no bearing on the favorable outcome for the defendants obtained in the litigation proceedings, and this litigation matter is now concluded. There

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

was no material financial impact to the Company because of this litigation matter.

## Ruckus Wireless v. NETGEAR

In May 2008, a lawsuit was filed against the Company by Ruckus Wireless (“Ruckus”), a developer of Wi-Fi technology, in the U.S. District Court, Northern District of California. Ruckus alleges that the Company infringes U.S. Patent Nos. 7,358,912 (“the ‘912 Patent”) and 7,193,562 (“the ‘562 Patent”) in the course of deploying Wi-Fi antenna array technology in its WPN824 RangeMax wireless router. Ruckus also sued Rayspan Corporation alleging similar claims of patent infringement. The Company filed its answer to the lawsuit in the third quarter of 2008. The Company and Rayspan Corporation jointly filed a request for inter partes reexamination of the Ruckus patents with the USPTO on September 4, 2008. The Court issued a stay of the litigation while the reexaminations proceeded in the USPTO. On November 28, 2008, a reexamination was ordered with respect to claims 11-17 of the ‘562 Patent, but denied with respect to claims 1-10 and 18-36. On December 17, 2008, the defendants jointly filed a petition to challenge the denial of reexamination of claims 1-10 and 18-36 of the ‘562 Patent. In July 2009, the petition was denied, and the remaining claims 11-17 were confirmed. The Company is appealing the confirmation of claims 11-17. On December 2, 2008, reexamination was granted with regard to the ‘912 Patent. In early October 2009, the Company received an Action Closing Prosecution in the reexamination of the ‘912 Patent. All the claims of the ‘912 Patent, with the exception of the unchallenged claims 7 and 8, were finally rejected by the USPTO. On October 30, 2009, Ruckus submitted an “after-final” amendment in the ‘912 Patent reexamination proceeding. The Company’s comments to Ruckus’ “after-final” amendment were submitted on November 30, 2009. On December 1, 2009, the Court found that bifurcating the ‘562 Patent from the ‘912 Patent and commencing litigation on the ‘562 Patent while the USPTO reexamination process and appeals are still pending would be an inefficient use of the Court’s resources. Accordingly, the Court ruled that the litigation stay should remain in effect. On September 12, 2010, the Company filed the rebuttal brief in its appeals of the USPTO’s rulings during the reexamination of the ‘562 Patent, and the Company requested an oral hearing with the Board of Appeals at the USPTO to discuss this brief. On September 13, 2010, Ruckus filed a notice of appeal of the ‘912 Patent to appeal the adverse rulings it received from the USPTO in the reexamination of this patent. The Company filed a respondent’s brief in the ‘912 Patent case on January 24, 2011. An oral hearing in the ‘562 case was set for February 1, 2011, but the Company decided to cancel it and let the USPTO decide the ‘562 case based solely on the previously submitted papers. On May 13, 2011, the USPTO indicated that the Company was successful in its appeal of the examiner’s previous decision to allow claims 11-17 in the ‘562 reexamination, and the USPTO Board of Appeals reversed the examiner’s decision and declared those claims invalid. On June 13, 2011, Ruckus submitted a request for rehearing by the Board of Appeals of its decision to reject claims 11-17 of the ‘562 Patent. On September 28, 2011, the Board of Patent Appeals and Interferences denied Ruckus’s request for a rehearing in the ‘562 Patent reexamination case. Ruckus did not timely file a notice of appeal to the Court of Appeals for the Federal Circuit appealing the USPTO’s cancellation of claims 11-17 of the ‘562 patent. Therefore, a reexamination certificate will issue with claims 11-17 cancelled and claims 1-10 and 18-36 confirmed.

On November 4, 2009, Ruckus filed a complaint in the U.S. District Court, Northern District of California alleging the Company and Rayspan Corporation infringe a patent that is related to the patents previously asserted against the Company and Rayspan Corporation by Ruckus, as discussed above. This asserted patent in this second case is U.S. Patent No. 7,525,486 entitled “Increased wireless coverage patterns.” As with the previous Ruckus action, the WPN824 RangeMax wireless router is the alleged infringing device. The Company challenged the sufficiency of Ruckus’s complaint in this new action and moved to dismiss the complaint. Ruckus opposed this motion. The Court partially agreed with the Company’s motion and ordered Ruckus to submit a new complaint, which Ruckus did. The initial case management conference occurred on February 11, 2010. On March 25, 2010, the Court ordered a stay until the completion of the ‘562 Patent’s reexamination proceedings in the first Ruckus lawsuit against the Company and Rayspan. The Court instructed the parties to submit status reports to the Court every six months, apprising the Court

of the status of the pending reexamination proceedings in the USPTO.

Ruckus and the Company recently requested that the stay of the California actions be lifted. This request to lift the stay was predicated on Ruckus's Withdrawal of Appeal and Cancellation of Claims ("Withdrawal") in re-examination at the USPTO pertaining to the '912 Patent. Through the filing of the Withdrawal, Ruckus announced its intent to withdraw and its actual withdrawal of its appeal of claims 1, 4-9-14, 18, 19, and 22-29 in re-examination (the "Appealed Claims"), and Ruckus further announced its intent to cancel and its actual cancellation of claims 30-31 in re-examination (the "Cancelled Claims"). Claims 2, 3, 15-17, 20, and 21 had previously been cancelled during re-examination (the "Previously Cancelled Claims"). Because the Appealed Claims and the Cancelled Claims represented the entirety of the claims remaining for consideration in re-examination, and the Previously Cancelled Claims are no longer of record in the offensive case by Ruckus against the Company, there are no remaining claims for re-examination in the '912 Patent and the '912 Patent cannot be asserted against the Company. Thus, the Company and Ruckus requested that the Court lift the stay of this litigation and calendar a case management conference, which was set for January 3, 2013. The California action will now again start proceeding after approximately four years of inactivity.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

On November 19, 2010, the Company filed suit against Ruckus in the U.S. District Court, District of Delaware for infringement of four of the Company's patents. The Company alleges that Ruckus's manufacture, use, sale or offers for sale within the United States or importation into the United States of products, including wireless communication products, infringe United States Patent Nos. 5,812,531, 6,621,454, 7,263,143, and 5,507,035, all owned by the Company. The Company granted Ruckus an extension to file its answer to the Company's suit, and on January 11, 2011, Ruckus filed a motion to dismiss the Company's suit based on insufficient pleadings. The Company filed its response to Ruckus's motion on January 31, 2011. In addition, on May 6, 2011, Ruckus filed a motion to transfer venue to the Northern District of California. The Court denied Ruckus' motion to transfer the case to the Northern District of California and granted the Company leave to file an amended complaint rather than address the Ruckus motion to dismiss based on insufficient pleadings. The Company filed the proposed amended complaint. Nevertheless, Ruckus filed a second motion to dismiss based on insufficient pleadings by the Company. On March 28, 2012, the Delaware District Court in a memorandum opinion and order denied Ruckus's second motion to dismiss. A scheduling conference occurred April 18, 2012, and the Company submitted its initial disclosures in the case on May 15, 2012. On May 31, 2012, Ruckus filed its third motion to dismiss, asserting that the Company cannot sustain its indirect infringement and willfulness allegations without pleading pre-suit knowledge of the patents. The Company responded to Ruckus's motion to dismiss on June 18, 2012. The Court released the schedule for the case on June 8, 2012 with Claim Construction and Summary Judgment Hearings scheduled for August 9, 2013 and a ten day jury trial scheduled for October 21, 2013. On July 13, 2012, the Company added to its complaint against Ruckus an allegation of infringement of patent number 6,512,480 ("System and method for narrow beam antenna diversity in an RF data transmission system") by Ruckus's ZoneFlex and MediaFlex products. The Company and Ruckus participated in a court-ordered mediation on September 13, 2012 in Delaware. The parties did not come to an agreement to settle the litigation pending between the parties. Discovery in this case is continuing with depositions scheduled to take place over the next several months. It is too early to reasonably estimate the financial impact to the Company as a result of the Ruckus litigation matters.

## Northpeak Wireless, LLC v. NETGEAR

In October 2008, a lawsuit was filed against the Company and 30 other companies by Northpeak Wireless, LLC ("Northpeak") in the U.S. District Court, Northern District of Alabama. Northpeak alleges that the Company's 802.11b compatible products infringe certain claims of U.S. Patent Nos. 4,977,577 ("the '577 Patent") and 5,987,058 ("the '058 Patent"). The Company filed its answer to the lawsuit in the fourth quarter of 2008. On January 21, 2009, the District Court granted a motion to transfer the case to the U.S. District Court, Northern District of California. In August 2009, the parties stipulated to a litigation stay pending a reexamination request to the USPTO on the asserted patents. The reexaminations of the patents are proceeding. In March 2011, the USPTO confirmed the validity of the asserted claims of the '577 Patent over certain prior art references. In April 2011, the USPTO issued a final office action rejecting both asserted claims of the '058 Patent as being obvious in light of the prior art. The case remains stayed by stipulation, and no trial date has been set. The Company does not expect there to be a material financial impact to the Company because of this litigation matter.

## Ericsson v. NETGEAR

On September 14, 2010, Ericsson Inc. and Telefonaktiebolaget LM 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; 6,330,435; 6,424,625; 6,519,223; 6,772,215; 5,987,019; 6,466,568; and 5,771,468 ("the '468 Patent"). Ericsson generally alleges 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 March 1, 2011, the defendants filed a motion to transfer venue to the District Court for the Northern District of California and their memorandum of law in support thereof. On March 21, 2011, Ericsson filed its opposition to the motion, and on April 1, 2011, defendants filed their reply to Ericsson's opposition to the motion to transfer. 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 hearing for June 28, 2012 and trial for June 3, 2013. On June 14, 2011, Ericsson submitted its infringement contentions against the Company. On September 29, 2011, the Court denied the defendants motion to transfer venue to the Northern District of California. In advance of the Markman hearing, the parties on March 9, 2012 exchanged proposed constructions of claim terms and on April 9, 2012 filed the Joint Claim Construction Statement with the District Court. On May 8, 2012, Ericsson submitted its opening Markman brief and on June 1, 2012 the defendants submitted their responsive Markman brief. Ericsson's Reply Markman brief was submitted June 15, 2012, and on June 28, 2012 the Markman hearing was held in the Eastern District of Texas. The Court has not yet released its Markman Order construing the claims of Ericsson's asserted patents. On June 21, 2012, Ericsson dismissed the '468 Patent ("Multi-purpose base station") with prejudice and gave the Company a

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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 is now an official defendant in the Ericsson case. Discovery is ongoing. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

Fujitsu v. NETGEAR

On September 3, 2010, Fujitsu filed a complaint against the Company, Belkin International, Inc., Belkin, Inc., D-Link Corporation, D-Link Systems, Inc., ZyXEL Communications Corporation, and ZyXEL Communications, Inc in the U.S. District Court, Northern District of California alleging that certain of the Company's products infringe upon Fujitsu's U.S. patent Re. 36,769 patent ("the '769 Patent") through various cards and interface devices within the Company's products. The Company answered the complaint denying the allegations of infringement and claiming that the asserted patent is invalid. In addition, the Company filed a motion to disqualify counsel for Fujitsu. The Company's disqualification motion was argued before the Court on December 16, 2010, and on December 22, 2010, the Court granted the Company's motion and disqualified counsel for Fujitsu. In response, Fujitsu requested a stipulation from all parties to reset the case management conference and scheduled hearing dates for the motions to dismiss. The initial case management conference was held on March 18, 2011. A claim construction hearing was held on October 14, 2011. On February 3, 2012, the Court issued its claim construction order based on the claim construction hearing. On March 3, 2011, the Fujitsu patent emerged from the latest ex-parte reexamination in the USPTO that was initiated by Belkin, Inc. The USPTO examiner rejected five of the "wired" claims in the patent, but found that the majority of claims of the patent were valid. Expert discovery opened May 4, 2012 with the exchange of initial expert reports. Rebuttal expert reports were exchanged on May 25, 2012, and expert discovery closed on June 8, 2012. A further case management conference was held on May 9, 2012 where the Court ordered that by June 12, 2012 Fujitsu must file a status report narrowing its asserted claims to no more than 10 claims, and narrowing the accused products accordingly, and Fujitsu filed the status report on the due date. By July 3, 2012, the Court ordered the Defendants to file a status report reducing its number of prior art references and obviousness combinations, and Defendants filed the status report on the due date. The Court also limited Fujitsu to one motion for summary judgment and allowed Defendants to jointly file two summary judgment motions. The Court further implemented the following dates: last day to file disposition motions of July 26, 2012; hearing on dispositive motions on September 6, 2012 at 1:30 pm; final pretrial conference on November 1, 2012; and jury trial beginning November 26, 2012. The Court ordered the length of the trial to be 10 days. The Court also set a further case management conference for September 6, 2012, immediately following the hearing on any dispositive motions filed. The parties submitted their summary judgment motions on July 26, 2012. Fujitsu submitted a summary judgment motion arguing that the defendants infringe the '769 Patent. The defendants submitted two summary judgment motions. The first argued that any infringement by the defendants was not willful, and the second argued that the '769 Patent is invalid.

On September 28, 2012, the Court issued its summary judgment ruling. The Court did not invalidate the '769 Patent and ruled that some of the Company's cards infringed the '769 Patent.

In addition, the Court rejected Fujitsu's narrowing arguments for the terms "card" and "slot" that are contained in the claims of the patent in suit, expressly holding that "card" should be given its plain and ordinary meaning and agreeing with Defendants that "slot" was a broad term meaning "an opening."

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

Powerline Innovations, LLC v. NETGEAR

On August 6, 2011 the Company, along with 16 other companies, was sued in the U.S. District Court, Eastern District of Texas, Tyler Division for patent infringement by a non-practicing entity called Powerline Innovations, LLC (“Powerline Innovations”). This is a single patent case, involving U.S. Patent No. 5,471,190, entitled “Method and Apparatus for Resource Allocation in a Communication Network System.” On the same day that it filed suit against the Company and 16 other companies, Powerline Innovations sued 14 additional companies in a separate suit in U.S. District Court, Eastern District of Texas for infringement of the same patent. The complaint against the Company alleges that it infringes the 5,471,190 patent based on the Company's use of methods for establishing control relationships between plural devices and names the Company's Powerline AV Ethernet Adapter, Model XAV101, as an accused infringing product. The Company answered the plaintiff's complaint on December 12, 2011, and asserted that it has not infringed the patent in suit and that the patent in suit is invalid. In addition, the Company asserted various affirmative defenses. An initial status conference took place on August 6, 2012. On October 1, 2012, the defendants remaining in the case filed a motion to transfer venue from the U.S. District Court, Eastern District of Texas to the U.S. District Court, Northern District of California. The Company does not expect there to be a material financial impact to the Company because of this litigation matter.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

On October 10, 2012, the Company was sued for a second time for patent infringement by Powerline Innovations. The patent involved in this case is United States Patent No. 8,157,581, titled "Thermal Management Method and Device for Powerline Communications". The accused Company products include Powerline Models XAVB1501, XAVB1601, XAV2001, XAVN2001, XAVB2001, XAVNB2001, XAV2101, XAVB2101, XAUB2511, XWN5001, XAVB5001, XAVB5101, XWNB5201, XAVB5601, XAVB5602 products. The Company has not yet answered the complaint and is evaluating the allegations by Powerline Innovations. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

NETGEAR v. Innovatio IP Ventures LLC.

On November 16, 2011, the Company filed a declaratory judgment action in the District of Delaware for non-infringement and invalidity of 17 WiFi-related patents brought in the approximately 15 actions throughout the United States by Innovatio IP Ventures LLC ("Innovatio") against end user customers of the Company and other companies. Shortly after filing the declaratory judgment action, the Company filed a response supporting Cisco Systems, Inc.'s ("Cisco") and Motorola Solutions, Inc.'s ("Motorola") Motion to Transfer for Coordinated Pretrial Proceedings Pursuant to 28 U.S.C. § 1407 that was before the United States Judicial Panel on Multidistrict Litigation ("JPML"). The pending motion to transfer would serve to consolidate all of the Innovatio lawsuits - including the Company's pending declaratory judgment action in Delaware-and transfer them to a single court for coordinated pretrial proceedings. On December 28, 2011, the JPML issued an order transferring the Innovatio actions throughout the United States, including the Company's declaratory judgment action, to the United States District Court for the Northern District of Illinois. Thus, the Company's declaratory judgment action and approximately 15 other similar cases will now proceed in the Northern District of Illinois in a consolidated fashion. The status conference originally scheduled for March 27, 2012 was postponed by the District Court until April 10, 2012. At the conference, the District Court discussed two primary issues (1) case phasing (i.e., which subset of defendants should proceed after Markman Hearing through the remaining proceedings) and (2) the defendants' proposal on damages contentions. The District Court stated that it tentatively felt that the case should proceed with one or more WiFi hardware suppliers after the Markman Hearing, but was going to reserve a final ruling on the issue. The District Court withheld ordering damages contentions for the time being. The District Court also ordered that the parties prepare a joint pretrial order reflecting the court's decisions and the schedule for the case. On July 10, 2012, Innovatio answered the Declaratory Judgment Complaint filed by the Company with various counterclaims, cross claims, and affirmative defenses. In its answer, Innovatio accused the Company of infringing six WiFi-related patents in addition to the 17 WiFi-related patents on which the Company brought its declaratory judgment action of non-infringement and invalidity. The Company filed its answer to Innovatio's various counterclaims, cross claims, and affirmative defenses on August 3, 2012. In addition, on October 1, 2012, Cisco, Motorola and the Company filed an amended complaint alleging racketeering, fraud, interference with contract, unfair business practices, and conspiracy, among other things, against Innovatio. Discovery in the case is ongoing. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

Harris Corporation v. NETGEAR.

On November 26, 2011, Harris Corporation ("Harris") sued the Company in the U.S. District Court, Middle District of Florida alleging that the Company willfully infringes six of Harris's patents -- U.S. Patent Nos. 6,504,515, 7,916,684, 5,787,177, 5,974,149, 6,189,104, and 6,397,336. Harris filed an amended complaint on February 17, 2012 that removed its initial allegations of willful infringement by the Company and also removed the allegations of direct infringement against the Company for U.S. Patent No. 7,916,684, leaving only indirect infringement allegations for the '684 Patent. The Company's answer to the amended complaint was submitted on March 2, 2012.

On April 3, 2012, the Company filed suit against Harris in the District Court of the Northern District of California asserting that Harris infringes four of the Company's patents. In the complaint, the Company alleges that Harris infringes: a) U.S. Patent No. 6,718,030, entitled "Virtual Private Network System and Method Using Voice of Internet Protocol" through Harris's VIDA Network and products, the VIDA Telephone Interconnect (VTI), the MASTR III Base Station, and the EDACS MASTR III repeater; b) U.S. Patent No. 7,200,400, entitled "Mobile to 802.11 Voice Multi-Network Roaming Utilizing SIP Signaling With SIP Proxy or Redirect Server" through Harris's VIDA Network and products, the Inter-RF Subsystem Interface (ISSI) Gateway, the Interoperability Gateway, and the UNITY XG-100P Portable Radio; c) U.S. Patent No. 7,218,722, entitled "System and Method For Providing Call Management Services in a Virtual Private Network Using Voice or Video Over Internet Protocol" through Harris's VIDA Network and products, the VIDA Telephone Interconnect (VTI), the P7200 Portable Radio, the OpenSky Network and Products, the MASTR III Base Station, and EDACS MASTR III repeater; and d) U.S. Patent No. 7,936,714, entitled "Spectrum Allocation System and Method For Multi-Band Wireless RF Data Communications" through Harris's UNITY XG-100P Portable Radio. Harris responded to the complaint on the due date for its answer.

Without admitting any wrongdoing or violation of law and to avoid the distraction and expense of continued litigation and

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

the uncertainty of a jury verdict on the merits, on October 19, 2012, Harris and the Company signed a final settlement agreement settling the two patent cases that the parties brought against each other. The settlement agreement included the following principal points: 1) dismissal with prejudice of the lawsuits pending between the Company and Harris; 2) a one-time lump-sum payment by the Company to Harris; 3) assignment of certain patents, and related patents from Harris to the Company; 4) a covenant not to sue each other for ten years by both parties that applies to lawsuits based upon any of the parties' patents; and 5) a covenant not to sue by both parties for the life of the patents in suit between the parties that applies to the patents in suit and all related patents, including without limitation the foreign counterparts. Each party agreed to bear its own costs and attorneys' fees. This arrangement does not have a material impact on the Company's consolidated financial position, results of operations, or cash flows. The Company allocated a portion of the one-time lump-sum payment to the quarterly period ended September 30, 2012, and the majority of the one-time lump-sum payment will be recorded in prepaids and other current assets in the fourth quarter of 2012.

U.S. Ethernet Innovation, LLC v. NETGEAR

On June 22, 2012, U.S. Ethernet Innovations, LLC ("USEI") sued the Company in the District Court for the Eastern District of Texas, alleging infringement of certain of its Ethernet-related patents: U.S. Patent Numbers 5,732,094 ("Method for automatic initiation of data transmission"); 5,434,872 ("Apparatus for automatic initiation of data transmission"); 5,299,313 ("Network interface with host independent buffer management") and 5,530,874 ("Network adapter with an indication signal mask and an interrupt signal mask"). USEI is a patent holding entity with a nominal office in the Eastern District of Texas. The accused products include products such as the "Netgear RT311 Internet Gateway Router." The Company received an extension until August 17, 2012 to answer the complaint. USEI has sued, in addition to the Company, the following companies on the same and other of its Ethernet-related patents: Ricoh Americas Corporation, TRENDnet, Inc., Xerox Corporation, Konica Minolta Business Solutions U.S.A., Inc., Freescale Semiconductor, Inc., Sharp Electronics Corporation, Digi International Inc., NetSilicon, Inc., Epson America, Inc., Cirrus Logic, Inc., Yamaha Corporation of America, Control4 Corporation, Samsung Electronics Co., Ltd., Samsung Electronics America, Inc., Samsung Telecommunications America, LLC, Samsung Austin Semiconductor, LLC, Oki Data Americas, Inc., STMicroelectronics N.V., and STMicroelectronics, Inc. (collectively, "Defendants").

The Company received a further extension to answer the complaint and answered on September 4, 2012 via a 12(b)(6) motion to dismiss the complaint for various reasons, including a lack of pleading specificity. USEI responded to the Company's motion to dismiss under Rule 12(b)(6) on September 21, 2012. The Company submitted its Reply in Support of its Motion to Dismiss on October 1, 2012.

The Court consolidated for discovery purposes USEI's cases against the aforementioned defendants and scheduled a consolidated Markman hearing for April 4, 2013 for the asserted patents. The Court also indicated that the court would consider any of Defendants' transfer motions as soon as possible. The trial date has been set for April 14, 2014. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

ReefEdge Networks, LLC v. NETGEAR, Inc.

On September 17, 2012, the Company was sued by ReefEdge Networks, LLC, a non-practicing entity. The Company has received an extension from the plaintiff until November 8, 2012 to answer the complaint.

The complaint alleges that NETGEAR infringes three related patents: 6,633,761 B1; 6,975,864 B2; 7,197,308 B2. In general terms, these asserted patents involve seamlessly handing-off portable wireless devices from one access point to another so as to provide roaming within a wireless network.

The complaint specifically accuses the Company's ProSafe wireless controller of infringing these three patents. On August 15, 2012, ReefEdge filed complaints in Delaware against Aruba Networks Inc., Cisco Systems Inc., Meru Networks Inc., and Ruckus Wireless Inc. alleging infringement of the same three patents. In the second tranche of lawsuits, ReefEdge sued--in addition to the Company--Brocade Communications Systems, Inc., Extreme Networks Inc., ADTRAN, Inc., Alcatel-Lucent Inc., D-Link Systems, Inc., Enterasys Networks, Inc., Motorola Solutions Inc., CDW Corporation, Avaya Inc., and ZyXEL Communications Corporation. The Company has not yet answered the complaint and is evaluating the allegations. It is too early to reasonably estimate any financial impact to the Company because of 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,

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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 European Union (“EU”) enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods, including home and commercial business networking products, financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. The deadline for the individual member states of the EU to transpose the directive into law in their respective countries was August 13, 2004 (such legislation, together with the directive, the “WEEE Legislation”). Producers participating in the market were financially responsible for implementing these responsibilities under the WEEE Legislation beginning in August 13, 2005. The Company adopted the authoritative guidance for asset retirement and environmental obligations in the third quarter of fiscal 2005 and has determined that its effect did not have a material impact on the Company's consolidated results of operations and financial position for the three and nine months ended September 30, 2012 and October 2, 2011. The WEEE Directive was recast on July 24, 2012, published on August 13, 2012, and will be implemented by all member states on February 14, 2014. The Company expects no material impact on the its consolidated results of operations and financial positions due to this recasting. Similar WEEE Legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China, India, Australia and Japan. The Company continues to monitor WEEE Legislation and similar legislation in other jurisdictions as individual countries issue their implementation guidance. The Company believes it has met the applicable requirements of current WEEE Legislation and similar legislation in other jurisdictions, to the extent implementation requirements have been published.

Additionally, the EU enacted the Restriction of Hazardous Substances Directive (“RoHS Legislation”), the REACH Regulation, Packaging Directive and the Battery Directive. EU RoHS Legislation, along with similar legislation in China, requires manufacturers to ensure certain substances, including polybrominated biphenyls (“PBD”), polybrominated diphenyl ethers (“PBDE”), mercury, cadmium, hexavalent chromium and lead (except for allowed exempted materials and applications), are below specified maximum concentration values in certain products put on the market after July 1, 2006. The RoHS Directive was recast on July 21, 2011 and is scheduled to go into force on January 3, 2013. The Company expects no material impact on the its consolidated results of operations and financial positions due to this recasting. The REACH Regulation requires manufacturers to ensure the published list of substances of very high concern in certain products are below specified maximum concentration values. The Battery Directive controls use of certain types of battery technology in certain products and requires mandatory marking. The Company believes it has met the requirements of the RoHS Directive Legislation, the REACH Regulation and the Battery Directive Legislation.

Additionally, the EU enacted the Energy Using Product (“EuP”) Directive, which came into force in August of 2007. The EuP Directive required manufacturers of certain products to meet minimum energy efficiency performance requirements. These requirements were documented in EuP implementing measures issued for specific product categories. The implementing measures affecting the Company's products are minimum power supply efficiencies and may include required equipment standby modes, which also reduce energy consumption. The EuP Directive was repealed in November of 2009 and replaced by the Energy Related Products (“ErP”) Directive, which includes the same implementing measures of the former EuP Directive and new implementing measures applicable to the Company's products. The Company is in compliance with applicable implementing measures of the ErP Directives since it came into force.

## 10. Stockholders' Equity

### Common Stock Repurchase Program

On October 21, 2008, the Company's Board of Directors authorized management to repurchase up to 6,000,000 shares of the Company's outstanding common stock. Under this authorization, 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 the Company's common stock. The Company did not repurchase any shares under this authorization during the three and nine months ended September 30, 2012, and October 2, 2011.

The Company repurchased approximately 22,000 shares, or \$0.8 million of common stock under a repurchase program to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving RSUs during the nine months ended September 30, 2012. Similarly, during the nine months ended October 2, 2011, the

Table of Contents

NETGEAR, INC.

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

Company repurchased approximately 24,000 shares, or \$0.9 million of common stock, respectively under the same program to help facilitate tax withholding for RSUs.

These shares were retired upon repurchase. 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.

Cumulative Other Comprehensive Income, Net

The following table sets forth the components of cumulative other comprehensive income, net of related taxes, as of September 30, 2012 and December 31, 2011 (in thousands):

	As of	
	September 30, 2012	December 31, 2011
Net unrealized (loss) gain on derivative instruments	\$(181	) \$6
Net unrealized gain on available-for-sale securities	10	17
Total cumulative other comprehensive (loss) income, net of taxes	\$(171	) \$23

## 11. Employee Benefit Plans

The Company grants options and restricted stock units from the Amended and Restated 2006 Long-Term Incentive Plan, and 2003 Stock Plan under which awards may be granted to all employees. Award vesting periods for these plans are generally four years. As of September 30, 2012, a total of 2,713,679 shares were reserved for future grants under these plans.

Additionally, 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. Employees may purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date. As of September 30, 2012, a total of 387,058 shares were reserved for future grants under the ESPP.

## Option Activity

Stock options activity during the nine months ended September 30, 2012, was as follows:

	Options Outstanding	
	Number of shares	Weighted Average Exercise Price Per Share
	(in thousands)	(in dollars)
December 31, 2011	3,950	\$27.03
Granted	1,272	33.81
Cancelled and expired	(313	) 30.34
Exercised	(472	) 22.79
September 30, 2012	4,437	\$29.19

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## RSU Activity

RSU activity during the nine months ended September 30, 2012, was as follows:

	RSUs Outstanding	
	Number of shares	Weighted Average Grant Date Fair Value Per Share
	(in thousands)	(in dollars)
December 31, 2011	177	\$27.86
RSUs granted	50	31.64
RSUs vested	(103)	) 29.19
RSUs cancelled	(9)	) 30.59
September 30, 2012	115	\$28.10

## Valuation and Expense Information

The fair value of each option award 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 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 is based on historical volatility over the most recent period commensurate with the estimated expected term.

The following table sets forth the assumptions used to fair value option grants during the three and nine months ended September 30, 2012 and October 2, 2011 based on its historical experience.

	Three Months Ended		Nine Months Ended	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
Expected life (in years)	4.4	4.3	4.3 - 4.4	4.3 - 4.4
Risk-free interest rate	0.48	% 1.09	% 0.48% - 0.91%	1.09% - 1.87%
Expected volatility	52.3	% 50.7	% 52.1% - 52.5%	49.9% - 50.7%
Dividend yield	—	—	—	—

The following table sets forth the total 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	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
Cost of revenue	\$473	\$259	\$1,021	\$737
Research and development	778	606	2,066	1,873
Sales and marketing	1,238	1,264	3,623	3,949
General and administrative	1,530	1,325	4,096	3,775
Total stock-based compensation	\$4,019	\$3,454	\$10,806	\$10,334

As of September 30, 2012, \$27.2 million of total unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 1.46 years. Additionally, \$2.2 million of total unrecognized compensation cost related to non-vested RSUs, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 0.83 years.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

12. Segment Information, Operations by Geographic Area and Significant Customers

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 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, storage and digital media products to connect people with the Internet and their content and devices. The commercial business unit consists of business networking, storage and security solutions without the cost and complexity of Big IT. The service provider business unit consists of made-to-order and retail proven, whole home networking solutions sold to service providers for sale to their customers. Each business unit is managed by a Senior Vice President/General Manager. 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.

In the second quarter of 2012, the CEO began temporarily serving as interim General Manager of the commercial business unit due to the previous general manager's departure from the Company. The CEO will continue to serve as interim general manager until a replacement is established.

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, general and administrative costs, stock-based compensation expenses, amortization of intangibles, acquisition-related integration costs, restructuring costs, litigation reserves and interest 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		
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011	
Net revenues:					
Retail	\$123,457	\$127,082	\$366,258	\$352,076	
Commercial	79,240	91,059	234,498	247,793	
Service provider	112,513	83,659	360,729	271,994	
Total net revenues	315,210	301,800	961,485	871,863	
Contribution income:					
Retail	\$17,759	\$19,958	\$62,590	\$60,843	
Retail contribution margin	14.4	% 15.7	% 17.1	% 17.3	%
Commercial	19,998	23,013	52,272	56,716	
Commercial contribution margin	25.2	% 25.3	% 22.3	% 22.9	%
Service Provider	11,283	6,662	33,822	24,063	
Service Provider contribution margin	10.0	% 8.0	% 9.4	% 8.8	%
Total segment contribution income	49,040	49,633	148,684	141,622	
Corporate and unallocated costs	(12,866 )	(11,994 )	(36,430 )	(33,986 )	
Amortization of intangible assets (1)	(1,354 )	(1,064 )	(3,317 )	(3,610 )	
Stock-based compensation expense	(4,019 )	(3,454 )	(10,806 )	(10,334 )	
Restructuring and other charges	—	—	—	(2,094 )	
Acquisition related compensation	—	—	—	(40 )	
Impact to cost of sales from acquisition accounting adjustments to inventory	—	—	—	(609 )	
Litigation reserves, net	(269 )	(44 )	(420 )	234	
Interest income	109	115	344	350	
Other income (expense), net	3,070	(267 )	2,823	(938 )	
Income before income taxes	\$33,711	\$32,925	\$100,878	\$90,595	

(1) Amount excludes amortization expense related to patents within purchased intangible assets in costs of revenues.

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	
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011
United States	\$172,926	\$144,969	\$495,717	\$419,460
Americas (excluding U.S.)	4,721	4,040	13,723	11,022
United Kingdom	45,127	38,010	141,731	124,831
EMEA (excluding U.K.)	59,241	81,725	205,533	227,855

Edgar Filing: NETGEAR, INC - Form 10-Q

APAC	33,195	33,056	104,781	88,695
Total net revenue	\$315,210	\$301,800	\$961,485	\$871,863

30

---

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Long-lived assets, comprising fixed assets, are reported based on the location of the asset. Long-lived assets by geographic location are as follows (in thousands):

	September 30, 2012	December 31, 2011
United States	\$10,549	\$9,901
Americas (excluding U.S.)	36	44
EMEA	668	331
China	6,651	4,909
APAC (excluding China)	1,023	699
	\$18,927	\$15,884

Significant customers as a percentage of net revenues are as follows:

	Three Months Ended		Nine Months Ended		
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011	
Best Buy Co., Inc. and Affiliates (Retailer)	9	% 11	% 8	% 11	%
Virgin Media Limited and Affiliates (Service Provider)	9	% 5	% 10	% 8	%
Ingram Micro, Inc. and Affiliates (Distributor)	8	% 10	% 9	% 10	%
All others	74	% 74	% 73	% 71	%
	100	% 100	% 100	% 100	%

## 13. Fair Value Measurements

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 (in thousands):

	As of September 30, 2012			
	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	\$497	\$497	\$—	\$—
Available-for-sale securities—U.S. Treasuries (1)	225,035	225,035	—	—
Available-for-sale securities—Certificates of Deposit (1)	2,784	2,784	—	—
Foreign currency forward contracts (2)	620	—	620	—
Total assets measured at fair value	\$228,936	\$228,316	\$620	\$—

(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 September 30, 2012		
	Total	Quoted market prices in active other	Significant unobservable

Edgar Filing: NETGEAR, INC - Form 10-Q

		markets (Level 1)	observable inputs (Level 2)	inputs (Level 3)
Foreign currency forward contracts (3)	\$(1,104	) \$—	\$(1,104	) \$—
Total liabilities measured at fair value	\$(1,104	) \$—	\$(1,104	) \$—

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

31

---

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, 2011 (in thousands):

	As of December 31, 2011			
	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	\$24,844	\$24,844	\$—	\$—
Available-for-sale securities—Treasuries (1)	144,703	144,703	—	—
Available-for-sale securities—Certificates of Deposit (1)	94	94	—	—
Foreign currency forward contracts (2)	1,237	—	1,237	—
Total assets measured at fair value	\$170,878	\$169,641	\$1,237	\$—

(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, 2011			
	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)	\$(723)	\$—	\$(723)	\$—
Total liabilities measured at fair value	\$(723)	\$—	\$(723)	\$—

(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+/A2 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 September 30, 2012 and December 31, 2011, 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.

#### 14. 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 \$3.0 million and \$9.4

million for the three and nine months ended September 30, 2012, respectively, and \$3.5 million and \$10.3 million for the three and nine months ended October 2, 2011, respectively.

#### 15. Restructuring and Other Charges

There were no restructuring charges or other charges during the three and nine months ended September 30, 2012. During the nine months ended October 2, 2011, the Company incurred \$1.6 million in restructuring costs for employee severance related to the reorganization into three specific business units: retail, commercial, and service provider. In addition, the Company incurred \$0.5 million in transition services in connection with the acquisition of the CNS division of Westell Technologies, Inc. Refer to Note 3, Business Acquisitions for additional information regarding the CNS acquisition. The Company presents expenses related to restructuring and other charges as a separate line item in its unaudited condensed consolidated statements of operations.

Table of Contents

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, and Section 21E of the Securities Exchange Act of 1934, as amended. 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, 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, network connectivity, network storage and security appliances. 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. The retail business unit consists of high performance, dependable and easy-to-use home networking, home monitoring, storage and digital media products to connect consumers with the Internet and their content and devices. The commercial business unit consists of business networking, storage and security solutions without the cost and complexity of Big IT. The service provider business unit consists of made-to-order and retail proven, whole home networking solutions sold to service providers for sale to their customers. We conduct business across three geographic regions: Americas, Europe, Middle-East and Africa ("EMEA") and Asia Pacific ("APAC").

We sell our networking 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, Radio Shack, Staples, Target, Wal-Mart, Argos (U.K.), Dixons (U.K.), PC World (U.K.), MediaMarkt (Germany, Austria), Dick Smith (Australia), JB HiFi (Australia) and Elkjop (Norway). Online retailers include Amazon.com, Dell, Newegg.com and Buy.com. 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"), DSL, 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, including Ingram Micro and Best Buy. We expect that these wholesale distributors and retailers will continue to contribute a significant percentage of our net revenue for the foreseeable future. Our service provider business has grown substantially and it is difficult to ascertain a seasonal pattern given that the business is less predictable than our other core businesses.

The commercial business, consumer, and broadband service provider markets are intensely competitive and subject to rapid technological change. We expect our competition to continue to intensify. We believe that the principal competitive factors in these 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.

Our net revenue increased \$13.4 million, or 4.4%, to \$315.2 million for the three months ended September 30, 2012, from \$301.8 million for the three months ended October 2, 2011. This increase was primarily driven by an increase in Service Provider Business Unit revenue, as a result of increased sales of broadband gateways and home wireless products to our service provider customers, and an increase in home wireless products to our retail customers. From a geographic perspective, this increase was primarily driven by an increase in Americas revenue. We also experienced an increase in APAC revenue; however we noted softness

Table of Contents

in Australia across all channels, due to concerns over demand from China for Australian exports. We continued to see macroeconomic weakness in the European market, with the slowdown spreading from southern Europe to the UK and Northern Europe, and therefore our net revenues in these markets have been negatively impacted.

Our gross margin decreased to 31.0% for the three months ended September 30, 2012, from 31.9% for the three months ended October 2, 2011. The decrease in gross margin was primarily attributable to the higher percentage of our total net revenue derived from sales to service providers, which generally carry lower gross margins. Operating expenses for the three months ended September 30, 2012 was \$67.2 million, or 21.3% of net revenue, compared to \$63.2 million, or 20.9% of net revenue, for the three months ended October 2, 2011. This increase was primarily attributable to increases in costs related to research and development projects and outside services.

Net income decreased \$2.9 million, or 11.1%, to \$23.8 million for the three months ended September 30, 2012, from \$26.7 million for the three months ended October 2, 2011. This decrease was primarily due to an increase in the provision for income taxes and operating expenses of \$3.7 million and \$4.0 million, respectively. The decrease was partially offset by a gain of \$3.1 million on the sale of a cost method investment and an increase in gross profit of \$1.4 million, which was largely attributable to revenue growth.

On July 2, 2012, we acquired AVAAK, Inc. ("AVAAK"), a privately-held company that develops wire-free video networking products for a total purchase consideration of \$24.0 million in cash. We believe the acquisition will bolster our retail business unit product offerings and expand our presence into the smart home market. The historical results of operations of AVAAK prior to the acquisition were not material to our results of operations.

We are currently rolling out home monitoring products from the AVAAK acquisition in North America and plan on a worldwide roll out in the first half of 2013. In addition we plan on rolling out wireless controller products from our prior quarter acquisition of certain assets from Firetide in the second half of 2013.

## Results of Operations

The following table sets forth the unaudited condensed consolidated statements of operations and the percentage change for the three and nine months ended September 30, 2012, with the comparable reporting periods in the preceding year.

	Three Months Ended			Nine Months Ended		
	September 30, 2012	% Change	October 2, 2011	September 30, 2012	% Change	October 2, 2011
	(In thousands, except percentage data)					
Net revenue	\$315,210	4.4	% \$301,800	\$961,485	10.3	% \$871,863
Cost of revenue	217,522	5.9	% 205,490	669,310	12.0	% 597,390
Gross profit	97,688	1.4	% 96,310	292,175	6.4	% 274,473
Operating expenses:						
Research and development	17,399	36.6	% 12,738	46,277	31.8	% 35,102
Sales and marketing	37,600	(5.1)	)% 39,600	114,247	(0.9)	)% 115,284
General and administrative	11,888	9.6	% 10,851	33,520	8.0	% 31,044
Restructuring and other charges—		**	—	—	(100.0)	)% 2,094
Litigation reserves, net	269	511.4	% 44	420	(279.5)	)% (234)
Total operating expenses	67,156	6.2	% 63,233	194,464	6.1	% 183,290
Income from operations	30,532	(7.7)	)% 33,077	97,711	7.2	% 91,183
Interest income	109	(5.2)	)% 115	344	(1.7)	)% 350
Other income (expense), net	3,070	(1,249.8)	)% (267)	2,823	(401.0)	)% (938)
Income before income taxes	33,711	2.4	% 32,925	100,878	11.4	% 90,595

Edgar Filing: NETGEAR, INC - Form 10-Q

Provision for income taxes	9,920	60.6	%	6,178	30,418	37.9	%	22,062
Net income	\$23,791	(11.1	)%	\$26,747	\$70,460	2.8	%	\$68,533

\*\* Percentage change not meaningful.

Table of Contents

The following table sets forth the unaudited condensed consolidated statements of operations, expressed as a percentage of net revenue, for the periods indicated:

	Three Months Ended		Nine Months Ended		
	September 30, 2012	October 2, 2011	September 30, 2012	October 2, 2011	
Net revenue	100	% 100	% 100	% 100	%
Cost of revenue	69.0	% 68.1	% 69.6	% 68.5	%
Gross margin	31.0	% 31.9	% 30.4	% 31.5	%
Operating expenses:					
Research and development	5.5	% 4.2	% 4.8	% 4.0	%
Sales and marketing	11.9	% 13.1	% 11.9	% 13.2	%
General and administrative	3.8	% 3.6	% 3.5	% 3.6	%
Restructuring and other charges	—	% —	% —	% 0.2	%
Litigation reserves, net	0.1	% 0.0	% 0.0	% 0.0	%
Total operating expenses	21.3	% 20.9	% 20.2	% 21.0	%
Income from operations	9.7	% 11.0	% 10.2	% 10.5	%
Interest income	0.0	% 0.0	% 0.0	% 0.0	%
Other income (expense), net	1.0	% (0.1)	)% 0.3	% (0.1)	)%
Income before income taxes	10.7	% 10.9	% 10.5	% 10.4	%
Provision for income taxes	3.2	% 2.0	% 3.2	% 2.5	%
Net income	7.5	% 8.9	% 7.3	% 7.9	%

## Three Months Ended September 30, 2012 Compared to Three Months Ended October 2, 2011

## Net Revenue

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.

Net revenue increased \$13.4 million, or 4.4%, to \$315.2 million for the three months ended September 30, 2012, from \$301.8 million for the three months ended October 2, 2011, primarily due to an increase in Service Provider Business Unit revenue, as a result of increased sales of broadband gateways and home wireless products to our service provider customers. From a geographic perspective, this increase was primarily driven by an increase in Americas revenue. For further discussion of net revenue by geographic region see the section entitled "Net Revenue by Geographic Region." For further discussion of net revenue by segment see the section entitled "Segment Information."

## Net Revenue by Geographic Region

	Three Months Ended		
	September 30, 2012	% Change	
	(In thousands, except percentage data)		
Americas	\$177,647	19.2	% \$149,009
Percentage of net revenue	56.4	%	49.4
EMEA	\$104,368	(12.8)	)% \$119,735
Percentage of net revenue	33.1	%	39.7
APAC	\$33,195	0.4	% \$33,056

Edgar Filing: NETGEAR, INC - Form 10-Q

Percentage of net revenue	10.5	%	10.9	%
Total net revenue	\$315,210	4.4	% \$301,800	

35

---

Table of Contents

The increase in Americas net revenue was primarily attributable to sales of our broadband gateways and home wireless products, partially offset by a decrease in sales of our network storage products. The decrease in EMEA net revenue was primarily attributable to decrease in sales of our home wireless products, switches and hubs, powerline and network storage products. The flat net revenue in APAC was primarily attributable to increased sales in our broadband gateway products, offset by a decrease in sales of network storage, switches and hubs, and multimedia products.

Americas continues to represent the largest percentage of our net revenues, while APAC decreased as a percentage of revenue, primarily due to weakness in Australia across all channels offset by growth in the rest of the APAC region. EMEA decreased as a percentage of revenues as we continued to see macroeconomic weakness in the European market, with the slowdown spreading from southern Europe to the UK and Northern Europe.

### 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; warranty costs associated with returned goods; write-downs for excess and obsolete inventory and amortization expense of certain acquired intangibles. 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, conversion costs and charges for excess or obsolete inventory. The following table presents costs of revenue and gross margin, for the periods indicated:

	Three Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Cost of revenue	\$217,522	5.9	% \$205,490	
Gross margin percentage	31.0	%	31.9	%

Cost of revenue increased \$12.0 million, or 5.9%, to \$217.5 million for the three months ended September 30, 2012, from \$205.5 million for the three months ended October 2, 2011. Our gross margin decreased to 31.0% for the three months ended September 30, 2012, from 31.9% for the three months ended October 2, 2011. The decrease in gross margin percentage was primarily attributable to relatively faster growth in revenue from service providers, which generally carries lower gross margins than our other products. Sales to service providers increased as a percentage of net revenue to 35.7% in the three months ended September 30, 2012 compared to 27.7% in the three months ended October 2, 2011. The decrease in gross margin percentage was partially offset by a decrease in warranty costs and relatively lower usage of air freight for inbound inventory for the three months ended September 30, 2012 as compared to the same period a year ago.

### 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

Edgar Filing: NETGEAR, INC - Form 10-Q

incurred. We have invested in building our research and development organization to enhance our ability to introduce innovative and easy-to-use products. In the future, we expect research and development expenses will increase in absolute dollars and as a percentage of revenue as we broaden our core competencies and expand into new software and networking product technologies. The following table presents research and development expense, for the periods indicated:

	Three Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Research and development expense	\$17,399	36.6	% \$12,738	
Percentage of net revenue	5.5	%	4.2	%

Table of Contents

Research and development expenses increased \$4.7 million, or 36.6%, to \$17.4 million for the three months ended September 30, 2012, from \$12.7 million for the three months ended October 2, 2011. Additionally, research and development expense increased as a percentage of net revenue to 5.5% for the three months ended September 30, 2012 as compared to 4.2% for the three months ended October 2, 2011. The increases were primarily attributable to an increase of \$2.5 million in costs related to our increased investment in research and development projects, and acquisition-related research and development. Additionally, the increases were attributable to an increase of \$1.2 million in payroll and other headcount-related costs driven by headcount growth. Research and development headcount increased by 44 employees to 258 employees at September 30, 2012 compared to 214 employees at October 2, 2011.

## 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, personnel expenses for sales and marketing staff and technical support expenses. The following table presents sales and marketing expense, for the periods indicated:

	Three Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Sales and marketing expense	\$37,600	(5.1	)%	\$39,600
Percentage of net revenue	11.9	%	13.1	%

Sales and marketing expenses decreased \$2.0 million, or 5.1%, to \$37.6 million for the three months ended September 30, 2012, from \$39.6 million for the three months ended October 2, 2011. Additionally, sales and marketing expense decreased as a percentage of net revenue to 11.9% for the three months ended September 30, 2012 compared to 13.1% for the three months ended October 2, 2011. These decreases were primarily attributable to a decrease of \$1.1 million in payroll and other headcount related costs related to variable compensation expenses. Additionally, these decreases were attributable to a decrease of \$0.7 million in marketing expenses, as we shifted our marketing efforts towards activities that were deemed to be a reduction in net revenue and away from operating expense related marketing. Sales and marketing headcount increased by 15 employees to 357 employees at September 30, 2012 compared to 342 employees at October 2, 2011.

## General and Administrative

General and administrative expenses consist of salaries and related expenses for executives, finance and accounting, human resources, information technology, professional fees, allowance for doubtful accounts and other general corporate expenses. The following table presents general and administrative expense, for the periods indicated:

	Three Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
General and administrative expense	\$11,888	9.6	%	\$10,851
Percentage of net revenue	3.8	%	3.6	%

General and administrative expenses increased \$1.0 million, or 9.6%, to \$11.9 million for the three months ended September 30, 2012, from \$10.9 million for the three months ended October 2, 2011. The increase was primarily attributable to a \$1.1 million increase in outside legal service costs due to additional litigation and merger and acquisition activity. Additionally, infrastructure expenses increased \$0.6 million, driven in part by the current year's acquisitions. The increases were partially offset by a decrease of \$0.7 million in payroll and other headcount related costs, primarily driven by a decrease in variable compensation expenses. General and administrative headcount increased by 18 employees to 125 employees at September 30, 2012 compared to 107 employees at October 2, 2011.

#### Litigation Reserve

We recorded a litigation reserve charge of \$269,000 during the three months ended September 30, 2012 as compared to a reserve charge of \$44,000 in the three months ended October 2, 2011 for estimated costs related to the settlement of various

Table of Contents

lawsuits filed against us. For a detailed discussion of our litigation matters, refer to Note 9, Commitments and Contingencies, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

## 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		
	September 30, 2012	% Change	October 2, 2011
	(In thousands, except percentage data)		
Interest income	\$109	(5.2 )%	\$115
Other income (expense), net	3,070	(1,249.8 )%	(267 )
Total interest income and other income (expense), net	\$3,179	(2,191.4 )%	\$(152 )

Interest income decreased \$6,000 to \$109,000 for the three months ended September 30, 2012 from \$115,000 for the three months ended October 2, 2011. The decrease in interest income was primarily attributable to the decrease in the interest rates in the three months ended September 30, 2012, as compared to the three months ended October 2, 2011.

Other income (expense), net, increased \$3.4 million, to income of \$3.1 million for the three months ended September 30, 2012, as compared to expense of \$0.3 million for the three months ended October 2, 2011. The increase was primarily attributable to the \$3.1 million gain on the sale of a cost method investment. In addition, our foreign currency hedging program effectively reduced volatility associated with hedged currency exchange rate movements during the three months ended September 30, 2012. For details of our hedging program and related foreign currency contracts, refer to Note 6, Derivative Financial Instruments, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

## Provision for Income Taxes

The income tax provision for the three months ended September 30, 2012 was \$9.9 million or an effective tax rate of 29.4%, compared to the tax provision for the three months ended October 2, 2011 of \$6.2 million or an effective tax rate of 18.8%. The increase in the effective tax rate for the three month period ended September 30, 2012 compared to the same period in the prior year was primarily caused by an increase in the mix of forecasted earnings from countries with relatively higher statutory tax rates. Additionally, the expiration of the federal research tax credit as of December 31, 2011 contributed to the increased effective tax rate for period. These increases were partially offset by a reduction in accruals for uncertain tax positions that were remeasured during the three month period ended September 30, 2012.

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. The Company is under examination in various US and foreign jurisdictions including by the US Internal Revenue Service. The examination by the Internal Revenue Service includes the 2008 and 2009 calendar years.

## Net Income

Net income decreased \$2.9 million, or 11.1%, to \$23.8 million for the three months ended September 30, 2012, from \$26.7 million for the three months ended October 2, 2011. This decrease was primarily due to an increase in the provision for income taxes and operating expenses of \$3.7 million and \$4.0 million, respectively. The decrease was partially offset by a gain of \$3.1 million on the sale of a cost investment and an increase in gross profit of \$1.4 million, which was largely attributable to revenue growth.

### 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 12, Segment Information, Operations by Geographic Area and Significant Customers, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q. Future changes to our organizational structure or business may result in changes to the reportable segments disclosed. The discussions below include the results of each of our segments for the three months ended

Table of Contents

September 30, 2012 with the comparable reporting periods in the preceding year.

## Retail

	Three Months Ended		October 2, 2011	
	September 30, 2012	% Change		
	( in thousands, except percentage data)			
Net revenue	\$123,457	(2.9 )%	\$127,082	
Percentage of net revenue	39.2	%	42.1	%
Contribution income	17,759	(11.0 )%	19,958	
Contribution margin	14.4	%	15.7	%

Net revenue decreased \$3.6 million, or 2.9%, to \$123.5 million for the three months ended September 30, 2012, from \$127.1 million for the three months ended October 2, 2011. The decrease was primarily due to weak EMEA sales of our broadband gateways and home wireless products, partially offset by an increase in sales of our home wireless products in the Americas. Contribution income decreased \$2.2 million, or 11.0%, to \$17.8 million for the three months ended September 30, 2012, from \$20.0 million for the three months ended October 2, 2011. The decrease was primarily driven by the decrease in revenue, and an increase in operating expenses. Specifically, the increase in operating expenses was driven primarily by investments in research and development.

## Commercial

	Three Months Ended		October 2, 2011	
	September 30, 2012	% Change		
	(in thousands, except percentage data)			
Net revenue	\$79,240	(13.0 )%	\$91,059	
Percentage of net revenue	25.1	%	30.2	%
Contribution income	19,998	(13.1 )%	23,013	
Contribution margin	25.2	%	25.3	%

Net revenue decreased \$11.9 million, or 13.0%, to \$79.2 million for the three months ended September 30, 2012, from \$91.1 million for the three months ended October 2, 2011. The decrease was primarily driven by decreased sales of our network storage products in the Americas and APAC, and a decrease in sales of unmanaged switches in EMEA. Contribution income decreased \$3.0 million, or 13.1%, to \$20.0 million for the three months ended September 30, 2012, from \$23.0 million for the three months ended October 2, 2011. This decrease was primarily attributable to the revenue decline.

## Service Provider

	Three Months Ended		October 2, 2011	
	September 30, 2012	% Change		
	( in thousands, except percentage data)			
Net revenue	\$112,513	34.5	\$83,659	
Percentage of net revenue	35.7	%	27.7	%
Contribution income	11,283	69.4	6,662	
Contribution margin	10.0	%	8.0	%

Net revenue in the service provider business unit increased \$28.8 million, or 34.5%, to \$112.5 million for the three months ended September 30, 2012, from \$83.7 million for the three months ended October 2, 2011. The increase was primarily attributable to increased sales of our broadband gateways and home wireless products. Contribution income increased \$4.6 million, or 69.4%, to \$11.3 million for the three months ended September 30, 2012, from \$6.7 million for the three months ended October 2, 2011, primarily due to revenue growth, while operating expenses grew at a slower pace.

Table of Contents

Nine Months Ended September 30, 2012 Compared to Nine Months Ended October 2, 2011

### Net Revenue

Net revenue increased \$89.6 million, or 10.3%, to \$961.5 million for the nine months ended September 30, 2012, from \$871.9 million for the nine months ended October 2, 2011. The increase in net revenue was primarily attributable increased sales of our broadband gateway, home wireless, and switches and hubs, partially offset by a decrease in sales of our network storage products. We experienced an increase in revenues in the Americas and APAC regions, and in all three business segments with particularly strong sales in the service provider market. For discussion of net revenue by geographic region see the section entitled "Net Revenue by Geographic Region." For discussion of net revenue by segment see the section entitled "Segment Information."

### Net Revenue by Geographic Region

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Americas	\$509,440	18.3	% \$430,482	
Percentage of net revenue	53.0	%	49.4	%
EMEA	\$347,264	(1.5	)% \$352,686	
Percentage of net revenue	36.1	%	40.4	%
APAC	\$104,781	18.1	% \$88,695	
Percentage of net revenue	10.9	%	10.2	%
Total net revenue	\$961,485	10.3	% \$871,863	

The increase in Americas net revenue was primarily attributable to the increase in sales of our broadband gateways and home wireless products, partially offset by a decrease in sales of our network storage products. The decrease in EMEA net revenue was primarily attributable to a decrease in sales of our network storage and powerline products, partially offset by an increase in sales of home wireless products. The increase in APAC was primarily attributable an increase in sales of our broadband gateways products.

The Americas continues to represent the largest percentage of our net revenues, while APAC decreased as a percentage of revenue, primarily due to weakness in Australia across all channels offset by growth in the rest of the APAC region. EMEA decreased as a percentage of revenues as the region continues to experience macroeconomic weakness in the European market, with the slowdown spreading from southern Europe to the UK and Northern Europe.

### Cost of Revenue and Gross Margin

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Cost of revenue	\$669,310	12.0	% \$597,390	
Gross margin percentage	30.4	%	31.5	%

Edgar Filing: NETGEAR, INC - Form 10-Q

Cost of revenue increased \$71.9 million, or 12.0%, to \$669.3 million for the nine months ended September 30, 2012, from \$597.4 million for the nine months ended October 2, 2011. Our gross margin decreased to 30.4% for the nine months ended September 30, 2012, from 31.5% for the nine months ended October 2, 2011. The decrease in gross margin was primarily attributable to relatively faster growth in our revenue from service providers, which generally carries lower gross margins than our other products. Sales to service providers increased as a percentage of net revenue to 37.5% in the nine months ended September 30, 2012 compared to 31.2% in the nine months ended October 2, 2011.

Table of Contents

## Operating Expenses

## Research and Development

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Research and development expense	\$46,277	31.8	% \$35,102	
Percentage of net revenue	4.8	%	4.0	%

Research and development expenses increased \$11.2 million, or 31.8%, to \$46.3 million for the nine months ended September 30, 2012, from \$35.1 million for the nine months ended October 2, 2011. Additionally, research and development expenses increased as a percentage of net revenue to 4.8% for the nine months ended September 30, 2012, from 4.0% for the nine months ended October 2, 2011. The increases were primarily attributable to an increase of \$5.2 million in costs primarily related to our increased investment in research and development projects, and acquisition-related research and development. Additionally, the increases were attributable to an increase of \$4.1 million in payroll and other headcount-related costs driven by headcount growth. Research and development headcount increased by 44 employees to 258 employees at September 30, 2012 compared to 214 employees at October 2, 2011.

## Sales and Marketing

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
Sales and marketing expense	\$114,247	(0.9	)% \$115,284	
Percentage of net revenue	11.9	%	13.2	%

Sales and marketing expense decreased \$1.1 million, or 0.9%, to \$114.2 million for the nine months ended September 30, 2012, from \$115.3 million for the nine months ended October 2, 2011. Additionally, sales and marketing expense decreased as a percentage of net revenue to 11.9% for the nine months ended September 30, 2012 as compared to 13.2% for the nine months ended October 2, 2011. The decreases were primarily attributable to \$3.0 million decrease in marketing expenses and \$1.0 million decrease outside services, as we shifted our marketing efforts towards activities that were deemed to be a reduction in net revenue and away from operating expense related marketing. The decrease was partially offset by \$2.2 million increase in payroll and other headcount-related costs driven by headcount growth. Sales and marketing headcount increased by 15 employees to 357 employees at September 30, 2012 compared to 342 employees at October 2, 2011.

## General and Administrative

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(In thousands, except percentage data)			
General and administrative expense	\$33,520	8.0	% \$31,044	
Percentage of net revenue	3.5	%	3.6	%

General and administrative expenses increased \$2.5 million, or 8.0%, to \$33.5 million for the nine months ended September 30, 2012, from \$31.0 million for the nine months ended October 2, 2011. The increase was primarily attributable to a \$2.4 million increase in outside legal services due to additional litigation and merger and acquisition activity. Additionally, infrastructure expenses increased by \$1.5 million, mainly driven by additional building and office rent resulting from the current year's acquisitions. The increase was partially offset by \$1.8 million decrease in payroll and other employee related expenses due to a decrease in variable compensation. General and administrative headcount increased by 18 employees to 125 employees at September 30, 2012 compared to 107 employees at October 2, 2011.

Table of Contents

## Litigation Reserve

We recorded litigation reserve charges of \$420,000 for estimated costs related to the settlement of various lawsuits filed against us during the nine months ended September 30, 2012, and a benefit of \$234,000 as the result of a recovery due to indemnification of one of our suppliers for previously reserved amounts, during the nine months ended October 2, 2011. For a detailed discussion of our litigation matters, refer to Note 9, Commitments and Contingencies, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

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

	Nine Months Ended		
	September 30, 2012	% Change	October 2, 2011
	(In thousands, except percentage data)		
Interest income	\$344	(1.7	)% \$350
Other income (expense), net	2,823	(401.0	)% (938
Total interest income and other income (expense), net	\$3,167	(638.6	)% \$(588

Interest income was flat for the nine months ended September 30, 2012 and the nine months ended October 2, 2011.

Other income (expense), net, increased \$3.7 million, to income of \$2.8 million for the nine months ended September 30, 2012, from expense of \$0.9 million for the nine months ended October 2, 2011. The increase was primarily attributable to the \$3.1 million gain on the sale of a cost method investment. In addition, our foreign currency hedging program reduced volatility associated with hedged currency exchange rate movements during nine months ended September 30, 2012. For details of our hedging program and related foreign currency contracts, refer to Note 6, Derivative Financial Instruments, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

## Provision for Income Taxes

The income tax provision for the nine months ended September 30, 2012 was \$30.4 million or an effective tax rate of 30.2%, compared to the tax provision for the nine months ended October 2, 2011 of \$22.1 million or an effective tax rate of 24.4%. The increase in the effective tax rate for the nine month ended September 30, 2012 compared to the same period in the prior year was primarily caused by an increase in the mix of forecasted earnings from countries with relatively higher statutory tax rates. Additionally, the expiration of the federal research tax credit as of December 31, 2011 contributed to the increased effective tax rate for the period. These increases were partially offset by a reduction in accruals for uncertain tax positions that were remeasured during the nine month period ended September 30, 2012.

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. The Company is under examination in various US and foreign jurisdictions including by the US Internal Revenue Service. The examination by the Internal Revenue Service includes the 2008 and 2009 calendar years.

## Net Income

Net income increased \$2.0 million, or 2.8%, to \$70.5 million for the nine months ended September 30, 2012, from \$68.5 million for the nine months ended October 2, 2011. This increase was primarily attributable to the increase in

gross profit of \$17.7 million primarily driven by revenue growth, and \$3.1 million gain from the sale of a cost method investment. Those increases were partially offset by an increase in the provision for income taxes of \$8.3 million and an increase in operating expenses of \$11.2 million.

Table of Contents

## Segment Information

## Retail

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	( in thousands, except percentage data)			
Net revenue	\$366,258	4.0	% \$352,076	
Percentage of net revenue	38.1	%	40.4	%
Contribution income	62,590	2.9	% 60,843	
Contribution margin	17.1	%	17.3	%

Net revenue in the retail business unit increased \$14.2 million, or 4.0%, to \$366.3 million for the nine months ended September 30, 2012, from \$352.1 million for the nine months ended October 2, 2011. The increase is primarily due to strong sales of our home wireless products, partially offset by a decrease in sales of our powerline, home storage, multimedia, broadband gateways and wired products. Contribution income increased \$1.8 million, or 2.9%, to \$62.6 million for the nine months ended September 30, 2012, from \$60.8 million for the nine months ended October 2, 2011. The increase in contribution income was primarily due to strong revenue growth, which was partially offset by an increase in operating expenses driven primarily by investments in research and development.

## Commercial

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	(in thousands, except percentage data)			
Net revenue	\$234,498	(5.4	)% \$247,793	
Percentage of net revenue	24.4	%	28.4	%
Contribution income	52,272	(7.8	)% 56,716	
Contribution margin	22.3	%	22.9	%

Net revenue in the commercial business unit decreased \$13.3 million, or 5.4%, to \$234.5 million for the nine months ended September 30, 2012, from \$247.8 million for the nine months ended October 2, 2011. The decrease is primarily attributable to a decrease in sales from our network storage product line. Contribution income decreased \$4.4 million, or 7.8%, to \$52.3 million for the nine months ended September 30, 2012, from \$56.7 million for the nine months ended October 2, 2011. The decrease was primarily attributable to the decline in revenue and an increase in research and development project costs.

## Service Provider

	Nine Months Ended			
	September 30, 2012	% Change	October 2, 2011	
	( in thousands, except percentage data)			
Net revenue	\$360,729	32.6	% \$271,994	
Percentage of net revenue	37.5	%	31.2	%
Contribution income	33,822	40.6	% 24,063	
Contribution margin	9.4	%	8.8	%

Net revenue in the service provider business unit increased \$88.7 million, or 32.6%, to \$360.7 million for the nine months ended September 30, 2012, from \$272.0 million for the nine months ended October 2, 2011. The increase is

primarily attributable to the sales growth of our broadband gateway products, primarily driven by service provider demand for our Docsis 3.0 products, and to a lesser extent, the acquisition of the Customer Networking Solutions division of Westell Technologies, Inc. Contribution income increased \$9.7 million, or 40.6%, to \$33.8 million for the nine months ended September 30, 2012, from \$24.1 million for

Table of Contents

the nine months ended October 2, 2011. The increase is primarily due to an increase in gross profit, driven by an increase in net revenue and a decrease in warranty costs. Operating expenses grew in line with net revenue.

Liquidity and Capital Resources

Our cash and cash equivalents balance decreased from \$208.9 million as of December 31, 2011 to \$134.6 million as of September 30, 2012. Our short-term investments, which represent the investment of funds available for current operations, increased from \$144.8 million as of December 31, 2011 to \$227.8 million as of September 30, 2012, as we shifted assets from low risk money market funds to treasuries with higher returns. Operating activities during the nine months ended September 30, 2012 provided cash of \$37.6 million, compared to \$63.2 million provided in the nine months ended October 2, 2011. Investing activities during the nine months ended September 30, 2012 used cash of \$125.2 million, primarily for purchases of short-term investments. During the nine months ended September 30, 2012, financing activities provided cash of \$13.3 million, resulting primarily from the issuance of common stock related to stock option exercises and our employee stock purchase program.

Our days sales outstanding ("DSO") decreased from 76 days as of December 31, 2011 to 72 days as of September 30, 2012. DSO as of September 30, 2012 was lower due to our continuous efforts to closely manage collections and effectively mitigate risk.

Our accounts payable decreased from \$117.3 million at December 31, 2011 to \$91.1 million at September 30, 2012. The decrease was primarily attributable to timing of payments.

Inventory increased by \$15.2 million from \$163.7 million at December 31, 2011 to \$178.9 million at September 30, 2012. In the three months ended September 30, 2012 we experienced annualized ending inventory turns of approximately 4.9, down from approximately 5.2 in the three months ended December 31, 2011.

We enter into foreign currency forward-exchange contracts, which typically mature in three to five 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 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 cumulative other comprehensive income until the related revenue, costs of revenue, or expenses are recognized.

On July 2, 2012, we acquired AVAAK, Inc. ("AVAAK"), a privately-held company that develops wire-free video networking products for a total purchase consideration of \$24.0 million in cash. We believe the acquisition will bolster our retail business unit product offerings and expand our presence into the smart home market. The historical results of operations of AVAAK prior to the acquisition were not material to our results of operations.

In October 2008, the Board of Directors authorized management to repurchase up to 6,000,000 shares of our common stock in the open market. The stock repurchase authorization does not have an expiration date and the pace of repurchase activity is at the discretion of management and contingent on a number of factors, including levels of cash generation from operations, cash requirements for acquisitions and the price of our common stock. We did not repurchase any shares under this authorization during the nine months ended September 30, 2012 and October 2, 2011. As of September 30, 2012, we were authorized to repurchase up to 4.8 million shares under the share repurchase plan.

In the nine months ended September 30, 2012, we repurchased approximately 22,000 shares, or \$0.8 million of our common stock under a repurchase program to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving RSUs. Similarly, during the nine months ended October 2, 2011, we repurchased approximately 24,000 shares, or \$0.9 million of our common stock,

respectively, 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 will be obtainable on terms

## Table of Contents

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 September 30, 2012 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, 2011.

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.

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. At September 30, 2012, we had approximately \$177 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.

As of September 30, 2012, we had total gross unrecognized tax benefits and related interest liabilities of \$17.6 million. The timing and amount of any payments which could result from these unrecognized tax benefits will depend upon a number of factors including the resolution of ongoing audits. Accordingly, the timing and the amount of payments which may occur within the next 12 months cannot be estimated.

### Off-Balance Sheet Arrangements

As of September 30, 2012, 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

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011. Our critical accounting policies have not materially changed during the nine months ended September 30, 2012.

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

During the nine months ended September 30, 2012, 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, 2011.

### 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.

#### 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

Table of Contents

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.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

The information set forth under Note 9, 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 29, 2012.

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;
- unanticipated shift or decline in profit by geographical region that would adversely impact our tax rate;
- slow or negative growth in the networking product, personal computer, Internet infrastructure, home electronics and related technology markets, as well as decreased demand for Internet access;
- operational disruptions, such as transportation delays or failure of our order processing system, particularly if they occur at the end of a fiscal quarter;
- geopolitical disruption leading to delay or even stoppage of our operations in manufacturing, transportation, technical support and research and development;
- 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;

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;

allowance for bad debts exposure with our existing customers and new customers, particularly as we expand into new

Table of Contents

international markets;

• disruptions or delays related to our financial and enterprise resource planning systems;

• our inability to accurately forecast product demand;

• component supply constraints from our vendors;

• unfavorable level of inventory and turns;

• unanticipated shift in overall product mix from higher to lower margin products that would adversely impact our margins;

• terms of our contracts with customers or suppliers that cause us to incur additional expenses or assume additional liabilities;

• the inability to maintain stable operations by our suppliers and other parties with which we have commercial relationships;

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

• an increase in price protection claims, redemptions of marketing rebates, product warranty and stock rotation returns or allowance for doubtful accounts;

• litigation involving 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;

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

• 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.

With the continuing uncertainty about economic conditions in Europe, Australia, the United States and elsewhere internationally, 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.

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

Table of Contents

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 or inability to raise additional capital;

our ability to report accurate financial results in our periodic reports filed with the SEC;

disclosures of previously non-public information in connection with our segment reporting, which commenced in the second fiscal quarter of 2011; and

changes in stock market analyst recommendations regarding our common stock, other comparable companies or our industry generally.

Economic conditions are likely to 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 services markets, and changes in the overall demand for networking products. A severe and/or prolonged economic downturn could adversely affect our customers' financial condition and the levels of business activity of our customers. Continued weakness in, and uncertainty about, global economic conditions could 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.

The recent indications of continued economic recession throughout various regions worldwide, especially in Europe as well as in Australia, have presented significant challenges to our business. If conditions in the global economy, including Europe, Australia and the United States, or other key vertical or geographic markets continue to remain weak and uncertain or weaken even further, such conditions could have a material adverse impact on our business, operating results and financial condition. In addition, 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 recent economic problems affecting the banking system and financial markets and the recent uncertainty in global economic conditions has resulted in a number of adverse effects including tightening in the credit markets, 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 recent challenges faced by the European Union to stabilize some of its member economies, such as Greece, Portugal, Spain, Hungary and even Italy, has 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. Should the European Union monetary policy measures be insufficient to restore confidence and stability to the financial markets, 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. For example, the aggregate number of resellers of our products decreased during the third quarter of 2012; we believe this

was caused by the difficult worldwide economic environment, and especially the difficulties experienced in Europe. 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.

\*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 commercial business market include Allied Telesys, Barracuda, Buffalo, Data Robotics, Dell, D-Link, Fortinet, Hewlett-Packard, Huawei, Cisco Systems, the Linksys division of Cisco Systems, QNAP Systems, Seagate Technology, SonicWALL, Synology, TRENDnet, WatchGuard and Western Digital. Our principal

Table of Contents

competitors in the home market for networking devices and television connectivity products include Apple, Belkin, D-Link, the Linksys division of Cisco Systems, Roku, TP-Link and Western Digital. Our principal competitors in the broadband service provider market include Actiontec, ARRIS, Comtrend, D-Link, Hitron, Huawei, Motorola, NetComm Wireless, Pace, Sagem, Scientific Atlanta—a Cisco company, SMC Networks, TechniColor, Ubee, Compal Broadband, ZTE and ZyXEL. Other competitors include numerous local vendors such as Devolo, LEA, AVM and the Hercules brand of Guillemot Corporation in Europe, Corega and Melco in Japan and TP-Link in China. 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, Samsung, 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 ODM's, and contract manufacturers who are selling and attempting to sell their products directly to service providers around the world. In addition, as we expand our product portfolio to include home monitoring cameras and services, we also face competition from incumbents and specialty providers in this space, including Linksys, D-Link, Logitech and Dropcam.

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. 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 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. 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. Our business is subject to the risks of international operations.

We derive a significant portion of our revenue from international operations. As a result, our financial condition and operating results could be significantly affected by risks associated with international activities, including economic and labor conditions, political instability, tax laws, changes in the value of the U.S. dollar versus local currencies, and natural disasters. Margins on sales of our products in foreign countries, and on sales of products that include components obtained from foreign suppliers, could be materially adversely affected by foreign currency exchange rate fluctuations and by international trade regulations. Additionally, certain foreign countries have complex regulatory requirements as conditions of doing business. For example, the United Kingdom Anti-Bribery Act of 2010 is broad legislation that prohibits bribery and applies to our operations worldwide. This foreign legislation follows in the spirit of the U.S. Foreign Corrupt Practices Act and focuses additional governmental efforts on anticorruption efforts worldwide. Meeting these requirements may increase our operating expenses as we continue to expand internationally.

\*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. Successfully predicting demand trends is difficult, and it is very difficult to predict the effect 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.

We recently developed and launched new products worldwide under a new brand as an effort to increase sales in a particular market segment. The new brand products may adversely affect sales of our existing products. Marketing of the new brand may also lead to confusion with our existing customers. We have little to no experience in selling a new brand simultaneously with our

49

---

Table of Contents

existing product portfolio. If we are unable to effectively manage the pricing, marketing, sale and distribution of products under our new brand together with our existing products, our business will be harmed.

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, our recent acquisition of the VueZone product line will require significant management effort to successfully scale and launch the products worldwide. If we are unable to effectively and successfully integrate 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. Any future delays in product development and introduction, or product introductions that do not meet broad market acceptance, or unsuccessful launches of newly acquired 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;

• 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 couple of years, we have significantly increased the rate of our new product introductions. If we cannot sustain the rapid pace of innovation or acquire new 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 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 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. 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,

50

---

## Table of Contents

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. 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 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.

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.

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.

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 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.

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 recent 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 Patrick Lo or other key personnel retire, resign or are otherwise terminated.

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 have been and will be investing increased additional in-house resources on software research and development, which could disrupt our ongoing business and present risks not originally contemplated.

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.

Table of Contents

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.

We are also subject to examination by the Internal Revenue Service (“IRS”) and other tax authorities, including state revenue agencies and foreign governments. In 2011, the IRS commenced an examination of our 2008 and 2009 tax years. 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 other tax authorities have increasingly focused attention on intercompany transfer pricing with respect to sales of products and services and the use of intangible assets. 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.

\*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 Securities and Exchange Commission passed final rules in August 2012 regarding investigation and disclosure of the use of certain “conflict materials” in our products. We contemplate that the rules apply to our business and accordingly, we expect to expend significant additional resources to ensure compliance. 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 have 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. EU member state legislation related to the RoHS2 Directive will become effective in January 2013. These restrictions limit the use of toxic substances in electronics products such as ours. RoHS 2 requires manufacturers provide conformity risk assessments and produce technical construction files for each product. NTGR has been working to comply with RoHS2 requirements however, there is no assurance that we will meet the compliance deadline. If we do not become compliant, we may have to restrict sales of our products in the European Union and our business would be harmed. 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

Table of Contents

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. We regularly audit our manufacturers; however, 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 rely on a limited number of retailers and wholesale distributors for a substantial portion of our sales, and if they refuse to pay our requested prices or reduce their level of purchases, our net revenue could decline.

We sell a substantial portion of our products through retailers, including Best Buy Co., Inc. and its affiliates, and wholesale distributors, including Ingram Micro, Inc. and Tech Data Corporation. We expect that a significant portion of our net revenue will continue to come from sales to a small number of retailers and wholesale distributors for the foreseeable future. In addition, because our accounts receivable are 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 retailers and wholesale distributors fails or becomes insolvent. We generally have no minimum purchase commitments or long-term contracts with any of these retailers or distributors. These purchasers could decide at any time to discontinue, decrease or delay their purchases of our products. If our retailers or wholesale distributors 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 retailers or wholesale distributors 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, if there is consolidation among our customer base, certain customers may be able 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, replacement of our products with those of our competitors and cancellations of orders, each of which would harm our operating results.

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, such as the one-time approximately \$10 million dollar order from a service provider customer in the second fiscal quarter of 2011. 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 disrupt our business. 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 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, such as Cisco Systems, 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. We also sell products to broadband service providers. Competition for selling to broadband service providers is 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. During the third quarter of 2012, the aggregate number of resellers of our products decreased from approximately 42,000 to approximately 40,000; we believe this was caused by the difficult worldwide economic environment, and especially the difficulties experienced in Europe. If we were 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.

Table of Contents

\*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 (“ODMs”) and original equipment manufacturers (“OEMs”), 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. 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 weak economic conditions, the viability of some of these third-party manufacturers may be at risk. Our ODM's are increasingly refusing to work with us on certain projects, such as projects for manufacturing products for our service provider customers. Because our service providers command significant resources, including for software support, and demand extremely competitive pricing, our ODM's 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. For example, as a result of our July 2012 acquisition of AVAAK, Inc., we have commenced doing business with a new contract manufacturer. Ensuring that the contract manufacturer is qualified to manufacture our products to our standards is time consuming. In addition, there is no assurance that the contract manufacturer can scale its production of our products at the volumes and in the quality that we require. If the 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 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 ODMs to

manufacture our products. In addition, our ODM's in China have continued to increase our costs of production, particularly in the past couple of years. These increased costs have affected our margins and ability to lower prices for our products to stay competitive. Recent labor unrest in China may also affect our ODMs 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 begin 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 ODM's 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

Table of Contents

are unable to properly manage these risks, our products may be more susceptible to defects and our business would be harmed.

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, 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 9 of the Notes to Unaudited Condensed Consolidated Financial Statements. If we do not resolve these claims on a favorable basis, our business, operating results and financial condition could be significantly harmed.

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. In the past, in connection with the restatement of previously issued financial statements, and our assessment of our disclosure controls and procedures, management concluded at one time that our disclosure controls and procedures were not effective and that we had a material weakness in internal control over financial reporting. We subsequently remediated

the material weakness and continue to closely monitor our controls and procedures. 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.

Table of Contents

\*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, we recently closed two acquisitions. First, in June 2012 we acquired select assets of a small engineering operation in India to enhance our wireless product offerings in our commercial business unit. Additionally in July 2012, we closed the acquisition of privately held AVAAK, Inc., creators of the VueZone® home video monitoring system. 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;
- growing or maintaining revenues to justify the purchase price and the increased expenses associated with acquisitions;
- entering into territories or markets that we have limited or no prior experience with;
- 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;
- diverting management's attention from running the day to day operations of our business; 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 of acquisitions, as we did in June and July 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.

\*System security risks, data protection breaches and cyber-attacks could disrupt our internal operations or information technology or networking services provided to customers, 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. Hackers may develop and deploy viruses, worms and other malicious software programs that are designed to attack our products and systems, including our internal network, or those of our vendors or customers. Additionally, outside parties may attempt to fraudulently induce our employees or users of our products to disclose sensitive information in order to gain access to our data or our customers' data. We have not established a formal business continuity plan. 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. Moreover, potential breaches of our security measures and the accidental loss, inadvertent disclosure or

Table of Contents

unapproved dissemination of proprietary information or sensitive or confidential data about us or our customers, including the potential loss or disclosure of such information or data as a result of hacking, fraud, trickery 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 connection with our acquisition of AVAAK, Inc. in July 2012, we expanded our business into offering a comprehensive online service offering with the new VueZone cloud monitoring service. If this cloud service is compromised by hackers, or if customer confidential information is accessed without authorization, our business will be harmed. Furthermore, operating an online cloud service is a new business for us and we may not have the expertise to properly manage risks related to data security and systems security. If we are unable to successfully prevent breaches of security relating to our VueZone service or customer private information, including customer videos and customer personal identification information, management would need to spend increasing amounts of time and effort in this area, and our business 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 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. For example, in the past we have announced a voluntary recall of a Powerline Ethernet Adapter made for Europe and other countries.

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, our reputation and brand could be damaged, and we could face legal claims regarding our products. A product liability or other claim could result in negative publicity and harm to our reputation, 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.

\*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. 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. 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 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

Table of Contents

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. 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 the recent 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.

\*If we fail to successfully overcome the challenges associated with profitably growing 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 2011 and throughout 2012. The service provider business is challenging and exceptionally competitive. We face a number of challenges associated with penetrating, marketing and selling to the broadband service provider channel that differ from what we have traditionally faced with the other channels. Difficulties and challenges in selling to service providers include a longer sales cycle, more stringent product testing and validation 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, 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. In addition, because our service providers command significant resources, including for software support, and demand extremely competitive pricing, our ODM's are starting to refuse to engage on service provider terms. Accordingly, as our ODM's increasingly decline to take orders for manufacturing our service provider products, our service provider business will be harmed.

Further, as the deployment of DOCSIS 3.0 technology by broadband service providers matures, we anticipate competing in an extremely price sensitive market and our margins may be affected. 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. 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. For example, we have been at the forefront of developing and selling DOCSIS 3.0 products to our service

provider customers in the past couple of years. As our competitors develop DOCSIS 3.0 products, our service provider customers may use these competitor products as an alternate source for this technology. Our service provider customers may then require us to lower our prices or they may choose to purchase more DOCSIS 3.0 products from our competitors. Accordingly, our business may be harmed and our revenues may 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 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. 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

Table of Contents

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. For example, service provider purchases decreased in the third quarter of 2012 following a run-up in service provider purchases in the first half of 2012, including purchases in anticipation of coverage relating to the 2012 Olympic games. 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 grow our service provider sales channel and our growth will be slowed.

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

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.

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 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 implemented a hedging program in November 2008 to hedge exposures to fluctuations in foreign currency exchange rates as a response to the risks 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, in the second fiscal quarter of 2009, we commenced implementation of a hedging program to reduce the impact of volatile exchange rates on net revenues, gross profit and operating profit for limited periods of time. However, the use of such hedging activities may only offset a portion of the adverse financial effect resulting from unfavorable movements in foreign exchange rates.

## Table of Contents

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

Under generally accepted accounting principles, we review our amortizable 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 amortizable 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 amortizable 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 amortizable 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. 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 amortizable intangible assets be determined resulting in an adverse impact on our results of operations.

In the second fiscal quarter of 2011, in connection with our reorganization into three specific business units (retail, commercial, and service provider), we allocated goodwill to each business unit and evaluated those allocations for potential impairment. No impairment existed as of the end of the second fiscal quarter of 2011. In the fourth fiscal quarter of 2011, we completed our annual impairment test of goodwill and determined no impairment existed as of December 31, 2011. We will continue to test goodwill for impairment at least annually at the business unit level. The allocation of goodwill may have greater impact for certain of the business segments, as compared to the other segments. Accordingly, the performance of a business unit may be adversely affected by the allocation of goodwill.

\*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.

Table of Contents

If the redemption rate for our end-user promotional programs is higher than we estimate, then our net revenue and gross margin will be negatively affected.

From time to time we offer promotional incentives, including cash rebates, to encourage end-users to purchase certain of our products. Purchasers must follow specific and stringent guidelines to redeem these incentives or rebates. Often qualified purchasers choose not to apply for the incentives or fail to follow the required redemption guidelines, resulting in an incentive redemption rate of less than 100%. Based on historical data, we estimate an incentive redemption rate for our promotional programs. If the actual redemption rate is higher than our estimated rate, then our net revenue and gross margin will be negatively affected.

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.

\*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 52% of overall net revenue in fiscal 2011 and 44% of overall net revenue for the three months ended September 30, 2012. 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:

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;

exchange rate fluctuations;

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 recently enacted Ecodesign directive (EuP) in Europe 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.

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

Table of Contents

legislation, such as the European Ecodesign directive (EuP), they may cease to order our products and our revenue would be harmed.

We are expanding our operations and infrastructure, which may strain our operations and increase our operating expenses.

We are expanding our operations and pursuing market opportunities both domestically and internationally in order to grow our sales. We expect that this expansion will require 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. In the second fiscal quarter of 2011, we reorganized our business into three business units: retail, commercial, and service provider. Our reorganization into three business units may cause significant distraction to our management and employees. For example, channel and pricing conflicts may arise in certain territories as each of our business units may engage in selling activities which may benefit that business unit at the expense of another business unit. In addition, disclosures of previously non-public information in connection with our reorganization may also provide our competitors with strategic data which may put us at a competitive disadvantage and harm our business. These new disclosures about our performance may also cause our stock price to decline. 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.

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

Economic conditions, 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. Significantly all of our critical enterprise-wide information technology systems, including our main servers, are currently housed in colocation facilities near our headquarters in Northern California. 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 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.

We depend significantly on worldwide economic conditions and their impact on consumer spending levels, which have recently deteriorated significantly in many countries and regions, including without limitation the United States, and may remain depressed for the foreseeable future. Factors that could influence the levels of consumer spending include increases in fuel and other energy costs, conditions in the residential real estate and mortgage markets, labor and healthcare costs, access to credit, consumer confidence and other macroeconomic factors affecting consumer spending behavior.

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 occurred in 2010 and have led to workers going on strike. The recent trend of 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 have been affected by record flooding in Thailand in the third fiscal quarter of 2011, and they informed us that our supply chain would be constrained for an indefinite amount of time, up to six months in some cases. 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 orders containing ReadyNAS products with hard disk drives. 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. Furthermore, earthquakes and resultant nuclear threats and tsunamis in Japan in March 2011 caused some 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.

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

(a) None.

(b) None.

(c) On October 21, 2008, our Board of Directors authorized management to repurchase up to 6,000,000 shares of our outstanding common stock. Under this authorization, 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 our share price. As of September 30, 2012, we were authorized to purchase up to 4.8 million shares under the share repurchase plan. We did not repurchase any shares of common stock under this repurchase authorization in the three months ended September 30, 2012.

Item 3. Defaults Upon Senior Securities

None.

Table of Contents

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

66

---

Table of Contents

## Item 6. Exhibits

Exhibit Number	Description
3.3	Amended and Restated Certificate of Incorporation of the registrant (Incorporated by reference to an exhibit filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-104419), which the Securities and Exchange Commission declared effective on July 30, 2003)
3.5	Amended and Restated Bylaws of the registrant (Incorporated by reference to an exhibit filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-104419), which the Securities and Exchange Commission declared effective on July 30, 2003)
4.1	Form of registrant's common stock certificate(Incorporated by reference to an exhibit filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-104419), which the Securities and Exchange Commission declared effective on July 30, 2003)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Definition Linkbase Document
101.LAB*	XBRL Taxonomy Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purpose of Section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.

\*

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 6, 2012

68

---

Table of Contents

Exhibit Index

Exhibit Number	Description
3.3	Amended and Restated Certificate of Incorporation of the registrant (Incorporated by reference to an exhibit filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-104419), which the Securities and Exchange Commission declared effective on July 30, 2003)
3.5	Amended and Restated Bylaws of the registrant (Incorporated by reference to an exhibit filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-104419), which the Securities and Exchange Commission declared effective on July 30, 2003)
4.1	Form of registrant's common stock certificate(Incorporated by reference to an exhibit filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-104419), which the Securities and Exchange Commission declared effective on July 30, 2003)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Definition Linkbase Document
101.LAB*	XBRL Taxonomy Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purpose of Section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.

\*