

NETGEAR, INC  
Form 10-Q  
May 03, 2019  
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 March 31, 2019.

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  
incorporation or organization) (IRS Employer  
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 every Interactive Data File required to be submitted 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 such files). Yes  No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Edgar Filing: NETGEAR, INC - Form 10-Q

Title of each class	Trading symbol(s):	Name of each exchange on which registered
Common Stock, \$0.001 par value	NTGR	The Nasdaq Stock Market LLC

The number of outstanding shares of the registrant's Common Stock, \$0.001 par value, was 31,491,699 as of April 26, 2019.

1

---

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 Stockholders' Equity</u>	<u>6</u>
	<u>Unaudited Condensed Consolidated Statements of Cash Flows</u>	<u>7</u>
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	<u>8</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>39</u>
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>50</u>
Item 4.	<u>Controls and Procedures</u>	<u>50</u>

PART II: OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	<u>51</u>
Item 1A.	<u>Risk Factors</u>	<u>51</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>78</u>
Item 3.	<u>Defaults Upon Senior Securities</u>	<u>78</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>78</u>
Item 5.	<u>Other Information</u>	<u>78</u>
Item 6.	<u>Exhibits</u>	<u>79</u>
	<u>Signatures</u>	<u>80</u>

Table of Contents

## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

## NETGEAR, INC.

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	As of	
	March 31,	December 31,
	2019	2018
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 185,680	\$ 201,047
Short-term investments	26,972	73,317
Accounts receivable, net of allowance for doubtful accounts of \$1,255 and \$1,254 as of March 31, 2019 and December 31, 2018, respectively	262,531	303,667
Inventories	236,123	243,871
Prepaid expenses and other current assets	34,791	35,997
Total current assets	746,097	857,899
Property and equipment, net	20,645	20,177
Operating lease right-of-use assets, net	36,613	—
Intangibles, net	15,058	17,146
Goodwill	80,721	80,721
Other non-current assets	71,241	67,433
Total assets	\$ 970,375	\$ 1,043,376
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 69,279	\$ 139,748
Accrued employee compensation	18,452	31,666
Other accrued liabilities	177,635	199,472
Deferred revenue	11,750	11,086
Income taxes payable	2,895	2,020
Total current liabilities	280,011	383,992
Non-current income taxes payable	18,142	19,600
Non-current operating lease liabilities	31,514	—
Other non-current liabilities	7,800	12,232
Total liabilities	337,467	415,824
Commitments and contingencies ( <a href="#">Note 10</a> )		
Stockholders' equity:		
Common stock	32	32
Additional paid-in capital	804,413	793,585
Accumulated other comprehensive income (loss)	14	(15 )
Accumulated deficit	(171,551 )	(166,050 )
Total stockholders' equity	632,908	627,552
Total liabilities and stockholders' equity	\$ 970,375	\$ 1,043,376

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	
	March 31,	April 1,
	2019	2018
Net revenue	\$249,082	\$245,201
Cost of revenue	167,074	168,882
Gross profit	82,008	76,319
Operating expenses:		
Research and development	18,832	21,191
Sales and marketing	35,855	37,874
General and administrative	13,117	15,761
Separation expense	264	—
Restructuring and other charges	(68	) (9
Total operating expenses	68,000	74,817
Income from operations	14,008	1,502
Interest income	701	748
Other income (expense), net	341	(1,318
Income before income taxes	15,050	932
Provision (benefit) for income taxes	2,207	(86
Net income from continuing operations	12,843	1,018
Net income from discontinued operations, net of tax	—	4,572
Net income	\$12,843	\$5,590
Net income per share - basic:		
Income from continuing operations	\$0.41	\$0.03
Income from discontinued operations	—	0.15
Net income	\$0.41	\$0.18
Net income per share - diluted:		
Income from continuing operations	\$0.39	\$0.03
Income from discontinued operations	—	0.14
Net income	\$0.39	\$0.17
Weighted average shares used to compute net income per share:		
Basic	31,483	31,427
Diluted	32,874	32,660

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 March 31, April 1, 2019      2018	
Net income	\$12,843	\$5,590
Other comprehensive income, before tax:		
Unrealized gains on derivative instruments	23	692
Unrealized gains (losses) on available-for-sale securities	15	(38 )
Other comprehensive income, before tax	38	654
Tax provision related to derivative instruments	(6 )	(61 )
Tax provision related to available-for-sale securities	(3 )	(11 )
Other comprehensive income, net of tax	29	582
Comprehensive income	\$12,872	\$6,172

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

Table of Contents

NETGEAR, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(In thousands)

	Common Stock					
	Shares	Amount	Additional Paid-In Capital	Other Comprehensive Income (Loss)	Accumulated deficit	Total Stockholder's Equity
Balance as of December 31, 2018	31,562	\$ 32	\$ 793,585	\$ (15 )	\$(166,050 )	\$ 627,552
Change in unrealized gains and losses on available-for-sale securities, net of tax	—	—	—	12	—	12
Change in unrealized gains and losses on derivatives, net of tax	—	—	—	17	—	17
Net income	—	—	—	—	12,843	12,843
Stock-based compensation	—	—	6,457	—	—	6,457
Repurchase of common stock	(436 )	—	—	—	(15,000 )	(15,000 )
Restricted stock unit withholdings	(89 )	—	—	—	(3,344 )	(3,344 )
Issuance of common stock under stock-based compensation plans	430	—	4,371	—	—	4,371
Balance as of March 31, 2019	31,467	\$ 32	\$ 804,413	\$ 14	\$(171,551 )	\$ 632,908

	Common Stock					
	Shares	Amount	Additional Paid-In Capital	Other Comprehensive Income (Loss)	Retained Earnings	Total Stockholder's Equity
Balance as of December 31, 2017	31,320	\$ 31	\$ 603,137	\$ (851 )	\$ 128,168	\$ 730,485
Adoptions of ASU 2014-09 (ASC 606 Rev Rec), ASU 2016-16, and ASU 2018-02, net of tax	—	—	—	—	8,593	8,593
Change in unrealized gains and losses on available-for-sale securities, net of tax	—	—	—	(49 )	—	(49 )
Change in unrealized gains and losses on derivatives, net of tax	—	—	—	631	—	631
Net income	—	—	—	—	5,590	5,590
Stock-based compensation	—	—	8,150	—	—	8,150
Restricted stock unit withholdings	(38 )	—	—	—	(2,271 )	(2,271 )
Issuance of common stock under stock-based compensation plans	252	1	4,589	—	—	4,590
Balance as of April 1, 2018	31,534	\$ 32	\$ 615,876	\$ (269 )	\$ 140,080	\$ 755,719

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)

	Three Months Ended	
	March 31,	April 1,
	2019	2018
Cash flows from operating activities:		
Net income	\$ 12,843	\$ 5,590
Net income from discontinued operations	—	(4,572 )
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,028	5,040
Purchase premium amortization/discount accretion on investments, net	(141 )	(107 )
Stock-based compensation	6,458	6,864
(Gains)/charges related to long-term investments, net	—	1,400
Deferred income taxes	1,148	870
Changes in assets and liabilities		
Accounts receivable	41,136	45,561
Inventories	7,748	(1,546 )
Prepaid expenses and other assets	453	(2,620 )
Accounts payable	(68,431 )	(15,029 )
Accrued employee compensation	(13,214 )	(2,720 )
Other accrued liabilities	(31,371 )	(19,214 )
Deferred revenue	1,733	(31 )
Income taxes payable	(583 )	3,397
Net cash provided by (used in) continuing operating activities	(37,193 )	22,883
Net cash provided by discontinued operating activities	—	34,113
Net cash provided by (used in) operating activities	(37,193 )	56,996
Cash flows from investing activities:		
Purchases of short-term investments	(146 )	(35,167 )
Proceeds from maturities of short-term investments	47,145	34,907
Purchases of property and equipment	(5,958 )	(2,774 )
Purchases of long-term investments	(5,200 )	—
Net cash provided by (used in) continuing investing activities	35,841	(3,034 )
Net cash used in discontinued investing activities	—	(410 )
Net cash provided by (used in) investing activities	35,841	(3,444 )
Cash flows from financing activities:		
Repurchases of common stock	(15,000 )	—
Restricted stock unit withholdings	(3,344 )	(2,271 )
Proceeds from exercise of stock options	2,026	1,912
Proceeds from issuance of common stock under employee stock purchase plan	2,303	2,732
Net cash provided by (used in) continuing financing activities	(14,015 )	2,373
Net cash provided by (used in) discontinued financing activities	—	—
Net cash provided by (used in) in financing activities	(14,015 )	2,373
Net increase (decrease) in cash and cash equivalents	(15,367 )	55,925
Cash and cash equivalents, at beginning of period	201,047	202,870
Cash and cash equivalents, at end of period	\$ 185,680	\$ 258,795
Non-cash investing and financing activities:		
Additions to property and equipment included in accounts payable and other accrued liabilities	\$ 2,550	\$ 598

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 company that delivers innovative networking and Internet connected products to consumers and businesses. The Company's products are built on a variety of proven technologies such as wireless (WiFi and 4G/5G mobile), Ethernet and powerline, with a focus on reliability and ease-of-use. The product line consists of devices that create and extend wired and wireless networks as well as devices that provide a special function and attach to the network, such as smart digital canvasses and services. These products are available in multiple configurations to address the changing needs of our customers in each geographic region in which the Company's products are sold.

The accompanying unaudited condensed consolidated financial statements include the accounts of NETGEAR, Inc. and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated in consolidation. The balance sheet dated December 31, 2018 has been derived from audited financial statements at such date. Accordingly, these unaudited condensed consolidated financial statements do not include all of the information and footnotes typically found in the audited consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company's financial position, results of operations, comprehensive income, stockholder's equity and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

On December 31, 2018, the Company completed the Spin-Off of Arlo Technologies, Inc. (“Arlo”), a majority owned subsidiary and reporting segment of NETGEAR. Arlo's historical financial results for periods prior to the Spin-Off are reflected in the unaudited condensed consolidated financial statements as discontinued operations. For further detail, refer to Note 4. Discontinued Operations.

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of net revenue and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019 or any future period.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 2. Summary of Significant Accounting Policies

The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018. Refer to Note 15. Leases, for the updated accounting policy on leases upon adoption of ASU 2016-02, "Leases" as of January 1, 2019.

Recent accounting pronouncements

Accounting Pronouncements Recently Adopted

ASU 2016-02

In February 2016, FASB issued ASU 2016-02, "Leases" (Topic 842), which requires a lessee to recognize on the balance sheets a right-of-use asset, representing its right to use the underlying asset for the lease term, and a corresponding lease liability. The liability is equal to the present value of lease payments while the right-of-use asset is based on the liability, subject to adjustment, such as for initial direct costs. In addition, ASU 2016-02 expands the disclosure requirements for lessees.

The Company adopted the new standard effective January 1, 2019 and was required to record a lease asset and lease liability related to its operating leases. The Company elected to utilize the alternative modified transaction method, under which the cumulative-effect adjustment to the opening balance is recognized on the date of adoption while comparative prior periods continue to be reported under the guidance in effect prior to January 1, 2019. Accordingly, the Company did not restate or make related disclosures under the new standard for comparative prior periods in the period of adoption, and the Company applied the new lease standard prospectively to leases existing or commencing on or after January 1, 2019. The Company elected the package of practical expedients permitted under the transition guidance within the standard to not (1) reassess whether any expired or existing contracts are considered or contain leases; (2) reassess the lease classification for any expired or existing leases; and (3) reassess the initial direct costs for any existing leases. The Company made an accounting policy election to treat the lease and non-lease components in its office lease contracts as a single performance obligation to the extent that the timing and pattern of transfer are similar for the lease and non-lease components and the lease component qualifies as an operating lease. The Company also made an accounting policy election not to recognize lease liabilities and right-of-use assets for leases with a term of 12 months or less. The Company will recognize these lease payments on a straight-line basis over the lease term.

Table of Contents

NETGEAR, INC.

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

The following table summarizes the impact of adopting ASU 2016-02 on the Company's unaudited condensed consolidated balance sheets for the fiscal year beginning January 1, 2019 as an adjustment to the opening balances:

	As of December 31, 2018 (In thousands)	Adjustments	As of January 1, 2019
<b>Assets:</b>			
Prepaid expenses and other current assets	\$35,997	\$ (543 )	\$35,454
Total current assets	\$857,899	\$ (543 )	\$857,356
Operating lease right-of-use assets, net	\$—	\$ 39,110	\$39,110
Total assets	\$1,043,376	\$ 38,567	\$1,081,943
<b>Liabilities:</b>			
Other accrued liabilities	\$199,472	\$ 10,909	\$210,381
Total current liabilities	\$383,992	\$ 10,909	\$394,901
Non-current operating lease liabilities	\$—	\$ 33,823	\$33,823
Other non-current liabilities	\$12,232	\$ (6,165 )	\$6,067
Total liabilities	\$415,824	\$ 38,567	\$454,391
Total liabilities and stockholders' equity	\$1,043,376	\$ 38,567	\$1,081,943

The standard did not impact our statements of operations and had no impact on our cash flows.

**Accounting Pronouncements Not Yet Effective**

In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments" (Topic 326), which replaces the incurred-loss impairment methodology and requires immediate recognition of estimated credit losses expected to occur for most financial assets, including trade receivables. Credit losses on available-for-sale debt securities with unrealized losses will be recognized as allowances for credit losses limited to the amount by which fair value is below amortized cost. ASU 2016-13 is effective for the Company beginning in the first fiscal quarter of 2020 and early adoption is permitted. The Company continues to assess the potential impact of the new guidance and related codification improvements on its financial position, results of operations and cash flows, including accounting policies, processes, and systems.

With the exception of the new standards discussed above, there have been no other new accounting pronouncements that have significance, or potential significance, to the Company's financial position, results of operations and cash flows.

**Note 3. Revenue**

Revenue from contracts with customers is recognized when control of the promised goods or services is transferred to the customers, in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Transaction Price Allocated to the Remaining Performance Obligations

Remaining performance obligations represent the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied as of the end of the reporting period. Unsatisfied and partially unsatisfied performance obligations consist of contract liabilities, in-transit orders with destination terms, and non-cancellable backlog. Non-cancellable backlog includes goods and services for which customer purchase orders have been accepted that are scheduled or in the process of being scheduled for shipment.

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied (or partially unsatisfied) as of March 31, 2019:

	1 year	2 years	Greater than 2 years	Total
Performance obligations	\$49,895	\$1,012	\$ 965	\$51,872

## Contract Balances

The Company records accounts receivable when it has an unconditional right to consideration. Contract liabilities are recorded when cash payments are received or due in advance of performance. Contract liabilities consist of advance payments and deferred revenue, where the Company has unsatisfied performance obligations. Contract liabilities are classified as Deferred revenue on the unaudited condensed consolidated balance sheets.

Payment terms vary by customer. The time between invoicing and when payment is due is not significant. For certain products or services and customer types, payment is required before the products or services are delivered to the customer.

The following table reflects the changes in contract balances for the three months ended March 31, 2019:

	Balance Sheet Location	March 31, 2019	December 31, 2018	\$ change	% change
(In thousands)					
Accounts Receivable, net	Accounts receivable, net	\$262,531	\$303,667	\$(41,136)	(13.5)%
Contract liabilities - current	Deferred revenue	\$11,750	\$11,086	\$664	6.0%
Contract liabilities - non-current	Other non-current liabilities	\$1,847	\$779	\$1,068	137.1%

The difference in the balances of the Company's contract assets and liabilities as of March 31, 2019 and December 31, 2018 primarily results from the timing difference between the Company's performance and the customer's payment.

During the three months ended March 31, 2019, \$3.7 million of revenue was deferred due to unsatisfied performance obligations, primarily relating to over time revenue. During the three months, \$2.0 million of revenue was recognized for the satisfaction of performance obligations over time. \$1.7 million of this recognized revenue was included in the contract liability balance at the beginning of the period.

There were no significant changes in estimates during the period that would affect the contract balances.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Disaggregation of Revenue

In the following table, net revenue is disaggregated by geographic region and sales channel. The Company conducts business across three geographic regions: Americas; Europe, Middle-East and Africa ("EMEA"); and Asia Pacific ("APAC"). The table also includes a reconciliation of the disaggregated revenue by reportable segment. The Company operates and reports in two segments: Connected Home, and Small and Medium Business ("SMB"). Sales and usage-based taxes are excluded from net revenue.

	Three Months Ended			April 1,		
	March 31,			2018		
	Connected	SMB	Total	Connected	SMB	Total
	Home			Home		
Geographic regions:						
Americas	\$ 113,687	\$ 34,342	\$ 148,029	\$ 129,038	\$ 30,974	\$ 160,012
EMEA	25,690	31,273	56,963	21,010	26,424	47,434
APAC	29,988	14,102	44,090	24,267	13,488	37,755
Total net revenue	\$ 169,365	\$ 79,717	\$ 249,082	\$ 174,315	\$ 70,886	\$ 245,201
Sales channels:						
Service provider	\$ 36,818	\$ 1,476	\$ 38,294	\$ 41,797	\$ 1,063	\$ 42,860
Non-service provider	132,547	78,241	210,788	132,518	69,823	202,341
Total net revenue	\$ 169,365	\$ 79,717	\$ 249,082	\$ 174,315	\$ 70,886	\$ 245,201

## Note 4. Discontinued Operations

On February 6, 2018, the Company announced that its Board of Directors had unanimously approved the pursuit of a separation of its smart camera business "Arlo" from NETGEAR (the "Separation") to be effected by way of initial public offering ("IPO") and spin-off. In August 2018, Arlo Technologies, Inc. ("Arlo") was listed on the New York Stock Exchange under the symbol "ARLO" and completed the IPO. Upon completion of the IPO, NETGEAR held approximately 84.2% of the outstanding shares of Arlo common stock, or 62,500,000 shares. On December 31, 2018, NETGEAR completed the distribution of these 62,500,000 shares of common stock of Arlo (the "Distribution") and no longer owns any shares of Arlo common stock. The Distribution took place by way of a pro rata common stock dividend to each NETGEAR stockholder of record on the record date of the Distribution, December 17, 2018, and NETGEAR stockholders received 1.980295 shares of Arlo common stock for every share of NETGEAR common stock held as of the record date.

Upon completion of the Distribution, the Company ceased to own a controlling financial interest in Arlo and Arlo's assets, liabilities, operating results and cash flows for all periods presented have been classified as discontinued operations within the unaudited condensed Consolidated Financial Statements.

Table of Contents

NETGEAR, INC.

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

The financial results of Arlo through the Distribution date are presented as income from discontinued operations, net of tax, in the unaudited condensed consolidated statement of operations. The following table presents financial results of Arlo for the three months ended April 1, 2018:

	Three Months Ended April 1, 2018 (In thousands)
Net revenues	\$ 99,772
Cost of revenue	71,586
Gross profit	28,186
Operating expenses:	
Research and development	7,757
Sales and marketing	5,784
General and administrative	876
Separation expense	6,784
Total operating expenses	21,201
Income from operations of discontinued operations	6,985
Other income (expense), net	66
Income from discontinued operations before income taxes	7,051
Provision for income taxes	2,479
Income from discontinued operations, net of tax	\$ 4,572

## Note 5. Business Acquisition

## Meural Inc.

On August 6, 2018, the Company acquired Meural Inc. ("Meural"), a New York based startup focused on producing and developing hardware and cloud platform capabilities for the digital distribution of curated artwork. Meural aims to provide a premium product to customers and to complement sales of digital canvasses with subscription services by offering customers the ability to subscribe to a large library of curated artworks. The Company believes that the acquisition enables it to enter a new and growing product category focused on consumer lifestyle and enhance its portfolio of hardware and service offerings.

Prior to the business acquisition, the Company had an investment in Meural since 2017. The total purchase consideration was \$22.2 million, which consisted of \$14.4 million of cash, which was paid in the third quarter of 2018, \$1.5 million due to the Company's settlement in its prior equity interest in Meural, and the acquisition date fair value of contingent consideration of \$6.3 million.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The merger agreement provides for the payment of contingent consideration to each selling shareholder of Meural based on the achievement of certain technical and service revenue milestones through August 6, 2023, with a maximum payout of \$3.5 million on each of two milestones. The valuation of the contingent consideration was derived using estimates of the probability of achievement within specified time periods, in a scenario based model for the technical milestone; and using an option pricing model in a risk neutral framework using a Monte Carlo simulation, based on projections of future service revenues for the service revenue milestone. The fair value of such contingent consideration payable to Meural's external shareholders is determined to be \$5.9 million and is included in Other non-current liabilities on the unaudited condensed consolidated balance sheets. As of March 31, 2019, there were no significant changes in the range of expected outcomes for the contingent consideration from the acquisition date. The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting. The results of Meural have been included in the unaudited condensed 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 purchase price allocation was as follows (in thousands):

Cash and cash equivalents	\$20
Accounts receivable	209
Inventories	760
Prepaid expenses and other current assets	500
Property and equipment	16
Intangibles	4,800
Non-current deferred income taxes	815
Goodwill	16,407
Accounts payable	(1,317 )
Other accrued liabilities	(35 )
Total purchase price	\$22,175

The \$16.4 million of goodwill recorded on the acquisition of Meural is not deductible for U.S. federal or U.S. state income tax purposes. The goodwill was generated as a result of the anticipated synergies, expected to be derived through selling Meural's products and services through NETGEAR's established worldwide sales channel and customer base. The goodwill was assigned to the Company's Connected Home segment.

In connection with the acquisition, the Company recorded \$0.8 million of deferred tax assets net of deferred tax liabilities. The deferred tax assets were recorded for the tax benefit of the net operating losses as of the date of the acquisition after consideration of limitations on their use under U.S. Internal Revenue Code section 382. The deferred tax assets were reduced by deferred tax liabilities for the book basis of intangible assets for which the Company has no tax basis.

The Company designated \$3.0 million of the acquired intangibles as developed technology. The valuation was derived using an income approach, based on the present value of the estimated future cash flows derived from projections of future operations attributable to the developed technology, discounted at a rate of 16.0% and are being amortized over an estimated useful life of seven years.

The Company designated \$0.6 million of the acquired intangibles as trade name, \$0.6 million of the acquired intangibles as customer relationship and \$0.6 million of the acquired intangibles as playlist database. The valuations of these intangibles were derived using variations of the income approach for the trade name and customer relationships, and replacement cost method for the playlist database. The valuations were based on certain key assumptions like the royalty rate, revenue and cash flows derived from projections of future operations and discount rates ranging from 16.0% to 19.0%. The intangible assets are being amortized over estimated useful lives of three years, two years and seven years for trade name, customer relationships and playlist database, respectively.





Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Note 6. Balance Sheet Components

## Available-for-sale short-term investments

	As of March 31, 2019				December 31, 2018			
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
	(In thousands)							
U.S. treasuries	\$23,471	\$	—\$ (1 )	\$ 23,470	\$70,330	\$ 1	\$ (17 )	\$ 70,314
Certificates of deposit	151	—	—	151	149	—	—	149
Total	\$23,622	\$	—\$ (1 )	\$ 23,621	\$70,479	\$ 1	\$ (17 )	\$ 70,463

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

## Inventories

	As of	
	March 31, 2019	December 31, 2018
	(In thousands)	
Raw materials	\$ 5,650	\$ 3,427
Finished goods	230,473	240,444
Total inventories	\$ 236,123	\$ 243,871

The Company records provisions for excess and obsolete inventory based on assumptions about future demand and market conditions. 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	
	March 31, 2019	December 31, 2018
	(In thousands)	
Computer equipment	\$9,814	\$ 9,205
Furniture, fixtures and leasehold improvements	18,477	18,286
Software	28,848	28,065
Machinery and equipment	62,249	60,552
Total property and equipment, gross	119,388	116,108
Accumulated depreciation and amortization	(98,743 )	(95,931 )
Total property and equipment, net	\$20,645	\$ 20,177

Depreciation and amortization expense pertaining to property and equipment was \$2.9 million for the three months ended March 31, 2019 and April 1, 2018, respectively.



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Intangibles, net

	As of March 31, 2019			As of December 31, 2018		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(In thousands)					
Technology	\$59,799	\$(57,085)	\$2,714	\$59,799	\$(56,978)	\$2,821
Customer contracts and relationships	56,800	(46,111)	10,689	56,800	(44,280)	12,520
Other	10,345	(8,690)	1,655	10,345	(8,540)	1,805
Total intangibles, net	\$126,944	\$(111,886)	\$15,058	\$126,944	\$(109,798)	\$17,146

Amortization of intangibles was \$2.1 million for the three months ended March 31, 2019 and \$2.2 million for the three months ended April 1, 2018.

As of March 31, 2019, estimated amortization expense related to finite-lived intangibles for the remaining years is as follows (in thousands):

2019 (remaining nine months)	\$4,954
2020	6,205
2021	2,044
2022	527
2023	514
Thereafter	814
Total estimated amortization expense	\$15,058

## Other non-current assets

	As of	
	March 31, 2019	December 31, 2018
	(In thousands)	
Non-current deferred income taxes	\$56,402	\$57,557
Long-term investments	8,086	2,886
Other	6,753	6,990
Total other non-current assets	\$71,241	\$67,433

## Other accrued liabilities

	As of	
	March 31, 2019	December 31, 2018
	(In thousands)	
Current operating lease liabilities	\$10,599	\$ —
Sales and marketing	74,659	91,548
Warranty obligations	12,531	14,412
Sales returns	42,202	46,318
Freight and duty	5,268	10,586
Other	32,376	36,608
Total other accrued liabilities	\$177,635	\$199,472



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Note 7. Derivative Financial Instruments

The Company's subsidiaries have had, and will continue to have material future cash flows, including revenue and expenses, which are denominated in currencies other than the Company's functional currency. The Company and all its subsidiaries designate the U.S. dollar as the functional currency. Changes in exchange rates between the Company's functional currency and other currencies in which the Company transacts business will cause fluctuations in cash flow expectations and cash flow realized or settled. Accordingly, the Company uses derivatives to mitigate its business exposure to foreign exchange risk. The Company enters into foreign currency forward contracts in Australian dollars, British pounds, Euros, Canadian dollar, 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 institutions and the Company does not consider non-performance a material risk.

The Company may choose not to hedge certain foreign exchange exposures for a variety of reasons, including, but not limited to, materiality, accounting considerations or 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 sheets at fair value. Cash flow hedge gains and losses are recorded in other comprehensive income ("OCI") until the hedged item is recognized in earnings. Derivatives that are not designated as hedging instruments are adjusted to fair value through earnings in Other income (expense), net in the unaudited condensed consolidated statements of operations.

The fair values of the Company's derivative instruments and the line items on the unaudited condensed consolidated balance sheets to which they were recorded as of March 31, 2019 and December 31, 2018 are summarized as follows:

Derivative Assets	Balance Sheet	March 2019	December 31, 2018	Balance Sheet	March 2019	December 31, 2018
	Location	(In thousands)		Location	(In thousands)	
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	\$841	\$ 784	Other accrued liabilities	\$140	\$ 331
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	18	2	Other accrued liabilities	25	37
Total		\$859	\$ 786		\$165	\$ 368

Refer to Note 14. Fair Value Measurements, in Notes to Unaudited Condensed Consolidated Financial Statements for detailed disclosures regarding fair value measurements in accordance with the authoritative guidance for fair value measurements and disclosures.

## Offsetting Derivative Assets and Liabilities

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

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following tables set forth the offsetting of derivative assets as of March 31, 2019 and December 31, 2018:

	Gross Amounts Not Offset on the Condensed Consolidated Balance Sheets		Net Amounts Of Assets Presented on the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
As of March 31, 2019	Gross Amounts of Recognized Assets	Offset on the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented on the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
	(In thousands)					
J.P. Morgan Chase	\$429	\$ —	\$ 429	\$ (110 )	\$ —	—\$ 319
Bank of America	156	—	156	—	—	156
Wells Fargo	274	—	274	(55 )	—	219
Total	\$859	\$ —	\$ 859	\$ (165 )	\$ —	—\$ 694

	Gross Amounts Not Offset on the Condensed Consolidated Balance Sheets		Net Amounts Of Assets Presented on the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
As of December 31, 2018	Gross Amounts of Recognized Assets	Offset on the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented on the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
	(In thousands)					
Bank of America	\$323	\$ —	\$ 323	\$ (64 )	\$ —	—\$ 259
Wells Fargo	463	—	463	(298 )	—	165
Total	\$786	\$ —	\$ 786	\$ (362 )	\$ —	—\$ 424

The following tables set forth the offsetting of derivative liabilities as of March 31, 2019 and December 31, 2018:

	Gross Amounts Not Offset on the Condensed Consolidated Balance Sheets		Net Amounts Of Liabilities Presented on	Financial Instruments	Cash Collateral Pledged	Net Amount
As of March 31, 2019	Gross Amounts of	Offset on the	Net Amounts Of Liabilities Presented on	Financial Instruments	Cash Collateral Pledged	Net Amount



Edgar Filing: NETGEAR, INC - Form 10-Q

Recognized the  
 Liabilities Consolidated Condensed  
 Balance Consolidated  
 Sheets Balance  
 Sheets

(In thousands)

J.P. Morgan Chase	\$110	\$	—	\$	110	\$	(110)	\$	—	\$	—
Wells Fargo	55	—	55	(55)	—	—	—	—	—	—	—
Total	\$165	\$	—	\$	165	\$	(165)	\$	—	\$	—

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

As of December 31, 2018	Gross Amounts Not Offset on the Consolidated Balance Sheets		Net Amounts Of Liabilities Presented on the Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
	Gross Amounts of Recognized Liabilities	Offset on the Consolidated Balance Sheets				
	(In thousands)					
J.P. Morgan Chase	\$6	\$	—\$ 6	\$ —	\$	—\$ 6
Bank of America	64	—	64	(64 )	—	—
Wells Fargo	298	—	298	(298 )	—	—
Total	\$368	\$	—\$ 368	\$ (362 )	\$	—\$ 6

## 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 less than six months. The Company enters into about ten forward contracts per quarter with an average size of approximately \$7.0 million USD equivalent related to its cash flow hedging program.

The effects of the Company's cash flow hedges on the unaudited condensed statements of operations for the three months ended March 31, 2019 and April 1, 2018 are summarized as follows:

	Location and Amount of Gains (Losses) Recognized in Income on Cash Flow Hedges				
	Three Months Ended March 31, 2019				
	Net revenue	Cost of revenue	Research and development	Sales and marketing	General and administrative
Statements of operations	\$249,082	\$167,074	\$ 18,832	\$ 35,855	\$ 13,117
Gains (losses) on cash flow hedge	\$414	\$(2 )	\$(26 )	\$(69 )	\$(11 )

	Location and Amount of Gains (Losses) Recognized in Income on Cash Flow Hedges				
	Three Months Ended April 1, 2018				
	Net revenue	Cost of revenue	Research and development	Sales and marketing	General and administrative

Edgar Filing: NETGEAR, INC - Form 10-Q

Statements of operations	\$245,201	\$168,882	\$ 21,191	\$ 37,874	\$ 15,761
Gains (losses) on cash flow hedge	\$(1,702 )	\$6	\$ 99	\$ 230	\$ 41

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

Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur within the designated hedge period or if not recognized within 60 days following the end of the hedge period. Deferred gains and losses in OCI with such derivative instruments are reclassified immediately into earnings through Other income (expense), net. Any subsequent changes in fair value of such derivative instruments also are reflected in

Table of Contents

NETGEAR, INC.

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

current earnings unless they are re-designated as hedges of other transactions. The Company did not recognize any material net gains or losses related to the loss of hedge designation as there were no discontinued cash flow hedges during the three months ended March 31, 2019 and April 1, 2018.

The pre-tax effects of the Company's derivative instruments in OCI and the unaudited condensed consolidated statement of operations for the three months ended March 31, 2019 and April 1, 2018 are summarized as follows:

	Three Months Ended March 31, 2019	
	Gains (Losses) Recognized in OCI - Effective Portion (In thousands)	Gains (Losses) Reclassified from OCI into Income - Effective Portion <sup>(1)</sup>
Derivatives Designated as Hedging Instruments		
Cash flow hedges:		
Foreign currency forward contracts	\$329	Net revenue \$ 414
Foreign currency forward contracts	—	Cost of revenue (2 )
Foreign currency forward contracts	—	Research and development (26 )
Foreign currency forward contracts	—	Sales and marketing (69 )
Foreign currency forward contracts	—	General and administrative (11 )
Total	\$329	\$ 306

<sup>(1)</sup> Refer to Note 11. Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

	Three Months Ended April 1, 2018	
	Gains (Losses) Recognized in OCI - Effective Portion (In thousands)	Gains (Losses) Reclassified from OCI into Income - Effective Portion <sup>(1)</sup>
Derivatives Designated as Hedging Instruments		
Cash flow hedges:		
Foreign currency forward contracts	\$(634)	Net revenue \$ (1,702 )
Foreign currency forward contracts	—	Cost of revenue 6
Foreign currency forward contracts	—	Research and development 99
Foreign currency forward contracts	—	Sales and marketing 230
Foreign currency forward contracts	—	General and administrative 41

Total	\$(634)	\$ (1,326 )
-------	---------	-------------

<sup>(1)</sup> Refer to Note 11. Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

#### Non-designated hedges

The Company enters into non-designated hedges under the authoritative guidance for derivatives and hedging to manage the exposure of non-functional currency monetary assets and liabilities held on its financial statements to fluctuations in foreign currency exchange rates, as well as to reduce volatility in other income and expense. The non-designated hedges are generally expected to offset the changes in value of its net non-functional currency asset and liability position resulting from foreign exchange rate fluctuations. Foreign currency denominated accounts receivable and payable are hedged with non-designated hedges when the related anticipated foreign revenue and expenses are recognized in the Company's financial statements. The Company also hedges certain non-functional currency monetary assets and liabilities that may not be incorporated into the cash flow hedge program. The Company adjusts its non-designated hedges monthly and enters into about ten non-designated derivatives per quarter. The average size of its non-designated hedges is approximately \$2.0 million USD equivalent and these hedges range from one to three months in duration.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The effects of the Company's non-designated hedge included in Other income (expense), net in the unaudited condensed consolidated statements of operations for the three months ended March 31, 2019 and April 1, 2018 are as follows:

Derivatives Not Designated as Hedging Instruments	Location of Gains (Losses) Recognized in Income on Derivative	Three Months Ended	
		March 31, 2019	April 1, 2018
Foreign currency forward contracts	Other income (expense), net	\$602	\$(1,855)

## Note 8. 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 common shares issuable upon exercise of stock options, vesting of restricted stock awards, and issuances of shares under the Employee Stock Purchase Plan (the "ESPP"), which are reflected in diluted net income per share by application of the treasury stock method. Potentially dilutive common shares are excluded from the computation of diluted net income per share when their effect is anti-dilutive.

Net income per share for the three months ended March 31, 2019 and April 1, 2018 are as follows:

	Three Months Ended	
	March 31, 2019	April 1, 2018
	(In thousands, except per share data)	
Numerator:		
Net income from continuing operations	\$ 12,843	\$ 1,018
Net income from discontinued operations	—	4,572
Net income	\$ 12,843	\$ 5,590
Denominator:		
Weighted average common shares - basic	31,483	31,427
Potentially dilutive common share equivalent	1,391	1,233
Weighted average common shares - dilutive	32,874	32,660
Basic net income per share		
Net income from continuing operations	\$0.41	\$0.03
Net income from discontinued operations	—	0.15
Net income	\$0.41	\$0.18

Diluted net income per share

Edgar Filing: NETGEAR, INC - Form 10-Q

Net income from continuing operations	\$0.39	\$0.03
Net income from discontinued operations	—	0.14
Net income	\$0.39	\$0.17

Anti-dilutive employee stock-based awards, excluded 507 773

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 9. Income Taxes

The income tax provision (benefit) for the three months ended March 31, 2019 and April 1, 2018, was \$2.2 million, or an effective tax rate of 14.7%, and \$(86) thousand, or an effective tax rate of (9.2)%, respectively. The increase in the effective tax rate for the three months ended March 31, 2019, compared to the three months ended April 1, 2018, resulted primarily from higher pre-tax earnings compared to the three months ended April 1, 2018. The effective tax rate for the period ended March 31, 2019 included a one-time benefit related to the closing of the French tax audit whereas the period ended April 1, 2018 included benefits from stock based compensation transactions accounted for as discrete benefits during the period.

The Company is subject to income taxes in the U.S. and numerous foreign jurisdictions. The future foreign tax rate could be affected by changes in the composition in earnings in countries with tax rates differing from the U.S. federal rate. The Company is under examination in various U.S. and foreign jurisdictions.

The Company files income tax returns in the U.S. federal jurisdiction as well as various state, local, and foreign jurisdictions. Due to the uncertain nature of ongoing tax audits, the Company has recorded its liability for uncertain tax positions as part of its long-term liability as payments cannot be anticipated over the next twelve months. The existing tax positions of the Company continue to generate an increase in the liability for uncertain tax positions. The liability for uncertain tax positions may be reduced for liabilities that are settled with taxing authorities or on which the statute of limitations could expire without assessment from tax authorities. The possible reduction in liabilities for uncertain tax positions resulting from the expiration of statutes of limitation in multiple jurisdictions in the next twelve months is approximately \$0.8 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

Note 10. Commitments and Contingencies

Leases

The Company leases office space, cars, distribution centers 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. Lease expense is recognized on a straight-line basis over the lease term. For further details, refer to Note 15. Leases.

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. For those orders not governed by master purchase agreements, the commitments are governed by the commercial terms on the Company's purchase orders subject to acknowledgment from its suppliers. As of March 31, 2019, the Company had approximately \$169.8 million in non-cancelable purchase commitments with suppliers. The Company establishes a loss liability for all products it does not expect to sell for which it has committed purchases from suppliers. Such losses have not been material to date. From time to time the Company's suppliers procure unique complex components on the Company's behalf. If these components do not meet specified technical criteria or are defective, the Company should not be obligated to purchase the materials. However, disputes may arise as a result and significant resources may be spent resolving such disputes.



Non-Trade Commitments

As of March 31, 2019, the Company had long term, non-cancellable purchase commitments of \$17.4 million pertaining to non-trade activities.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Warranty Obligations

Changes in the Company's warranty obligations, which is included in Other accrued liabilities on the unaudited condensed consolidated balance sheets, are as follows:

	Three Months Ended	
	March 31, April 1,	
	2019	2018
	(In thousands)	
Balance as of beginning of the period	\$14,412	\$44,068
Reclassified to sales returns upon adoption of ASC 606	—	(29,147 )*
Provision for warranty obligation made during the period	1,281	3,844
Settlements made during the period	(3,162 )	(3,273 )
Balance at end of period	\$12,531	\$15,492

\* Upon adoption of ASC 606 on January 1, 2018, certain warranty reserve balances totaling \$29.1 million were reclassified to sales returns as these liabilities are payable to the Company's customers and settled in cash or by credit on account. Under ASC 606, these amounts are to be accounted for as sales with right of return.

## Guarantees and Indemnifications

The Company, as permitted under Delaware law and in accordance with its Bylaws, indemnifies its officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a Director and Officer Insurance Policy that enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the fair value of each indemnification agreement is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2019.

In its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers (the "Indemnified Parties") for any expenses or liability resulting from claimed infringements by the Company's products of patents, trademarks or copyrights of third parties that are asserted against the Indemnified Parties, subject to customary carve outs. The terms of these indemnification agreements are generally perpetual after execution of the agreement. The maximum amount of potential future indemnification is generally unlimited. From time to time, the Company receives requests for indemnity and may choose to assume the defense of such litigation asserted against the Indemnified Parties. The Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2019.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Employment Agreements

The Company has signed various change in control and severance agreements with key executives. Upon a termination without cause or resignation with good reason, executive officers would be entitled to (1) cash severance equal to the executive officer's annual base salary, and, for the Chief Executive Officer, an additional amount equal to his target annual bonus, (2) 12 months of health benefits continuation and (3) accelerated vesting of any unvested equity awards that would have vested during the 12 months following the termination date. Upon a termination without cause or resignation with good reason that occurs during the one month prior to or 12 months following a change in control of the Company, executive officers would be entitled to (1) cash severance equal to a multiple (2x for the Chief Executive Officer and 1x for all other executive officers) of the sum of the executive officer's annual base salary and target annual bonus, (2) a number of months (24 for the Chief Executive Officer and 12 for other executive officers) of health benefits continuation and (3) accelerated vesting of all outstanding, unvested equity awards. Severance will be conditioned upon the execution and non-revocation of a release of claims. The change in control and severance agreements will not provide for any excise tax gross ups. If the merger-related payments or benefits of the executive officer are subject to the 20% excise tax under Section 4999 of the tax code, then the executive officer will either receive all such payments and benefits subject to the excise tax or such payments and benefits will be reduced so that the excise tax does not apply, whichever approach yields the best after-tax outcome for the executive officer. The Company has no liabilities recorded for these agreements as of March 31, 2019.

Litigation and Other Legal Matters

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

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

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

respectively.

In May 2014, the Company filed with the Provincial Tax Court of Milan an appeal brief, including a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2004 year. The hearing was held and decision was issued on December 19, 2014. The Tax Court decided in favor of the Company and nullified the assessment by the Inland Revenue Agency for 2004. The Inland Revenue Agency appealed the decision of the Tax Court on June 12, 2015. The Company filed its counter appeal with respect to the 2004 year during September 2015. On February 26, 2016, the Regional Tax Court conducted the appeals hearing for the 2004 year, ruling in favor of the Company. On June 13, 2016, the Inland Revenue Agency appealed the decision to the Supreme Court. The Company filed a counter appeal on July 23, 2016 and is awaiting scheduling of the hearing.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

In June 2015, the Company filed with the Provincial Tax Court of Milan an appeal brief including a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2005 through 2006 tax years. The hearing for suspension was held and the Request for Suspension of payment was granted. The hearing for the validity of the tax assessment for 2005 and 2006 was held in December 2015 with the Provincial Tax Court issuing its decision in favor of the Company. The Inland Revenue Agency filed its appeal with the Regional Tax Court. The Company filed its counter brief on September 30, 2016 and the hearing was held on March 22, 2017. A decision favorable to the Company was issued by the Court on July 5, 2017. The Italian Tax Authority has appealed the decision to the Supreme Court and the Company has responded with a counter appeal brief on December 3, 2017 and awaits scheduling of the hearing.

The hearing for the validity of the tax assessment for 2007 was held on March 10, 2016 with the Provincial Tax Court who issued its decision in favor of the Company on April 7, 2016. The Inland Revenue Agency has filed its appeal to the Regional Tax Court and the Company has submitted its counter brief. The hearing was held on November 17, 2017 and the Company received a positive decision on December 11, 2017. On June 11, 2018, the Italian government filed its appeal brief with the Supreme Court, and the Company filed its counter brief on July 12, 2018 and awaits scheduling the hearing.

With respect to 2008 through 2010, the Company filed its appeal briefs with the Provincial Tax Court in October 2015 and the hearing for the validity of the tax assessments was held on April 21, 2016. A decision favorable to the Company was issued on May 12, 2016. The Inland Revenue Agency has filed its appeal to the Regional Tax Court. The Company filed its counter brief on February 5, 2017. The hearing was held on May 21, 2018, and the Company received a favorable decision on June 12, 2018. The decision has yet to be served to the Tax Office. The enactment of recent legislative actions that introduced a tax amnesty program (Law n.136/2018) had the effect of suspending the deadline to appeal the Court decision for nine months. Accordingly, this effectively extended the Tax Office deadline for filing its appeal from January 12, 2019 to November 19, 2019.

With respect to 2011 through 2012, the Company has filed its appeal brief on February 26, 2016 with the Provincial Tax Court to contest the relevant tax assessments. The hearing for suspension was held and the Request for Suspension of payment was granted. On October 13, 2016, the Company filed its final brief with the Provincial Tax Court. The hearing was held on October 24, 2016 and a decision favorable to the Company was issued by the Court. The Inland Revenue Agency appealed the decision before the Regional Tax Court. The Regional Tax Court heard the case on February 26, 2019 for both years and issued a decision favorable to the Company on March 11, 2019. The decision has not yet been served to the Tax Office. Once served, the Tax Office will have until October 14, 2019 to appeal the decision to the Supreme Court..

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

Via Vadis v. NETGEAR, Inc.

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

By referring to “built-in BitTorrent software,” the Company believes that the complaint is referring to the BitTorrent Sync application, which was released by BitTorrent Inc. in spring of 2014. At a high-level, the application allows file

synchronization across multiple devices by storing the underlying files on multiple local devices, rather than on a centralized server. The Company's ReadyNAS products do not include BitTorrent software when sold. The BitTorrent application is provided as one of a multitude of potential download options, but the software itself is not included on the Company's devices when shipped. Therefore, the only viable allegation at this point is an indirect infringement allegation.

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

On February 6, 2015, the Company filed its motion to transfer venue from the Western District of Texas to the Northern District of California with the Court; on February 13, 2015, Via Vadis filed its opposition to the Company's motion to transfer; and on February 20, 2015, the Company filed its reply brief on its motion to transfer. In early April 2015, the Company received the plaintiff's infringement contentions, and on June 12, 2015, the defendants served invalidity contentions. On July 30, 2015,

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

the Court granted the Company's motion to transfer venue to the Northern District of California. In addition, the Company learned that Amazon and Blizzard filed petitions for the inter partes reviews ("IPRs") for the patents in suit. On October 30, 2015, the Company and Via Vadis filed a joint stipulation requesting that the Court vacate all deadlines and enter a stay of all proceedings in the case pending the Patent Trial and Appeal Board's final non-appealable decision on the IPRs initiated by Amazon and Blizzard. On November 2, 2015, the Court granted the requested stay. On March 8, 2016, the Patent Trial and Appeal Board issued written decisions instituting the IPRs jointly filed by Amazon and Blizzard. In early March of 2017, The Patent Trial and Appeal Board (PTAB) issued various decisions regarding Amazon's and Blizzard's IPRs of the patents in suit. One of the IPRs of the '125 patent resulted in a finding by the PTAB that Amazon and Blizzard had failed to show invalidity. The second IPR on the '125 patent, however, resulted in cancellation of all claims asserted in Via Vadis's suit against the Company. Reissue '521 did not have any claims found invalid by the PTAB, and some dependent claims of the '680 patent survived the IPRs, and some claims of the '680 patent were canceled. Via Vadis has completed its appeal of the PTAB decisions on the IPRs, which were affirmed by the Federal Circuit. Meanwhile, the W.D. Texas Court issued a claim construction order finding the '680 patent indefinite. The parties in the W.D. of Texas case are seeking to lift the stay in their case. The Northern District of California case against the Company remains stayed.

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

Chrimar Systems, Inc. v NETGEAR, Inc.

On July 1, 2015, the Company was sued by a non-practicing entity named Chrimar Systems, Inc., doing business as CMS Technologies and Chrimar Holding Company, LLC (collectively, "CMS"), in the Eastern District of Texas for allegedly infringing four patents-U.S. Patent Nos. 8,155,012 (the "'012 Patent"), entitled "System and method for adapting a piece of terminal equipment"; 8,942,107 (the "'107 Patent"), entitled "Piece of ethernet terminal equipment"; 8,902,760 (the "'760 Patent"), entitled "Network system and optional tethers"; and 9,019,838 (the "'838 Patent"), entitled "Central piece of network equipment" (collectively "patents-in-suit").

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

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

On December 3, 2015, the Company filed with the Court a motion to transfer venue to the District Court for the Northern District of California and their memorandum of law in support thereof. On December 23, 2015, CMS filed its response to the Company's motion to transfer, and, on January 8, 2016, the Company filed its reply brief in support of its motion to transfer venue. On January 15, 2016, the Court granted the Company's motion to transfer venue to the District Court for the Northern District of California. The initial case management conference in the Northern District of California occurred on May 13, 2016, and on August 19, 2016, the parties exchanged preliminary claim constructions and extrinsic evidence. On August 26, 2016, the Company and three defendants in other Northern District of California CMS cases (Juniper Networks, Inc., Ruckus Wireless, Inc., and Fortinet, Inc.) submitted motions to stay their cases. The defendants in part argued that stays were appropriate pending the resolution of the currently-pending IPRs of the patents-in-suit before the Patent Trial and Appeal Board (PTAB), including four IPR

Petitions filed by Juniper. On September 9, 2016, CMS submitted its opposition to the motions to stay the cases. On September 26, 2016, the Court ordered the cases stayed in their entirety, until the PTAB reaches institution decisions with respect to Juniper's four pending IPR petitions. Juniper's four IPR petitions were instituted by the PTAB in January 2017, and the Company subsequently moved to join the IPR petitions as an "understudy" to Juniper, only assuming a more active role in the petitions in the event Juniper settles with CMS. For all four patents in suit against the Company, the PTAB ordered that (a) the Petitioners' (the Company, Ruckus, and Brocade) Motion for Joinder to the Juniper IPRs is granted; (b) the Petitioners IPRs are instituted on the same grounds as in the Juniper IPRs and Petitioners are joined with the Juniper IPRs; and (c) all further filings by Petitioners in the joined proceedings will be in the Juniper IPRs. On December 21, 2017, the PTAB issued the first of the four Final Written Decisions in the IPRs filed by the Company on the patents in suit, ruling that the claims of the '107 Patent asserted by Chrimar were invalid. This was quickly followed by two more Final Written Decisions -- on January 3, 2018, the '838 patent's asserted claims were ruled invalid, and on January 23, 2018 the '012 patent's asserted claims were ruled invalid.



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Chrimar has 30 days from each Final Written Decision to seek a rehearing at the PTAB and 63 days from each to file an appeal. On April 26, 2018, the PTAB issued its decision invalidating all of the claims of the '760 patent challenged in the IPR. The PTAB's reasoning was similar to the reasoning set forth in the PTAB's previous decisions on the 012, 107 and 838 patents. The '760 patent claims were, however, amended by Chrimar during the pendency of the '760 IPR, and the PTAB did not rule on the validity of the amended claims, as they were not challenged in the original IPR Petitions (they couldn't have been because the Chrimar amendments had not yet happened). On June 6, 2018, Chrimar's appeals on all 4 written decisions by the USPTO invalidating all challenged claims were consolidated. The parties have completed briefing the matter and are awaiting schedule for oral argument before the Federal Circuit.

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

Vivato v. NETGEAR, Inc.

On April 19, 2017, the Company was sued by XR Communications (d/b/a) Vivato ("Vivato") in the United States District Court, Central District of California.

Based on its complaint, Vivato purports to be a research and development and product company in the WiFi area, but it appears that Vivato is not currently a manufacturer of commercial products. The three (3) patents that Vivato asserts against the Company are U.S. Patent Nos. 7,062,296, 7,729,728, and 6,611,231. The '296 and '728 patents are entitled "Forced Beam Switching in Wireless Communication Systems Having Smart Antennas." The '231 patent is entitled "Wireless Packet Switched Communication Systems and Networks Using Adaptively Steered Antenna Arrays." Vivato also has recently asserted the same patents in the Central District of California against D-Link, Ruckus, and Aruba, among others.

According to the complaint, the accused products include WiFi access points and routers supporting MU-MIMO, including without limitation access points and routers utilizing the IEEE 802.11ac-2013 standard. The accused technology is standards-based, and more specifically, based on the transmit beamforming technology in the 802.11ac WiFi standard.

The Company answered an amended complaint on July 7, 2017. In its answer, the Company objected to venue and recited that objection as a specific affirmative defense, so as to expressly reserve the same. The Company also raised several other affirmative defenses in its answer.

On August 28, 2017, the Company submitted its initial disclosures to the plaintiff. The initial scheduling conference was on October 2, 2017, and the Court set five day jury trial for March 19, 2019 for the leading Vivato/D-Link case, meaning the Company's trial date will be at some point after March 19, 2019.

On March 20, 2018, the Company and other defendants in the various Vivato cases moved the Court to stay the case pending various IPRs filed on all of the patents in suit. Every asserted claim of all three patents-in-suit is now subject to challenge in IPRs that are pending before the U.S. Patent and Trial Appeal Board ("PTAB"). In particular, the Company, Belkin, and Ruckus are filing one set of IPRs on the three patents in suit; Cisco is filing another set of independent IPRs on the three patents in suit; and Aruba is filing yet another set of independent IPRs on the three patents in suit. On April 11, 2018, the Court granted the motion to stay pending filing of the IPRs. On May 3, 2018, the Company and other defendants filed their IPRs. The PTAB instituted the IPRs for the '296 and '728 patents, but not the '231 patent from the Ruckus and Belkin set of petitions. However, the Cisco IPR for the '231 patent was instituted. Vivato has proposed amendments to its claims and the parties are currently briefing the matter before the PTAB. The District Court case remains stayed.

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

27

---

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Hera Wireless v. NETGEAR, Inc.

On July 14, 2017, the Company was sued by Sisvel (via Hera Wireless) in the District of Delaware on three related patents allegedly covering the 802.11n standard. Similar complaints were filed against Amazon, ARRIS, Belkin, Buffalo, and Roku. On December 12, 2017, the Company answered the complaint, denying why each claim limitation of the patents in suit were allegedly met and asserting various affirmative defenses, including invalidity and noninfringement. A proposed joint Scheduling Order was submitted to the Court on January 24, 2018 with trial proposed for March of 2020.

On February 27, 2018, Hera Wireless identified the accused products and the asserted claims, alleging that any 802.11n compliant product infringes, and identified only the Company's Orbi and WND930 products with particularity. Hera Wireless' infringement contentions were submitted on April 28, 2018. Discovery is ongoing.

On June 28, 2018, the Company and other defendants submitted invalidity contentions. The Company along with other defendants jointly filed IPRs challenging 3 of the patents in suit on July 18, 2018. On September 14, 2018, the Company and other defendants jointly filed a second set of IPRs with the USPTO challenging the remaining 6 patents asserted in the Amended Complaint. The USPTO has instituted IPRs on five of the patents-in-suit and the Company is awaiting institution decisions on the other four patents. The District Court case has been stayed pending outcome of the IPRs.

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

Fischer v. NETGEAR, Inc.

On June 4, 2018, Plaintiff Rob Fischer filed a purported class-action complaint in the Circuit Court of Cook County, Ill, alleging the Company's Range Extender does not extend the range of a consumer's WiFi network as shown in a diagram in a data sheet. On August 3, 2018, the Company filed a motion to dismiss the case and a hearing was held on November 29, 2018, where the motion was denied. The Company filed its Answer on December 27, 2018. The parties are conducting routine discovery.

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

Modern Telecom Systems (MTS) v. NETGEAR, Inc.

On August 3, 2018, Plaintiff MTS filed a patent infringement lawsuit against NETGEAR in the District of Delaware. MTS accuses all of NETGEAR's routers that are compliant with those 802.11 standards of infringing U.S. Patent No. 6,504,886 ("the '886 Patent"), and specifically identifies NETGEAR's Nighthawk X10 Smart WiFi Router. The Company filed its Answer on January 4, 2019.

The Company's case was consolidated with ARRIS / Ruckus and Brother. In March 2019, the Company joined a motion for judgment on the pleadings that the patent-in-suit is invalid under Section 101 led by Arris.

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

Mentone Solutions v. NETGEAR, Inc.

On October 31, 2018, Mentone Solutions LLC filed a patent infringement suit against the Company in the District of Delaware, alleging infringement of U.S. Patent No. 6,952,413 (the '413 patent). Mentone alleges NETGEAR's LTE Modem LB2120 device, and in particular the device's dual carrier HSPA+ ("DC-HSPA+") capability infringes the '413 patent. The Company filed its Answer on February 21, 2019.

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

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

John Pham v. Arlo Technologies, Inc., NETGEAR Inc., et al., and other related actions

On January 9, 2019 and January 10, 2019, February 1, 2019 and February 8, 2019, the Company was sued in four separate securities class action suits in Superior Court of California, County of Santa Clara, along with Arlo Technologies, individuals, and underwriters involved in the spin-off of Arlo. Two more similar state actions have been filed against Arlo Technologies Inc. et al.. In total, six putative class action complaints have now been filed in California state court in Santa Clara County. The Company is named as a defendant in five of the six lawsuits. The complaints generally allege that Arlo's IPO materials contained false and misleading statements, hiding problems with Arlo's Ultra product. These claims are styled as violations of Sections 11, 12(a), and 15 of the Securities Act of 1933.

There is also a putative class action pending in federal court in the Northern District of California, on behalf of the same class of plaintiffs, making very similar claims. The Company is not presently named in the federal action. Defendants are planning to file motions to stay the state court actions in deference to the federal court action. There will be a hearing in state court on April 26, 2019, where the court will consider whether to consolidate the six lawsuits and appoint a "lead plaintiff." The Company is opposing the appointment of a lead plaintiff in the state court actions. There will be another hearing on May 31, 2019 to consider defendants' motions to stay the state court cases.

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

Note 11. Stockholders' Equity

Stock Repurchases

From time to time, the Company's Board of Directors has authorized programs under which the Company may repurchase shares of its common stock, depending on market conditions, in the open market or through privately negotiated transactions. Under the authorizations, the timing and actual number of shares subject to repurchase are at the discretion of management and 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. As of March 31, 2019, 1.0 million shares remained authorized for repurchase under the repurchase program. The Company repurchased, reported based on trade date, 0.4 million shares of common stock at a cost of \$15.0 million under the repurchase authorization during the three months ended March 31, 2019. The Company did not repurchase any shares of common stock under the authorizations during the three months ended April 1, 2018.

The Company repurchased, as reported based on trade date, approximately 89,000 shares of common stock at a cost of \$3.3 million to administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving RSUs during the three months ended March 31, 2019. Similarly, during the three months ended April 1, 2018, the Company repurchased, as reported based on trade date, approximately 38,000 shares of common stock at a cost of \$2.3 million to 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.

Table of Contents

NETGEAR, INC.

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

## Accumulated Other Comprehensive Income (Loss)

The following table sets forth the changes in accumulated other comprehensive income ("AOCI") by component for the three months ended March 31, 2019 and April 1, 2018:

	Unrealized gains (losses) on available securities	Unrealized gains (losses) on available securities	Estimated tax benefit (provision)	Total
	(In thousands)			
Balance as of December 31, 2018	\$(18)	\$ (8 )	\$ 11	\$(15)
Other comprehensive income (loss) before reclassifications	15	329	(73 )	271
Less: Amount reclassified from accumulated other comprehensive income	—	306	(64 )	242
Net current period other comprehensive income (loss)	15	23	(9 )	29
Balance as of March 31, 2019	\$(3 )	\$ 15	\$ 2	\$14
	(In thousands)			
	Unrealized gains (losses) on available securities	Unrealized gains (losses) on available securities	Estimated tax benefit (provision)	Total
Balance as of December 31, 2017	\$(146)	\$ (838 )	\$ 133	\$(851)
Other comprehensive loss before reclassifications	(38 )	(1,500 )	388	(1,150)
Less: Amount reclassified from accumulated other comprehensive income	—	(2,192 )	460	(1,732)
Net current period other comprehensive income (loss)	(38 )	692	(72 )	582
Balance as of April 1, 2018	\$(184)	\$ (146 )	\$ 61	\$(269)

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following tables provide details about significant amounts reclassified out of each component of AOCI for the three months ended March 31, 2019 and April 1, 2018:

Details about Accumulated Other Comprehensive Income Components	Three Months Ended March 31, 2019	
	Amount Reclassified	Affected Line Item in the Statements of from Operations AOCI (In thousands)
Gains (losses) on cash flow hedge:		
Foreign currency forward contracts	\$414	Net revenue
Foreign currency forward contracts	(2 )	Cost of revenue
Foreign currency forward contracts	(26 )	Research and development
Foreign currency forward contracts	(69 )	Sales and marketing
Foreign currency forward contracts	(11 )	General and administrative
	306	Total from continuing operations before tax
	(64 )	Tax impact from continuing operations
	242	Total, from continuing operations net of tax
	—	Total, from discontinued operations net of tax
	\$242	Total, net of tax
Details about Accumulated Other Comprehensive Income Components	Three Months Ended April 1, 2018	
	Amount Reclassified from AOCI (In thousands)	Affected Line Item in the Statements of Operations
Gains (losses) on cash flow hedge:		
Foreign currency forward contracts	\$ (1,702 )	Net revenue
Foreign currency forward contracts	6	Cost of revenue
Foreign currency forward contracts	99	Research and development
Foreign currency forward contracts	230	Sales and marketing
Foreign currency forward contracts	41	General and administrative
	(1,326 )	Total from continuing operations before tax
	278	Tax impact from continuing operations
	(1,048 )	Total, from continuing operations net of tax
	(684 )	Total, from discontinued operations net of tax
	\$ (1,732 )	Total, net of tax

Note 12. Employee Benefit Plans

The Company grants options and RSUs under the 2016 Incentive Plan (the "2016 Plan"), under which awards may be granted to all employees. Award vesting periods for this plan are generally four years. In January 2019, the Company received the approval from its Compensation Committee to increase the number of shares that the Company may issue under the 2016 plan to a new total of 3.1 million shares, pursuant to the adjustment provisions of the 2016 Plan as a result of the Distribution. As of March 31, 2019, approximately 3.0 million shares were reserved for future grants under the 2016 Plan.

Additionally, the Company sponsors an Employee Stock Purchase Plan (the "ESPP"), pursuant to which eligible employees may contribute up to 10% of compensation, subject to certain income limits, to purchase shares of the Company's common stock. The terms of the plan include a look-back feature that enables employees to purchase stock semi-annually at a price equal to 85% of the lesser of the fair market value at the beginning of the offering period or the purchase date. The duration of each



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

offering period is generally six-months. As of March 31, 2019, approximately 0.7 million shares were available for issuance under the ESPP.

## Option Activity

Stock option activity during the three months ended March 31, 2019 was as follows:

	Number of shares	Weighted Average Exercise Price Per Share
	(In thousands)	(In dollars)
Outstanding as of December 31, 2018	1,969	\$ 25.30
Exercised	(100 )	\$ 20.76
Outstanding as of March 31, 2019	1,869	\$ 25.54

## RSU Activity

RSU activity during the three months ended March 31, 2019 was as follows:

	Number of shares	Weighted Average Grant Date Fair Value Per Share
	(In thousands)	(In dollars)
Outstanding as of December 31, 2018	1,627	\$ 34.31
Granted	25	\$ 39.36
Vested	(255 )	\$ 34.65
Cancelled	(12 )	\$ 34.77
Outstanding as of March 31, 2019	1,385	\$ 34.33

## Valuation and Expense Information

The Company measures stock-based compensation at the grant date based on the estimated fair value of the award. Estimated compensation cost relating to RSUs is based on the closing fair market value of the Company's common stock on the date of grant. The fair value of options granted and the purchase rights granted under the ESPP 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 of options granted and the purchase rights granted under the ESPP 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 of options granted and the purchase rights granted under the ESPP is based on historical volatility over the most recent period commensurate with the estimated expected term.



Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The table below sets forth the weighted average assumptions used to estimate the fair value of option grants and purchase rights granted under the ESPP during the three months ended March 31, 2019 and April 1, 2018.

	Three Months Ended			
	Stock Options		ESPP	
	March 31, 2019	April 1, 2018	March 31, 2019	April 1, 2018
Expected life (in years)	N/A	4.4	0.5	0.5
Risk-free interest rate	N/A	2.32 %	2.49 %	1.81 %
Expected volatility	N/A	30.9 %	42.6 %	37.1 %
Dividend yield	N/A	—	—	—

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

	Three Months Ended	
	March 31, 2019	April 1, 2018
	(In thousands)	
Cost of revenue	\$668	\$563
Research and development	1,192	1,012
Sales and marketing	2,041	2,205
General and administrative	2,557	3,084
Total stock-based compensation	\$6,458	\$6,864

As of March 31, 2019, \$7.4 million of unrecognized compensation cost related to stock options is expected to be recognized over a weighted-average period of 2.1 years. \$41.1 million of unrecognized compensation cost related to unvested RSUs is expected to be recognized over a weighted-average period of 2.3 years.

## Note 13. Segment Information

Operating segments are components of an enterprise about which separate financial information is available and is regularly evaluated by management, namely the Chief Operating Decision Maker ("CODM") of an organization, in order to determine operating and resource allocation decisions. By this definition, the Company has identified its CEO as the CODM and operates and reports in two segments: Connected Home, and SMB:

**Connected Home:** Focused on consumers and consists of high-performance, dependable and easy-to-use WiFi internet networking solutions, 4G/5G mobile products, and smart devices such as Orbi Voice smart speakers and Meural digital canvasses; and

**SMB:** Focused on small and medium-sized businesses and consists of business networking, storage, wireless LAN and security solutions that bring enterprise-class functionality to small and medium-sized businesses at an affordable price.

The Company believes that this structure reflects its current operational and financial management, and provides the best structure for the Company to focus on growth opportunities while maintaining financial discipline. The leadership team of each segment is focused on product development efforts, both from a product marketing and engineering standpoint, to service the unique needs of their customers.

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

Table of Contents

NETGEAR, INC.

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

of, and allocate resources to, each of the segments. Certain operating expenses are not allocated to segments because they are separately managed at the corporate level. These unallocated indirect costs include corporate costs, such as corporate research and development, corporate marketing expense and general and administrative costs, amortization of intangibles, stock-based compensation expense, separation expense, restructuring and other charges, interest income and other income (expense), net. The CODM does not evaluate operating segments using discrete asset information.

Financial information for each reportable segment and a reconciliation of segment contribution income to income before income taxes is as follows:

	Three Months Ended	
	March 31, 2019	April 1, 2018
	(In thousands, except percentage data)	
Net revenue:		
Connected Home	\$ 169,365	\$ 174,315
SMB	79,717	70,886
Total net revenue	\$ 249,082	\$ 245,201
Contribution income:		
Connected Home	\$ 19,119	\$ 16,212
Contribution margin	11.3 %	9.3 %
SMB	\$ 22,685	\$ 16,522
Contribution margin	28.5 %	23.3 %
Total segment contribution income	\$ 41,804	\$ 32,734
Corporate and unallocated costs	(19,132 )	(22,298 )
Amortization of intangibles <sup>(1)</sup>	(2,010 )	(2,079 )
Stock-based compensation expense	(6,458 )	(6,864 )
Separation expense	(264 )	—
Restructuring and other charges	68	9
Interest income	701	748
Other income (expense), net	341	(1,318 )
Income before income taxes	\$ 15,050	\$ 932

<sup>(1)</sup> Amount excludes amortization expense related to patents within purchased intangibles in cost of revenue.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## Operations by Geographic Region

The Company conducts business across three geographic regions: Americas, EMEA, and APAC. Net revenue consists of gross product shipments and service revenue, less allowances for estimated sales returns, price protection, end-user customer rebates and other channel sales incentives deemed to be a reduction of net revenue per the authoritative guidance for revenue recognition, and net changes in deferred revenue. For reporting purposes, revenue is generally attributed to each geographic region based on the location of the customer.

The following table shows net revenue by geography for the periods indicated:

	Three Months Ended March 31, April 1, 2019      2018 (In thousands)	
United States (U.S.)	\$ 145,791	\$ 157,146
Americas (excluding U.S.)	2,238	2,866
EMEA	56,963	47,434
APAC	44,090	37,755
Total net revenue	\$ 249,082	\$ 245,201

## Long-lived assets by Geographic Region

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

	As of March 31   December 31, 2019      2018 (In thousands)	
United States	\$ 5,757	\$ 4,993
Canada	3,882	4,359
EMEA	148	95
China	7,748	7,652
APAC (excluding China)	3,110	3,078
Total property and equipment, net	\$ 20,645	\$ 20,177

Table of Contents

NETGEAR, INC.

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

## Note 14. Fair Value Measurements

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of March 31, 2019:

As of March 31, 2019

	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
(In thousands)				
Assets:				
Cash equivalents: money-market funds	\$27,637	\$ 27,637	\$ —	\$ —
Available-for-sale debt investments: U.S. treasuries <sup>(1)</sup>	23,470	—	23,470	—
Available-for-sale investments: certificates of deposit <sup>(1)</sup>	151	—	151	—
Trading securities: mutual funds <sup>(1)</sup>	3,351	3,351	—	—
Foreign currency forward contracts <sup>(2)</sup>	859	—	859	—
Total assets measured at fair value	\$55,468	\$ 30,988	\$ 24,480	\$ —
Liabilities:				
Foreign currency forward contracts <sup>(3)</sup>	\$165	\$ —	\$ 165	\$ —
Contingent considerations <sup>(4)</sup>	5,953	—	—	5,953
Total liabilities measured at fair value	\$6,118	\$ —	\$ 165	\$ 5,953

<sup>(1)</sup> Included in Short-term investments on the Company's unaudited condensed consolidated balance sheets.

<sup>(2)</sup> Included in Prepaid expenses and other current assets on the Company's unaudited condensed consolidated balance sheets.

<sup>(3)</sup> Included in Other accrued liabilities on the Company's unaudited condensed consolidated balance sheets. Included in Other non-current accrued liabilities on the Company's unaudited condensed consolidated balance sheets. The contingent consideration represents the estimated fair value of the additional variable cash

<sup>(4)</sup> consideration payable in connection with the acquisition of Meural that is contingent upon the achievement of certain technical and service revenue milestones. Refer to Note 5. Business Acquisition, regarding detailed disclosures on the determination of fair value of the contingent consideration.

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, 2018:

	As of December 31, 2018			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
	(In thousands)			
<b>Assets:</b>				
Cash equivalents: money-market funds	\$22,573	\$ 22,573	\$ —	\$ —
Available-for-sale debt investments: U.S. treasuries <sup>(1)</sup>	70,314	—	70,314	—
Available-for-sale investments: certificates of deposit <sup>(1)</sup>	149	—	149	—
Trading securities: mutual funds <sup>(1)</sup>	2,854	2,854	—	—
Foreign currency forward contracts <sup>(2)</sup>	786	—	786	—
Total assets measured at fair value	\$96,676	\$ 25,427	\$ 71,249	\$ —
<b>Liabilities:</b>				
Foreign currency forward contracts <sup>(3)</sup>	\$368	\$ —	\$ 368	\$ —
Contingent considerations <sup>(4)</sup>	5,953	—	—	5,953
Total liabilities measured at fair value	\$6,321	\$ —	\$ 368	\$ 5,953

<sup>(1)</sup> Included in Short-term investments on the Company's unaudited condensed consolidated balance sheets.

<sup>(2)</sup> Included in Prepaid expenses and other current assets on the Company's unaudited condensed consolidated balance sheets.

<sup>(3)</sup> Included in Other accrued liabilities on the Company's unaudited condensed consolidated balance sheets.

Included in Other non-current accrued liabilities on the Company's consolidated balance sheets. The contingent consideration represents the estimated fair value of the additional variable cash consideration payable in

<sup>(4)</sup> connection with the acquisition of Meural that is contingent upon the achievement of certain technical and service revenue milestones. Refer to Note 5. Business Acquisition, regarding detailed disclosures on the determination of fair value of the contingent consideration.

The Company's investments in cash equivalents and trading 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's available-for-sale investments are classified within Level 2 of the fair value hierarchy because they are valued based on readily available pricing sources for comparable instruments, identical instruments in less active markets, or models using market observable inputs. 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. As of March 31, 2019 and December 31, 2018, 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 Company enters into foreign currency forward contracts with only those counterparties that have long-term credit ratings of A-/A3 or higher. The Company's contingent considerations resulting from acquisitions are classified within Level 3 of the fair value hierarchy as the valuations typically reflect management's estimate of assumptions that market participants would use in pricing the asset or liability. The carrying value of non-financial assets and liabilities measured at fair value in the financial statements on a recurring basis, including accounts receivable and accounts payable, approximate fair value due to their short maturities.



Note 15. Leases

The Company determines if an arrangement is a lease or contains a lease at inception. Operating leases are included in operating lease right-of-use (“ROU”) assets, other accrued liabilities, and operating lease liabilities on our unaudited condensed consolidated balance sheets. Leases with an initial term of 12 months or less are not recorded on the balance sheet. The Company has lease agreements with lease and non-lease components, which are generally accounted for separately. For certain office leases, the Company accounts for the lease and non-lease components as a single lease component. Lease expense is recognized on a straight-line basis over the lease term.

Table of Contents

NETGEAR, INC.

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

ROU assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. Generally the implicit rate of interest in arrangements is not readily determinable and the Company utilizes its incremental borrowing rate in determining the present value of lease payments. The Company's incremental borrowing rate is a hypothetical rate based on its understanding of what its credit rating would be. The operating lease ROU asset includes any lease payments made and excludes lease incentives.

The Company's lease arrangements comprise of operating leases for office space, cars, distribution centers and equipment. The leases have remaining lease terms of 1 year to 10 years, some of which include options to extend for up to a further 5 years, and some of which include options to terminate prior to completion of the contractual lease term with or without penalties. The Company determines the duration of the lease arrangement giving thought to whether or not it is reasonably certain that the Company will exercise options to extend or terminate the lease arrangement ahead of its contractual term. The leases do not contain any material residual value guarantees.

The components of lease costs were as follows:

As of  
March 31,  
2019  
(in  
thousands)

Operating lease cost <sup>(1)</sup><sup>(2)</sup> \$ 3,348

<sup>(1)</sup> Includes short-term lease cost, which is immaterial.

<sup>(2)</sup> Included in cost of revenue, sales and marketing, research and development and general and administration in the Company's unaudited condensed statement of operations.

Supplemental cash flow information related to leases was as follows:

	Three Months Ended March 31, 2019 (in thousands)
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash flows relating to operating leases	\$ 3,038
Lease liabilities arising from obtaining right-of-use assets:	
Operating leases	\$ 577

Supplemental balance sheet information related to leases was as follows:

	As of March 31, 2019
Weighted Average Remaining Lease Term (in years)	
Operating leases	4.9

Weighted Average Discount Rate	
Operating leases	3.8 %

38

---

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

As of March 31, 2019, maturity analysis of operating lease liabilities were as follows (in thousands):

	Operating Lease
2019 (remaining nine months)	\$8,880
2020	10,153
2021	7,981
2022	6,972
2023	4,507
Thereafter	7,713
Total lease payments	46,206
Less imputed interest	(4,093 )
Total	\$42,113

As of December 31, 2018, future minimum lease payments under non-cancelable operating leases are as follows (in thousands):

	Leases (1)
2019	\$11,900
2020	9,986
2021	7,785
2022	6,856
2023	4,478
Thereafter	7,725
Total future minimum lease payments	\$48,730

(1) Amounts are based on ASC 840 Leases that was superseded upon the adoption of ASC 842 Leases on January 1, 2018.

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

## Forward-looking Statements

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

## Business and Executive Overview

We are a global company that delivers innovative networking and Internet connected products to consumers and businesses. Our products are built on a variety of proven technologies such as wireless (WiFi and 4G/5G mobile), Ethernet

39

---

## Table of Contents

and powerline, with a focus on reliability and ease-of-use. Our product line consists of devices that create and extend wired and wireless networks as well as devices that provide a special function and attach to the network, such as smart digital canvasses. These products are available in multiple configurations to address the changing needs of our customers in each geographic region in which our products are sold.

On December 31, 2018, we completed the Spin-Off of Arlo Technologies, Inc. ("Arlo"), a majority owned subsidiary and reporting segment of NETGEAR. Arlo's historical financial results for periods prior to the Spin-Off are reflected in our unaudited condensed consolidated financial statements as discontinued operations. For further detail, refer to Note 4. Discontinued Operations, Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Report on Form 10-Q.

We operate and report in two segments: Connected Home, and Small and Medium Business ("SMB"). We believe that this structure reflects our current operational and financial management, and provides the best structure for us to focus on growth opportunities while maintaining financial discipline. The leadership team of each segment is focused on product development efforts, both from a product marketing and engineering standpoint, to service the unique needs of their customers. The Connected Home segment is focused on consumers and consists of high-performance, dependable and easy-to-use WiFi internet networking solutions, 4G/5G mobile products, and smart devices such as Orbi Voice smart speakers and Meural digital canvasses. The SMB segment is focused on small and medium-sized businesses and consists of business networking, storage, wireless LAN and security solutions that bring enterprise-class functionality to small and medium-sized businesses at an affordable price. We conduct business across three geographic regions: Americas; Europe, Middle-East and Africa ("EMEA"); and Asia Pacific ("APAC").

The markets in which all of our segments operate are intensely competitive and subject to rapid technological change. We believe that the principal competitive factors in the consumer and small and medium business 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, security, and customer service and support. To remain competitive, we believe we must continue to aggressively invest resources in developing new products and subscription services, enhancing our current products, expanding our channels and maintaining customer satisfaction worldwide. Among these investments is an enhanced focus on cybersecurity relating to our products and systems, as the threat of cyber-attacks and exploitation of potential security vulnerabilities in our industry is on the rise and is increasingly a significant consumer concern.

We sell our products through multiple sales channels worldwide, including traditional retailers, online retailers, wholesale distributors, direct market resellers ("DMRs"), value-added resellers ("VARs"), and broadband service providers. Our retail channel includes traditional retail locations domestically and internationally, such as Best Buy, Costco, Wal-Mart, Staples, Office Depot, Target, FNAC (Europe), MediaMarkt (Europe), Darty (France), JB HiFi (Australia), Elkjop (Norway) and Sunning and Guomei (China). Online retailers include Amazon.com worldwide, Newegg.com (US), JD.com and Alibaba (China), as well as Coolblue.com (Netherlands). Our DMRs include CDW Corporation, Insight Corporation and PC Connection in domestic markets. Our main wholesale distributors include Ingram Micro, D&H and Tech Data. In addition, we also sell our products through broadband service providers, such as multiple system operators ("MSOs"), xDSL, mobile, 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 is derived from a limited number of wholesale distributors, service providers and retailers. We expect this trend will continue in the foreseeable future.

During the three months ended March 31, 2019, we experienced a \$3.9 million increase in net revenue and income from operations increased \$12.5 million compared to the prior year period. The increase in net revenue was attributable to the performance of our SMB segment which saw a net revenue increase of 12.5%, partially offset by a

decline in the Connected Home segment of 2.8%. SMB experienced an increase in net revenue mainly due to the growth in switch products. The decrease in Connected Home net revenue was primarily due to lower net revenue of mobile and home wireless products, partially offset by an increase in net revenue of broadband modem and gateway products. The decline in mobile net revenue was as a result of lower sales to service provider customers while the decline in home wireless products was mainly due to a decline in

40

---

Table of Contents

802.11ac (“AC”) router products. Operating expenses decreased \$6.8 million in the three months ended March 31, 2019 compared to the prior year period as a result of decreased spending in general and administrative of \$2.5 million, research and development of \$2.3 million and sales and marketing of \$2.0 million. The fall in operating expenses, along with higher revenue and gross profit achievement, resulted in an overall increase in income from operations compared to the prior year period.

On a geographic basis, net revenue increased in the EMEA and APAC by \$9.5 million and \$6.3 million, respectively, and declined in Americas by \$12.0 million in the three months ended March 31, 2019 as compared to the prior year period. The increase in EMEA was primarily driven by increased net revenue from our switch, mobile and home wireless products. The increase in APAC was primarily attributable to increased net revenue of our broadband modem and gateway, mobile and switch products. The decrease in Americas net revenue was primarily driven by lower net revenue of our mobile and home wireless products, partially offset by increased net revenue of switch products.

Looking forward with respect to our Connected Home segment, we expect to increase marketing spending in the second quarter to increase awareness and adoption of our 802.11ax (“WiFi 6”) products. We believe the increased marketing is necessary as we seek to reverse declines observed in the North American consumer WiFi market in the first quarter of 2019 and capitalize on the technological inflection point of WiFi 6 through accelerated adoption of WiFi 6 products. In addition, we expect service provider net revenue to be approximately \$25 million in the second quarter of fiscal 2019 before returning to \$35 million to \$40 million a quarter for the remainder of the year. We expect growth in our SMB segment driven by sales of our 10Gig, PoE, PoE+, web-managed and app-managed switches, and ProAV switches. We expect the year over year growth rate experienced in the first quarter of fiscal 2019 to moderate and are targeting mid-single digit growth for the full year.

## Results of Operations

The following table sets forth the unaudited condensed consolidated statements of operations for the three months ended March 31, 2019, with the comparable reporting period in the preceding year.

	Three Months Ended			
	March 31, 2019		April 1, 2018	
	(In thousands, except percentage data)			
Net revenue	\$249,082	100.0 %	\$245,201	100.0 %
Cost of revenue	167,074	67.1 %	168,882	68.9 %
Gross profit	82,008	32.9 %	76,319	31.1 %
Operating expenses:				
Research and development	18,832	7.6 %	21,191	8.6 %
Sales and marketing	35,855	14.3 %	37,874	15.5 %
General and administrative	13,117	5.3 %	15,761	6.4 %
Separation expense	264	0.1 %	—	— %
Restructuring and other charges	(68)	0.0 %	(9)	(0.0) %
Total operating expenses	68,000	27.3 %	74,817	30.5 %
Income from operations	14,008	5.6 %	1,502	0.6 %
Interest income	701	0.3 %	748	0.3 %
Other income (expense), net	341	0.1 %	(1,318)	(0.5) %
Income before income taxes	15,050	6.0 %	932	0.4 %
Provision (benefit) for income taxes	2,207	0.8 %	(86)	(0.0) %
Net income from continuing operations	\$12,843	5.2 %	\$1,018	0.4 %





Table of Contents

## Net Revenue by Geographic Region

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

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

	Three Months Ended			
	March 31,	%	April 1,	
	2019	Change	2018	
	(In thousands, except percentage data)			
Americas	\$148,029	(7.5 )%	\$160,012	
Percentage of net revenue	59.4	%	65.3	%
EMEA	\$56,963	20.1 %	\$47,434	
Percentage of net revenue	22.9	%	19.3	%
APAC	\$44,090	16.8 %	\$37,755	
Percentage of net revenue	17.7	%	15.4	%
Total net revenue	\$249,082	1.6 %	\$245,201	
Americas				

The decrease in Americas net revenue in the three months ended March 31, 2019, compared to the prior year period, was primarily driven by lower net revenue of our mobile and home wireless products in the Connected Home segment, partially offset by increased net revenue from switch products in the SMB segment. Net revenue from mobile products declined \$12.3 million compared to the prior year comparative quarter, mainly due to lower sales to service provider customers. Net revenue from home wireless products declined \$7.6 million as we observed a contraction in the consumer WiFi market compared to the prior year period. The declines in mobile and home wireless product net revenue resulted in Connected Home net revenue falling compared to the prior year period by 11.9%. SMB net revenue increased by 10.9% compared to the prior year period entirely driven by increased net revenue from switch products.

## EMEA

EMEA net revenue increased in the three months ended March 31, 2019, compared to the prior year period, primarily driven by increased net revenue from our mobile, home wireless and switch products. We saw an increase in order volume from our UK customers in the lead up to the United Kingdom's originally scheduled departure from the European Union on March 29, 2019 subsequently delayed until October 31, 2019. In addition, net revenue from service providers increased by \$3.4 million compared to the prior year period. Connected Home and SMB net revenue increased by 22.3% and 18.4%, respectively.

## APAC

APAC net revenue increased by \$6.3 million in the three months ended March 31, 2019, compared to the prior year period. The increase was primarily attributable to increased net revenue of our broadband modem and gateway, mobile and switch products. The increase in broadband modem and gateway and mobile products was primarily as a result of net revenue from sales to service providers increasing compared to the prior year period. Connected Home and SMB net revenue increased by 23.6% and 4.6%, respectively, mainly due to growth in the aforementioned

product categories.

#### Cost of Revenue and Gross Margin

Cost of revenue consists primarily of the following: the cost of finished products from our third party manufacturers; overhead costs, including purchasing, product planning, inventory control, warehousing and distribution logistics; third-party software licensing fees; inbound freight; import duties/tariffs; warranty costs associated with returned goods; write-downs for

42

---

Table of Contents

excess and obsolete inventory; amortization expense of certain acquired intangibles; and costs attributable to the provision of service offerings.

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 channel sales incentives, changes in our cost of goods sold due to fluctuations in prices paid for components, net of vendor rebates, warranty and overhead costs, inbound freight and duty/tariffs, conversion costs, charges for excess or obsolete inventory and amortization of acquired intangibles. The following table presents costs of revenue and gross margin, for the periods indicated:

	Three Months Ended		
	March 31,	%	April 1,
	2019	Change	2018
	(In thousands, except percentage data)		
Cost of revenue	\$167,074	(1.1 )%	\$168,882
Gross margin	32.9	%	31.1 %

Cost of revenue decreased slightly for the three months ended March 31, 2019 while the net revenue increased by 1.6%, compared to the prior year period, mainly driven by the decreased expense relating to warranty.

Gross margin increased for the three months ended March 31, 2019 compared to the prior year period, primarily due to lower provisions for sales returns and warranty, partially offset by higher provisions for channel promotion activities.

We expect gross margin percentage for fiscal 2019 to be in line with the prior year. Forecasting future gross margin percentages is difficult, and there are a number of risks related to our ability to maintain or improve our current gross margin levels. Our cost of revenue as a percentage of net revenue can vary significantly based upon a number of factors such as the following: uncertainties surrounding revenue levels, including future pricing and/or potential discounts as a result of the economy or in response to the strengthening of the U.S. dollar in our international markets, and related production level variances; import customs duties and imposed tariffs; competition; changes in technology; changes in product mix; variability of stock-based compensation costs; royalties to third parties; fluctuations in freight and repair costs; manufacturing and purchase price variances; changes in prices on commodity components; warranty costs; and the timing of sales, particularly to service provider customers. We expect that revenue derived from paid subscription service plans will increase in the future, which may have a positive impact on our gross margin. From time to time, however, we may experience fluctuations in our gross margin as a result of the factors discussed above.

## Operating Expenses

### Research and Development

Research and development expense consists 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, IT and facility allocations, and other consulting fees. Research and development expenses are recognized as they are incurred. We have invested in building our research and development organization to enhance our ability to introduce innovative and easy-to-use products. The following table presents research and development expense, for the periods indicated:

Edgar Filing: NETGEAR, INC - Form 10-Q

Three Months Ended  
March 31%      April 1,  
2019      Change      2018  
(In thousands, except  
percentage data)

Research and development expense \$18,832 (11.1)% \$21,191

Research and development expense decreased for the three months ended March 31, 2019, compared to the prior year period, mainly due to decreases of \$1.9 million in IT and facility allocations and \$0.8 million in engineering projects and outside

Table of Contents

professional services, partially offset by an increase of \$0.4 million in personnel-related expenditures. Research and development headcount increased from 263 as of April 1, 2018 to 275 as of March 31, 2019. The increase in research and development headcount was driven in part by the acquisition of Meural in the Connected Home segment. We believe that innovation and technological leadership is critical to our future success, and we are committed to continuing a significant level of research and development to develop new technologies, products and services to combat competitive pressures. We continue to invest in research and development to grow our cloud platform capabilities, and connected home products portfolio including services and mobile applications, expand our 10Gig, PoE, web-managed and app-managed and Pro-AV switch products, and develop innovative WiFi and 4G/5G mobile Advanced and 5G coverage solutions. For the remainder of fiscal 2019, we expect research and development expenses to increase in absolute dollars as we allocate resources to help accelerate growth in key strategic areas such as the development of our WiFi 6 product portfolio as well as service offerings. Research and development expenses will fluctuate depending on the timing and number of development activities in any given quarter and could vary significantly as a percentage of net revenue, depending on actual revenues achieved in any given quarter.

## Sales and Marketing

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

Three Months Ended		
March 31%	April 1,	
2019	Change	2018
(In thousands, except percentage data)		

Sales and marketing expense	\$35,855 (5.3 )%	\$37,874
-----------------------------	------------------	----------

Sales and marketing expense decreased for the three months ended March 31, 2019, compared to the prior year period, due to decreases in personnel-related expenditures of \$2.1 million. Headcount decreased from 324 employees as of April 1, 2018 to 297 employees as of March 31, 2019. The fall in headcount was primarily associated with restructuring activities initiated in the fourth quarter of 2018.

We expect our sales and marketing expense to be in line or slightly increase in absolute dollars for the remainder of fiscal year 2019, as we continue to invest in brand marketing to strengthen our competitive position in fast growing product categories. Expenses may fluctuate depending on revenue levels achieved as certain expenses, such as commissions, are determined based upon the revenues achieved. Forecasting sales and marketing expenses as a percentage of net revenue is highly dependent on expected revenue levels and could vary significantly depending on actual revenues achieved in any given quarter. Marketing expenses will also fluctuate depending upon the timing, extent and nature of marketing programs.

## General and Administrative

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

Three Months Ended		
March 31%	April 1,	
2019	Change	2018

Edgar Filing: NETGEAR, INC - Form 10-Q

(In thousands, except  
percentage data)

General and administrative expense \$13,117 (16.8)% \$15,761

General and administrative expense decreased for the three months ended March 31, 2019, compared to the prior year period, primarily due to declines of \$1.6 million in personnel-related expenditures and \$0.5 million in legal and professional

44

---

Table of Contents

services. Headcount decreased from 180 employees as of April 1, 2018 to 145 employees as of March 31, 2019. The fall in headcount was primarily attributable to the separation of the Arlo business as a number of NETGEAR employees were transferred to Arlo Technologies and were not subsequently replaced.

We expect our general and administrative expenses to be in line or slightly increase in absolute dollars for the remainder of fiscal year 2019. General and administrative expenses could fluctuate depending on a number of factors, including the level and timing of expenditures associated with litigation defense costs in connection with the litigation matters described in Note 10. Commitments and Contingencies, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q. Future general and administrative expense increases or decreases in absolute dollars are difficult to predict due to the lack of visibility of certain costs, including legal costs associated with defending claims against us, as well as legal costs associated with asserting and enforcing our intellectual property portfolio and other factors.

## 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	
	March 3 <del>1</del> 2019	April 1, 2018
	Change	
	(In thousands, except percentage data)	
Interest income	\$701	(6.3 )%
Other income (expense), net	341	**
Total	\$1,042	**

\*\*Percentage change not meaningful.

Interest income decreased slightly for the three months ended March 31, 2019, compared to the prior year period, mainly due to average short-term investment balances being lower than the prior year period.

Other income (expense), net increased for the three months ended March 31, 2019 compared to the prior year period. In the three months ended April 1, 2018, we incurred an impairment charge of \$1.4 million pertaining to a long-term investment. Our foreign currency hedging program effectively reduced volatility associated with hedged currency exchange rate movements during the three months ended March 31, 2019. For a detailed discussion of our hedging program and related foreign currency contracts, refer to Note 7. Derivative Financial Instruments, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

## Provision for Income Taxes

	Three Months Ended	
	March 31, 2019	April 1, 2018
	% Change	
	(In thousands, except percentage data)	
Provision (benefit) for income taxes	\$2,207	**
Effective tax rate	14.7 %	(9.2 )%

\*\*Percentage change not meaningful.





Table of Contents

The increase in the effective tax rate for the three months ended March 31, 2019, compared to the three months ended April 1, 2018, resulted primarily from higher pre-tax earnings compared to the three months ended April 1, 2018. The effective tax rate for the period ended March 31, 2019 included a one-time benefit related to the closing of the French tax audit whereas the period ended April 1, 2018 included benefits from stock based compensation transactions accounted for as discrete benefits during the period.

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Our future foreign tax rate could be affected by changes in the composition in earnings in countries with tax rates differing from the U.S. federal rate. We are under examination in various U.S. and foreign jurisdictions.

## Segment Information

A description of our products and services, as well as segment financial data, for each segment and a reconciliation of segment contribution income to income before income taxes can be found in Note 13. Segment Information, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

## Connected Home

	Three Months Ended			
	March 31,	%	April 1,	
	2019	Change	2018	
	(in thousands, except percentage data)			
Net revenue	\$ 169,365	(2.8 )%	\$ 174,315	
Percentage of total net revenue	68.0	%	71.1	%
Contribution income	\$ 19,119	17.9 %	\$ 16,212	
Contribution margin	11.3	%	9.3	%

The decrease in Connected Home segment net revenue for the three months ended March 31, 2019, compared to the prior year period, was primarily due to lower net revenue from our mobile and home wireless products, partially offset by increased net revenue of broadband modem and gateway products. Net revenue from mobile products declined \$8.4 million compared to the prior year period, mainly due to lower sales to service provider customers. Net revenue from home wireless products declined \$4.3 million mainly due to declines in AC products sales, partially offset by growth in WiFi systems and gaming routers. On a geographic basis, we experienced a decline of 11.9% in the Americas, partially offset by growth of 22.3% and 23.6% in EMEA and APAC, respectively. The decline in Americas was driven by a combination of lower net revenue from service providers and a contraction of the consumer home WiFi market.

Contribution income increased for the three months ended March 31, 2019, compared to the prior year period, primarily attributable to higher gross profit attainment and lower operating expenses as a proportion of net revenue.

## SMB

	Three Months Ended			
	March 31,	%	April 1,	
	2019	Change	2018	
	(in thousands, except percentage data)			
Net revenue	\$ 79,717	12.5 %	\$ 70,886	
Percentage of total net revenue	32.0	%	28.9	%
Contribution income	\$ 22,685	37.3 %	\$ 16,522	

Edgar Filing: NETGEAR, INC - Form 10-Q

Contribution margin	28.5	%	23.3	%
---------------------	------	---	------	---

SMB segment net revenue increased for the three months ended March 31, 2019, compared to the prior year period, primarily due to increased net revenue from switch and SMB wireless products. The increase in net revenue on a year over

46

---

Table of Contents

year basis was driven in part by new product introductions and lower provisions for sales returns. On a geographic basis, we experienced growth in all regions.

Contribution income increased for the three months ended March 31, 2019, compared to the prior year period, primarily as a result of the increased net revenue and lower operating expenditures.

## Liquidity and Capital Resources

Our principal sources of liquidity are cash, cash equivalents, short-term investments, and cash generated from operations. Our cash equivalents and short-term investments are comprised primarily of money-market funds, U.S. treasury securities, and certificates of deposits. As of March 31, 2019, we had cash, cash equivalents and short-term investments totaling \$212.7 million. Our cash and cash equivalents balance decreased from \$201.0 million as of December 31, 2018 to \$185.7 million as of March 31, 2019. Our short-term investments, which represent the investment of funds available for current operations, decreased from \$73.3 million as of December 31, 2018 to \$27.0 million as of March 31, 2019.

As of March 31, 2019, 52% of our cash and cash equivalents and short-term investments were outside of the U.S. The cash and cash equivalents and short-term investments balances outside of the U.S. are subject to fluctuation based on the settlement of intercompany balances. As we repatriate these funds in accordance with our designation of funds not permanently reinvested outside of the US, we will be required to pay income taxes in certain U.S. states and applicable foreign withholding taxes during the period when such repatriation occurs. We have recorded deferred taxes for the tax effect of repatriating the funds to the U.S.

The following table presents our cash flows for the periods presented.

	Three Months Ended March 31, 2019 (In thousands)	April 1, 2018
Cash provided by (used in):		
Continuing operating activities	\$ (37,193 )	\$ 22,883
Continuing investing activities	35,841	(3,034 )
Continuing financing activities	(14,015 )	2,373
Net increase in cash and cash equivalents from discontinued operations	—	33,703
Net cash increase (decrease)	\$ (15,367 )	\$ 55,925

## Continuing operating activities

Net cash used in operating activities was \$37.2 million for the three months ended March 31, 2019 compared to \$22.9 million of net cash provided by operating activities in the prior year period, primarily due to a net cash outflow from working capital movements, partially offset by higher net income. The net cash outflow from working capital

movements was driven in part by increased payments associated with inventory to support our manufacturing migration to mitigate imposed tariffs, and increased days sales outstanding ("DSO") due to timing of shipments.

Our DSO slightly decreased to 95 days as of March 31, 2019 as compared to 97 days as of December 31, 2018. Our accounts payable decreased from \$139.7 million as of December 31, 2018 to \$69.3 million as of March 31, 2019, primarily as a result of timing of payments associated with inventory to support our manufacturing migration as mentioned above. Inventory decreased from \$243.9 million as of December 31, 2018 to \$236.1 million as of March 31, 2019. Ending inventory turns were 2.8 in the three months ended March 31, 2019 down from 3.3 turns in the three months ended December 31, 2018.

## Table of Contents

### Continuing investing activities

Net cash provided by investing activities was \$35.8 million for the three months ended March 31, 2019 compared to net cash used of \$3.0 million in the prior year period, primarily due to lower purchase of short-term investments along with higher proceeds from maturities of short-term investments, partially offset by increased capital expenditures and long-term investments.

### Continuing financing activities

Net cash used in financing activities was \$14.0 million in the three months ended March 31, 2019 compared to \$2.4 million of net cash provided by financing activities in the prior year period. The change in the financing activities was primarily attributable to increased repurchases of our common stock.

From time to time, our Board of Directors has authorized programs under which we may repurchase shares of our common stock. Under the authorizations, the timing and actual number of shares subject to repurchase are at the discretion of management and are contingent on a number of factors, such as levels of cash generation from operations, cash requirements for acquisitions and the price of our common stock. As of March 31, 2019, 1.0 million shares remained authorized for repurchase under the repurchase program. During the three months ended March 31, 2019, we repurchased and retired, reported based on trade date, 0.4 million shares of common stock at a cost of \$15.0 million. During the three months ended April 1, 2018, we did not repurchase any shares of common stock under the authorizations. During the three months ended March 31, 2019 and April 1, 2018, we also repurchased and retired, reported based on trade date, approximately 89,000 and 38,000 shares of common stock, and at a cost of \$3.3 million and \$2.3 million, respectively, to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving RSUs. For a detailed discussion of our common stock repurchases, refer to Note 11. Stockholders' Equity, in Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

We enter into foreign currency forward-exchange contracts, which typically mature within six 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 on the consolidated balance sheets at each reporting period the fair value of our forward-exchange contracts and record any fair value adjustments in our consolidated statements of operations and on our consolidated balance sheets. 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 designated cash flow hedges under the authoritative guidance for derivatives and hedging are recorded within accumulated other comprehensive income until the related revenue, costs of revenue, or expenses are recognized.

Based on our current plans and market conditions, we believe that our existing cash, cash equivalents and short-term investments, together with cash generated from operations, will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months. However, we may require or desire additional funds to support our operating expenses and capital requirements or for other purposes, such as acquisitions, and may seek to raise such additional funds through public or private equity financing or from other sources. We cannot assure you that additional financing will be available at all or that, if available, such financing would be obtainable on terms favorable to us and would not be dilutive. Our future liquidity and cash requirements will depend on numerous factors, including the introduction of new products and potential acquisitions of related businesses or technology.

### Contractual Obligations

There have been no material changes during the three months ended March 31, 2019 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, 2018. We lease office space, cars, distribution centers 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

## Table of Contents

scale. Lease expense is recognized on a straight-line basis over the lease term. Refer to Note 15. Leases, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, for the updated accounting policy for leases upon the adoption of ASU 2016-02, "Leases" (Topic 842) as of January 1, 2019 and details on our leases. The amounts presented are consistent with contractual terms and are not expected to differ significantly, unless a substantial change in our headcount needs requires us to exit an office facility early or expand our occupied space.

We have entered into various master purchase agreements for inventory 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. For those orders not governed by master purchase agreements the commitments are governed by the commercial terms on our purchase orders subject to acknowledgment from our suppliers. As of March 31, 2019, we had approximately \$169.8 million in non-cancelable purchase commitments with suppliers. We establish a loss liability for all products we do not expect to sell for which we have committed purchases from suppliers. Such losses have not been material to date. From time to time our suppliers procure unique complex components on our behalf. If these components do not meet specified technical criteria or are defective, we should not be obligated to purchase the materials. However, disputes may arise as a result and significant resources may be spent resolving such disputes.

As of March 31, 2019, we had long term, non-cancellable purchase commitments of \$17.4 million pertaining to non-trade activities.

As of March 31, 2019, we had an estimated long term liability of \$6.5 million related to a one-time transaction tax that resulted from the passage of the Tax Act.

As of March 31, 2019, we had \$13.9 million of gross unrecognized tax benefits and related interest and penalties. The timing of any payments that could result from these unrecognized tax benefits will depend upon a number of factors. The unrecognized tax benefits have been excluded from the contractual obligations table because reasonable estimates cannot be made of whether, or when, any cash payments for such items might occur. The possible reduction in liabilities for uncertain tax positions in multiple jurisdictions that may impact the statements of operations in the next 12 months is approximately \$0.8 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

### Off-Balance Sheet Arrangements

As of March 31, 2019, we did not have any off-balance-sheet arrangements as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

### Critical Accounting Policies and Estimates

For a complete description of what we believe to be the critical accounting policies and estimates used in the preparation of our Unaudited Condensed Consolidated Financial Statements, refer to our Annual Report on Form 10-K for the year ended December 31, 2018. Refer to Note 15. Leases, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, for the updated accounting policy on leases upon the adoption of ASU 2016-02, "Leases" (Topic 842) as of January 1, 2019.

### Recent Accounting Pronouncements

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





Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

During the three months ended March 31, 2019, 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, 2018.

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

Other than certain controls implemented in connection with adoption of the lease accounting standard (Topic 842), there have been no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially effect, our internal control over financial reporting. It should be noted that any system of controls, however well designed and operated, can provide only reasonable assurance, and not absolute assurance, that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals in all future circumstances.

Table of Contents

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

The information set forth under Note 10. Commitments and Contingencies, in the Notes to Unaudited Condensed Consolidated Financial Statements 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 22, 2019.

\*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;

• changes in U.S. and international tax and trade policy that adversely affect customs, tax or duty rates, such as the higher tariffs on products imported from China enacted by the current U.S. administration;

• introductions of new technologies and changes in consumer preferences that result in either unanticipated or unexpectedly rapid product category shifts;

• slow or negative growth in the networking product, personal computer, Internet infrastructure, smart home, home electronics and related technology markets;

• seasonal shifts in end market demand for our products, particularly in our Connected Home business segment;

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

• increases in expenses related to the development, introduction and marketing of new products that adversely impact our margins;

unanticipated decreases or delays in purchases of our products by our significant traditional and online retail customers;

51

---

Table of Contents

- component supply constraints or sudden, unforeseen price increases from our vendors;
- unanticipated increases in costs, including air freight, associated with shipping and delivery of our products;
- discovery or exploitation of security vulnerabilities in our products, services or systems, leading to negative publicity, decreased demand or potential liability, including potential breach of our customers' data privacy or disruption of the continuous operation of our cloud infrastructure and our products;
- shift in overall product mix sales from higher to lower margin products, or from one business segment to another, that would adversely impact our margins;
- foreign currency exchange rate fluctuations in the jurisdictions where we transact sales and expenditures in local currency;
- the inability to maintain stable operations by our suppliers and other parties with which we have commercial relationships;
- unfavorable level of inventory and turns;
- changes in or consolidation of our sales channels and wholesale distributor relationships or failure to manage our sales channel inventory and warehousing requirements;
- delay or failure to fulfill orders for our products on a timely basis;
- delay or failure of our service provider customers to purchase at their historic volumes or at the volumes that they or we forecast;
- changes in tax rates or adverse changes in tax laws that expose us to additional income tax liabilities;
- operational disruptions, such as transportation delays or failure of our order processing system, particularly if they occur at the end of a fiscal quarter;
- disruptions or delays related to our financial and enterprise resource planning systems;
- our inability to accurately forecast product demand, resulting in increased inventory exposure;
- allowance for doubtful accounts exposure with our existing retailers, distributors and other channel partners and new retailers, distributors and other channel partners, particularly as we expand into new international markets;
- geopolitical disruption, including sudden changes in immigration policies, leading to disruption in our workforce or delay or even stoppage of our operations in manufacturing, transportation, technical support and research and development;
- terms of our contracts with customers or suppliers that cause us to incur additional expenses or assume additional liabilities;
- an increase in price protection claims, redemptions of marketing rebates, product warranty and stock rotation returns or allowance for doubtful accounts;

litigation involving alleged patent infringement, consumer class actions, securities class actions or other claims that could negatively impact our reputation, brand, business and financial condition;

Table of Contents

• epidemic or widespread product failure, performance problems or unanticipated safety issues in one or more of our products that could negatively impact our reputation, brand and business;

• any changes in accounting rules, including the potential impact of our adoption of new revenue recognition standards;

• 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 code of ethics, 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;

• workplace or human rights violations in certain countries in which our third-party manufacturers or suppliers operate, which may affect the NETGEAR brand and negatively affect our products' acceptance by consumers;

• unanticipated shifts or declines in profit by geographical region that would adversely impact our tax rate;

• our failure to implement and maintain the appropriate internal controls over financial reporting which may result in restatements of our financial statements; and

• any changes in accounting rules.

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

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

There has been significant volatility in the market price and trading volume of securities of technology and other companies, which may be unrelated to the financial performance of these companies. These broad market fluctuations may negatively affect the market price of our common stock.

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

• actual or anticipated fluctuations in our operating results or our competitors' operating results;

• actual or anticipated changes in the growth rate of the general networking sector, our growth rates or our competitors' growth rates;

• conditions in the financial markets in general or changes in general economic conditions, including government efforts to stabilize currencies;

• actual or anticipated changes in governmental regulation, including taxation and tariff policies;

interest rate or currency exchange rate fluctuations;

our ability to forecast or report accurate financial results; and

53

---



Table of Contents

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

\*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 or 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 consumer market include ARRIS, ASUS, AVM, Devolo, D-Link, Eero (owned by Amazon), Google, Linksys (owned by Foxconn), Samsung, Synology, Symantec, TP-Link and Western Digital. Our principal competitors in the business market include Allied Telesys, Barracuda, Buffalo, Cisco Systems, Dell, D-Link, Fortinet, Hewlett-Packard Enterprise, QNAP Systems, Seagate Technology, SonicWall, Synology, TP-Link, Ubiquiti, WatchGuard and Western Digital. Our principal competitors in the service provider market include Actiontec, Airties, Arcadyan, ARRIS, ASUS, AVM, Compal Broadband, D-Link, Eero (owned by Amazon), Franklin, Google, Hitron, Huawei, Novatel Wireless, Plume, Sagem, Sercomm, SMC Networks, TechniColor, TP-Link, Ubee, ZTE and Zyxel. Other competitors include numerous local vendors such as Xiaomi in China, AVM in Germany and Buffalo in Japan. In addition, these local vendors may target markets outside of their local regions and may increasingly compete with us in other regions worldwide. Our potential competitors also include other consumer electronics vendors, including Apple, LG Electronics, Microsoft, Panasonic, Sony, Toshiba and Vizio, who could integrate networking and streaming capabilities into their line of products, such as televisions, set top boxes and gaming consoles, and our channel customers who may decide to offer self-branded networking products. We also face competition from service providers who may bundle a free networking device with their broadband service offering, which would reduce our sales if we were not the supplier of choice to those service providers. In the service provider space, we are also facing significant and increased competition from original design manufacturers, or ODMs, and contract manufacturers who are selling and attempting to sell their products directly to service providers around the world.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers, and exert more influence on sales channels than we can. Certain of our significant competitors also serve as key sales and marketing channels for our products, potentially giving these competitors a marketplace advantage based on their knowledge of our business activities and/or their ability to negatively influence our sales opportunities. For example, Amazon provides an important sales channel for our products, and it recently acquired Eero, one of our competitors in the mesh WiFi systems product category. In addition, certain competitors may have different business models, such as integrated manufacturing capabilities, that may allow them to achieve cost savings and to compete on the basis of price. Other competitors may have fewer resources, but may be more nimble in developing new or disruptive technology or in entering new markets. We anticipate that current and potential competitors will also intensify their efforts to penetrate our target markets. For example, price competition is intense in our industry in certain geographical regions and product categories. Many of our competitors in the service provider and retail spaces price their products significantly below our product costs in order to gain market share. Certain substantial competitors have business models that are more focused on customer acquisition and access to customer data rather than on financial return from product sales, and these competitors have the ability to provide sustained price competition to many of our products in the market. 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. Our competitors may acquire other companies in the market and leverage combined resources to gain market share. In some instances, our competitors may be acquired by larger companies with additional formidable resources, such as the recent purchase of ARRIS by CommScope and Eero by Amazon. 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.

Table of Contents

\*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 consumer, business and service provider markets, and to quickly develop or acquire, and manufacture and sell products that satisfy these demands in a cost-effective manner. In order to differentiate our products from our competitors' products, we must continue to increase our focus and capital investment in research and development, including software development. For example, we have committed a substantial amount of resources to the development, manufacture, marketing and sale of our Nighthawk home networking products and Orbi WiFi system, and to introducing additional and improved models in these lines. If these products do not continue to maintain or achieve widespread market acceptance, or if we are unsuccessful in capitalizing on other smart home market opportunities, our future growth may be slowed and our financial results could be harmed. Also, as the mix of our business increasingly includes new products and services that require additional investment, this shift may adversely impact our margins, at least in the near-term. For example, we are making significant investments in the development and introduction of our new WiFi 6 products, including marketing efforts to build awareness of the benefits of this next-generation WiFi standard, and we expect these efforts to adversely impact our margins in the first half of 2019. Successfully predicting demand trends is difficult, and it is very difficult to predict the effect that introducing a new product will have on existing product sales. We will also need to respond effectively to new product announcements by our competitors by quickly introducing competitive products.

In addition, we have acquired companies and technologies in the past and as a result, have introduced new product lines in new markets. We may not be able to successfully manage integration of the new product lines with our existing products. Selling new product lines in new markets will require our management to learn different strategies in order to be successful. We may be unsuccessful in launching a newly acquired product line in new markets which requires management of new suppliers, potential new customers and new business models. Our management may not have the experience of selling in these new markets and we may not be able to grow our business as planned. For example, in August 2018, we acquired Meural Inc., a leader in digital platforms for visual art, to enhance our Connected Home product and service offerings. If we are unable to effectively and successfully further develop these new product lines, we may not be able to increase or maintain our sales and our gross margins may be adversely affected.

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

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

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

increased levels of product returns.

Throughout the past few years, we have significantly increased the rate of our new product introductions. If we cannot sustain that pace of product introductions, either through rapid innovation or acquisition of new products or product lines, we

## Table of Contents

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, or if we are unable to improve the margins on our previously introduced and rapidly growing product lines, our net revenue and overall gross margin would likely decline.

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

We sell a substantial portion of our products through traditional and online retailers, including Best Buy Co., Inc., Amazon.com, Inc. and their affiliates, wholesale distributors, including Ingram Micro, Inc. and Tech Data Corporation, and service providers, such as AT&T. We expect that a significant portion of our net revenue will continue to come from sales to a small number of customers for the foreseeable future. In addition, because our accounts receivable are often concentrated with a small group of purchasers, the failure of any of them to pay on a timely basis, or at all, would reduce our cash flow. We are also exposed to increased credit risk if any one of these limited numbers of customers fails or becomes insolvent. We generally have no minimum purchase commitments or long-term contracts with any of these customers. These purchasers could decide at any time to discontinue, decrease or delay their purchases of our products. If our customers increase the size of their product orders without sufficient lead-time for us to process the order, our ability to fulfill product demands would be compromised. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. Accordingly, the prices that they pay for our products are subject to negotiation and could change at any time. Our ability to maintain strong relationships with our principal customers is essential to our future performance. If any of our major customers reduce their level of purchases or refuse to pay the prices that we set for our products, our net revenue and operating results could be harmed. Furthermore, some of our customers are also our competitors in certain product categories, which could negatively influence their purchasing decisions. For example, Amazon recently acquired Eero, one of our competitors in the mesh WiFi systems product category. 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, concentration and consolidation among our customer base may allow certain customers to command increased leverage in negotiating prices and other terms of sale, which could adversely affect our profitability. If, as a result of increased leverage, customer pressures require us to reduce our pricing such that our gross margins are diminished, we could decide not to sell our products to a particular customer, which could result in a decrease in our revenue. Consolidation among our customer base may also lead to reduced demand for our products, elimination of sales opportunities, replacement of our products with those of our competitors and cancellations of orders, each of which would harm our operating results. Consolidation among our service provider customers worldwide may also make it more difficult to grow our service provider business, given the fierce competition for the already limited number of service providers worldwide and the long sales cycles to close deals. If consolidation among our customer base becomes more prevalent, our operating results may be harmed.

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, or any sudden, unforeseen price increase for such components, would harm our ability to meet product deliveries as scheduled or as budgeted. 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

Table of Contents

on our behalf on a purchase order basis, and we do not have any contractual commitments or guaranteed supply arrangements with our suppliers. If demand for a specific component increases, we may not be able to obtain an adequate number of that component in a timely manner. In addition, if worldwide demand for the components increases significantly, the availability of these components could be limited. Further, our suppliers may experience financial or other difficulties as a result of uncertain and weak worldwide economic conditions. Other factors which may affect our suppliers' ability or willingness to supply components to us include internal management or reorganizational issues, such as roll-out of new equipment which may delay or disrupt supply of previously forecasted components, or industry consolidation and divestitures, which may result in changed business and product priorities among certain suppliers. It could be difficult, costly and time consuming to obtain alternative sources for these components, or to change product designs to make use of alternative components. In addition, difficulties in transitioning from an existing supplier to a new supplier could create delays in component availability that would have a significant impact on our ability to fulfill orders for our products.

We provide our third-party manufacturers with a rolling forecast of demand, which they use to determine our material and component requirements. Lead times for ordering materials and components vary significantly and depend on various factors, such as the specific supplier, contract terms and demand and supply for a component at a given time. Some of our components have long lead times, such as wireless local area network chipsets, switching fabric chips, physical layer transceivers, connector jacks and metal and plastic enclosures. If our forecasts are not timely provided or are less than our actual requirements, our third-party manufacturers may be unable to manufacture products in a timely manner. 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. At times we have elected to use more expensive transportation methods, such as air freight, to make up for manufacturing delays caused by component shortages, which reduces our margins. In addition, at times sole suppliers of highly specialized components have provided components that were either defective or did not meet the criteria required by our customers, resulting in delays, lost revenue opportunities and potentially substantial write-offs.

\*Changes in trade policy in the United States and other countries, including the imposition of tariffs and the resulting consequences, may adversely impact our business, results of operations and financial condition.

The U.S. government has indicated and demonstrated its intent to alter its approach to international trade policy through the renegotiation, and potential termination, of certain existing bilateral or multi-lateral trade agreements and treaties with, and the imposition of tariffs on a wide range of products and other goods from, a number of countries. In particular, while China currently enjoys "most favored nation" trading status with the United States, the U.S. government has proposed to revoke that status and has implemented tariffs on a significant number of products manufactured in China. For example, a 10% tariff has already taken effect on certain products imported into the United States beginning on September 24, 2018. A previously scheduled increase in this tariff rate to 25% has been postponed, pending ongoing negotiations between the U.S. government and China. Moreover, the current U.S. administration has indicated that it is considering expanding these tariffs to additional products imported from China.

Our analysis of our supply chain, manufacturing processes and product compositions is ongoing, but our review to date indicates that some of our products are affected by these tariffs. Although we have been working closely with our manufacturing partners to implement ways to mitigate the impact of these tariffs on our supply chain as promptly as reasonably practicable, including shifting production outside of China, these efforts may disrupt our operations, may not be completely successful and may result in higher long-term manufacturing costs. As a result, we may be required to raise our prices on certain products, which could result in the loss of customers and harm to our market share, competitive position and operating performance.



Table of Contents

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

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

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

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

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

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

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

All of our products are manufactured, assembled, tested and generally packaged by a limited number of third-party manufacturers, including original design manufacturers, or ODMs, 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 or are themselves competitors in certain product categories. Due to changing economic conditions, the viability of some of these third-party manufacturers may be at risk. Our ODMs are increasingly refusing to work with us on certain projects, such as projects for manufacturing products for our service provider customers. Because our service provider customers command significant resources, including for software support, and demand extremely competitive pricing, our ODMs are starting to refuse to engage on service provider terms. The loss of the services of any of our primary third-party manufacturers could cause a significant disruption in operations and delays in product shipments. Qualifying a new manufacturer and commencing volume production is expensive and time consuming. Ensuring that a contract manufacturer is qualified to manufacture our products to our standards is time consuming. In addition, there is no assurance that a contract manufacturer can scale its production of our products at the volumes and in the quality that we require. If a contract manufacturer is unable to do these things, we may have to move production for the products to a new or existing third party manufacturer which would take significant effort and our business may be harmed. In addition, as we contemplate moving manufacturing into different jurisdictions, we will be subject to

additional significant challenges in ensuring that quality, processes and costs, among other issues, are consistent with our expectations. For example, while we expect our manufacturers to be responsible for penalties assessed on us because of excessive failures of the products, there is no assurance that we will be able to collect such reimbursements from these manufacturers, which causes us to take on additional risk for potential failures of our products.

## Table of Contents

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

- unexpected increases in manufacturing and repair costs;
- inability to control the quality and reliability of finished products;
- inability to control delivery schedules;
- potential liability for expenses incurred by third-party manufacturers in reliance on our forecasts that later prove to be inaccurate;
- potential lack of adequate capacity to manufacture all or a part of the products we require; and
- potential labor unrest affecting the ability of the third-party manufacturers to produce our products.

All of our products must satisfy safety and regulatory standards and some of our products must also receive government certifications. Our third party manufacturers are primarily responsible for conducting the tests that support our applications for most regulatory approvals for our products. If our third party manufacturers fail to timely and accurately conduct these tests, we would be unable to obtain the necessary domestic or foreign regulatory approvals or certificates to sell our products in certain jurisdictions. As a result, 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 and assembly occurs in the Asia Pacific region and any disruptions due to natural disasters, health epidemics and political, social and economic instability in the region would affect the ability of our third party manufacturers to manufacture our products. In addition, our third party manufacturers in China have continued to increase our costs of production, particularly in the past couple of years. If these costs continue to increase, it may affect our margins and ability to lower prices for our products to stay competitive. Labor unrest in China may also affect our third party manufacturers as workers may strike and cause production delays. If our third party manufacturers fail to maintain good relations with their employees or contractors, and production and manufacturing of our products is affected, then we may be subject to shortages of products and quality of products delivered may be affected. Further, if our manufacturers or warehousing facilities are disrupted or destroyed, we would have no other readily available alternatives for manufacturing and assembling our products and our business would be significantly harmed.

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

Product security vulnerabilities, data protection breaches and cyber-attacks could disrupt our products or services, and any such disruption could increase our expenses, damage our reputation, harm our business and adversely affect our stock price.

Our products and services may contain unknown security vulnerabilities. For example, the firmware, software and open source software that we or our manufacturing partners have installed on our products may be susceptible to hacking or misuse. In addition, we offer a comprehensive online cloud management service paired with a number of our products. If malicious actors compromise this cloud service, or if customer confidential information is accessed without authorization, our business will be harmed. Operating an online cloud service is a relatively new business for us and we may not have the expertise to properly manage risks related to data security and systems security. We rely on third-party providers for a number of critical

Table of Contents

aspects of our cloud services and customer support, including web hosting services, billing and payment processing, and consequently we do not maintain direct control over the security or stability of the associated systems. Our management has spent increasing amounts of time, effort and expense in this area, and in the event of the discovery of a significant product security vulnerability, we would incur additional substantial expenses and our business would be harmed. If we or our third-party providers are unable to successfully prevent breaches of security relating to our products, services or customer private information, including customer personal identification information, or if these third-party systems failed for other reasons, it could result in litigation and potential liability for us, damage our brand and reputation, or otherwise harm our business.

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

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

In addition, availability of our products from third-party manufacturers and our ability to distribute our products into the United States and non-U.S. jurisdictions may be impacted by factors such as an increase in duties, tariffs or other restrictions on trade; raw material shortages, work stoppages, strikes and political unrest; economic crises and international disputes or conflicts; changes in leadership and the political climate in countries from which we import products; and failure of the United States to maintain normal trade relations with China and other countries. Any of these occurrences could materially adversely affect our business, operating results and financial condition.

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

In addition, the economic problems affecting the financial markets and the uncertainty in global economic conditions resulted in a number of adverse effects including a low level of liquidity in many financial markets, extreme volatility in credit, equity, currency and fixed income markets, instability in the stock market and high unemployment. For example, the challenges faced by the European Union to stabilize some of its member economies, such as Greece, Portugal, Spain, Hungary and Italy, have had international implications affecting the stability of global financial markets and hindering economies worldwide. Many member nations in the European Union have been addressing the issues with controversial austerity measures. In addition, the potential consequences of the "Brexit" process in the United Kingdom have led to significant uncertainty in the region. Should the European Union monetary policy measures be insufficient to restore confidence and stability to the financial markets, or should the United Kingdom's "Brexit" decision lead to additional economic or political instability, the global economy, including the U.S., U.K. and European Union economies where we have a significant presence, could be hindered, which could have a material adverse effect on us. There could also be a number of other follow-on effects from these economic developments 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.



## Table of Contents

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 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.

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

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

We devote considerable internal and external resources to network security, data encryption and other security measures to protect our systems and customer data, but these security measures cannot provide absolute security. In addition, many jurisdictions strictly regulate data privacy and protection and may impose significant penalties for failure to comply with these requirements. For example, the European Union's General Data Protection Regulation ("GDPR"), which became effective in May 2018, has required us to expend significant time and resources to prepare for compliance. Also, in June 2018, the State of California enacted the California Consumer Privacy Act of 2018, that

will go into effect beginning January 1, 2020, which will also likely require us to expend significant time and resources to prepare for compliance. Potential breaches of our security measures and the accidental loss, inadvertent disclosure or unapproved dissemination of proprietary information or sensitive or confidential data about us, our employees or our customers, including the potential loss or disclosure of such information or data as a result of employee error or other employee actions, hacking, fraud, social engineering or other forms of deception, could expose us, our customers or the individuals affected to a risk of loss or misuse of this information, result in litigation



Table of Contents

and potential liability for us, subject us to significant governmental fines, damage our brand and reputation, or otherwise harm our business. In addition, the cost and operational consequences of implementing further data protection measures could be significant. Likewise, we expect that there will continue to be new proposed laws, regulations and industry standards relating to privacy and data protection in the United States, the EU and other jurisdictions, such as the California Consumer Privacy Act of 2018, which has been characterized as the first “GDPR-like” privacy statute to be enacted in the United States because it mirrors a number of the key provisions in the GDPR. We cannot presently determine the impact such laws, regulations and standards will have on our business. In any event, it is possible that governmental authorities will conclude that our business practices do not comply with current or future statutes, regulations, agency guidance or case law involving applicable healthcare or privacy laws, including the GDPR, in light of the lack of applicable precedent and regulations.

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

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

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

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

We sell a significant number of products through broadband service providers worldwide. However, the service provider sales channel is challenging and exceptionally competitive. 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, rigorous service provider certification processes may delay our sale of new products, or our products ultimately may fail these tests. In either event, we may lose some or all of the amounts we expended in trying to obtain business from the service provider, as well as lose the business opportunity altogether. In addition, even if we have a product which a service provider customer may wish to

purchase, we may choose not to supply products to the potential service provider customer if the contract requirements, such as service level requirements, penalties, and liability provisions, are too onerous. Accordingly, our business may be harmed and our revenues may be reduced. We have, in exceptional limited circumstances, while still in contract negotiations, shipped products in advance of and subject to agreement on a definitive contract. We do not record revenue from these shipments until a definitive contract exists. There is risk that we do not ultimately close and sign a definitive contract. If this occurs, the timing of revenue recognition is uncertain and our business would be harmed. In addition, we often commence building custom-made products prior to execution of a contract in order to meet the customer's contemplated launch

Table of Contents

dates and requirements. Service provider products are generally custom-made for a specific customer and may not be salable to other customers or in other channels. If we have pre-built custom-made products but do not come to agreement on a definitive contract, we may be forced to scrap the custom-made products or re-work them at substantial cost and our business would be harmed.

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

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

If we were to lose a service provider customer for any reason, we may experience a material and immediate reduction in forecasted revenue that may cause us to be below our net revenue and operating margin expectations for a particular period of time and therefore adversely affect our stock price. For example, many of our competitors in the service provider space aggressively price their products in order to gain market share. We may not be able to match the lower prices offered by our competitors, and we may choose to forgo lower-margin business opportunities. Many of the service provider customers will seek to purchase from the lowest cost provider, notwithstanding that our products may be higher quality or that our products were previously validated for use on their proprietary network. Accordingly, we may lose customers who have lower, more aggressive pricing, and our revenues may be reduced. In addition, service providers may choose to prioritize the implementation of other technologies or the roll out of other services than home networking. Weakness in orders from this industry could have a material adverse effect on our business, operating results, and financial condition. We have seen slowdowns in capital expenditures by certain of our service provider customers in the past, and believe there may be potential for similar slowdowns in the future. Any slowdown in the general economy, over supply, consolidation among service providers, regulatory developments and constraint on capital expenditures could result in reduced demand from service providers and therefore adversely affect our sales to them. If we do not successfully overcome these challenges, we will not be able to profitably manage our service provider sales channel and our financial results will be harmed.

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

## Table of Contents

with our third-party manufacturers to engineer the most cost-effective design for our products. In addition, we must carefully manage the price paid for components used in our products. We must also successfully manage our freight and inventory costs to reduce overall product costs. We also need to continually introduce new products with higher sales prices and gross margins in order to maintain our overall gross margins. If we are unable to manage the cost of older products or successfully introduce new products with higher gross margins, our net revenue and overall gross margin would likely decline.

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

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

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

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

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

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

Our future success depends in large part upon the continued services of our key technical, engineering, 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 engineering, research, development, sales or marketing personnel, particularly if 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 organization into two business segments with separate leadership teams, 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-

Table of Contents

term succession plan, we may not be able to have the proper personnel in place to effectively execute our long term business strategy if Mr. Lo or other key personnel retire, resign or are otherwise terminated.

\*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 tax laws or 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. Foreign jurisdictions have increased the volume of tax audits of multinational corporations. Further, many countries, have either changed or are considering changes to their tax laws. These changes are largely punitive to U.S. multinational corporations. Changes in tax laws could affect the distribution of our earnings, result in double taxation and adversely affect our results. On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the “Tax Act”) was signed into law making significant changes to the Internal Revenue Code. In particular, sweeping changes were made to the U.S. taxation of foreign operations. Changes include, but are not limited to, a corporate tax rate decrease from 35% to 21% effective for tax years beginning after December 31, 2017, the transition of U.S. international taxation from a worldwide tax system to a quasi-territorial system, and a one-time transition tax on the mandatory deemed repatriation of cumulative foreign earnings. Additionally, new provisions were added to mitigate the potential erosion of the U.S. tax base and to discourage use of low tax jurisdictions to own intellectual property and other valuable intangible assets. The Company completed its analysis of the impact of U.S. Tax reform and has finalized all estimates previously considered provisional under Staff Accounting Bulletin 118 in the fourth quarter of 2018. The changes in tax law under the Tax Act are complex and regulations governing the implementation continue to be issued. While the Company believes it has correctly accounted for the impact of the Tax Act, guidance continues to be issued and may differ from our interpretation based on existing facts and circumstances. We urge our stockholders to consult with their legal and tax advisors with respect to the legislation and potential tax consequences of investing in our stock.

In addition to the impact of the Tax Act on our federal taxes, the Tax Act may impact our taxation in other jurisdictions, including with respect to state income taxes. Additionally, other foreign governing bodies may enact changes in their tax laws in reaction to the Tax Act that could result in changes in our global tax position and materially affect our financial position.

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

The United Kingdom HMRC (Her Majesty’s Revenue and Customs) began an inquiry regarding the application of UK Diverted Profits Tax (DPT), a law which took effect as of April 1, 2015. In assessing the whether they believe the Company is subject to the DPT legislation, UK HMRC has expanded its review to include overall transfer pricing for 2014 through 2016. If we are unsuccessful in defending our positions, our profitability will be reduced.

We received notice from the French Tax Administration on December 21, 2017 of their intent to audit our 2015 and 2016 tax filings for corporate income tax and value-added taxes. We received notification of final assessment of tax on January 11, 2019. We have agreed to these changes, none of which were material.



Table of Contents

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

Our separation from Arlo and the distribution of Arlo shares to our stockholders may not achieve some or all of the anticipated benefits and may adversely affect our business.

On February 6, 2018, we announced that our Board of Directors had unanimously approved the pursuit of a separation of our smart camera business “Arlo” from NETGEAR (the “Separation”), to be effected by way of initial public offering (“IPO”) and spin-off. On August 7, 2018, Arlo Technologies, Inc. (“Arlo”) completed its IPO and generated proceeds of approximately \$170.2 million, net of offering costs. Upon completion of the IPO, we held 62,500,000 shares of Arlo common stock, representing approximately 84.2% of the outstanding shares of Arlo common stock. On December 31, 2018, we completed the distribution of these 62,500,000 shares to our stockholders (the “Distribution”), and we no longer own any shares of Arlo common stock after the Distribution.

There is a risk that we may not be able to achieve the full strategic, operational and financial benefits to us and Arlo that were anticipated to result from the Separation or that such benefits may be delayed or not occur at all. In fact, the Distribution may adversely affect our business. Following the Distribution, we are a smaller company with a less diversified product portfolio and a narrower business focus. As a result, we may be more vulnerable to changing market conditions, which could materially and adversely affect our business, financial condition and results of operations. Although NETGEAR and Arlo are now two independent companies, our long joint history may cause consumers and investors to continue to associate the companies with each other, either positively or negatively. Separating the businesses may also eliminate or reduce synergies or economies of scale that existed prior to the Distribution, which could harm our business.

We could incur significant liability if the Distribution is determined to be a taxable transaction.

We have received an opinion from outside tax counsel to the effect that the Distribution qualifies as a transaction that is generally tax-free for U.S. federal income tax purposes. The opinion relies on certain facts, assumptions, representations and undertakings from Arlo and us regarding the past and future conduct of the companies’ respective businesses and other matters. If any of these facts, assumptions, representations or undertakings are incorrect or not satisfied, our stockholders and we may not be able to rely on the opinion of tax counsel and could be subject to significant tax liabilities. Notwithstanding the opinion of tax counsel we have received, the IRS could determine on audit that the Distribution is taxable if it determines that any of these facts, assumptions, representations or undertakings are not correct or have been violated or if it disagrees with the conclusions in the opinion. If the Distribution were determined to be taxable for U.S. federal income tax purposes, in general, we would recognize taxable gain as if we had sold Arlo common stock in a taxable sale for its fair market value, and our stockholders who received shares of Arlo common stock in the Distribution would be subject to tax as if they had received a taxable distribution equal to the fair market value of such shares.

We may be exposed to claims and liabilities as a result of the Distribution.

We entered into a separation agreement and various other agreements with Arlo to govern the Distribution and the relationship of the two companies going forward. These agreements provide for specific indemnity and liability obligations and could lead to disputes between us and Arlo. The indemnity rights we have against Arlo under the agreements may not be sufficient to protect us, for example if our losses exceeded our indemnity rights or if Arlo did not have the financial resources to meet its indemnity obligations. In addition, our indemnity obligations to Arlo may be significant, and these risks could negatively affect our results of operations and financial condition.

Table of Contents

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

International sales comprise a significant amount of our overall net revenue. International sales were approximately 41% of overall net revenue in the first quarter of 2019 and approximately 35% of overall net revenue in fiscal 2018. We continue to be committed to growing our international sales, and while we have committed resources to expanding our international operations and sales channels, these efforts may not be successful. International operations are subject to a number of other risks, including:

• exchange rate fluctuations;

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

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

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

• changes in local tax and customs duty laws or changes in the enforcement, application or interpretation of such laws (including potential responses to the higher tariffs on certain imported products recently announced by the current U.S. administration);

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

• increased difficulty in managing inventory;

• delayed revenue recognition;

• less effective protection of intellectual property;

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

• difficulties and costs of staffing and managing foreign operations; and

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

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



## Table of Contents

We must comply with indirect tax laws in multiple jurisdictions, as well as complex customs duty regimes worldwide. Audits of our compliance with these rules may result in additional liabilities for taxes, duties, interest and penalties related to our international operations which would reduce our profitability.

Our operations are routinely subject to audit by tax authorities in various countries. Many countries have indirect tax systems where the sale and purchase of goods and services are subject to tax based on the transaction value. These taxes are commonly referred to as sales and/or use tax, value-added tax (VAT) or goods and services tax (GST). In addition, the distribution of our products subjects us to numerous complex customs regulations, which frequently change over time. Failure to comply with these systems and regulations can result in the assessment of additional taxes, duties, interest and penalties. While we believe we are in compliance with local laws, we cannot assure that tax and customs authorities would agree with our reporting positions and upon audit may assess us additional taxes, duties, interest and penalties.

Additionally, some of our products are subject to U.S. export controls, including the Export Administration Regulations and economic sanctions administered by the Office of Foreign Assets Control. We also incorporate encryption technology into certain of our solutions. These encryption solutions and underlying technology may be exported outside of the United States only with the required export authorizations or exceptions, including by license, a license exception, appropriate classification notification requirement and encryption authorization.

Furthermore, our activities are subject to U.S. economic sanctions laws and regulations that prohibit the shipment of certain products and services without the required export authorizations, including to countries, governments and persons targeted by U.S. embargoes or sanctions. Additionally, the current U.S. administration has been critical of existing trade agreements and may impose more stringent export and import controls. Obtaining the necessary export license or other authorization for a particular sale may be time consuming, and may result in delay or loss of sales opportunities even if the export license ultimately is granted. While we take precautions to prevent our solutions from being exported in violation of these laws, including using authorizations or exceptions for our encryption products and implementing IP address blocking and screenings against U.S. government and international lists of restricted and prohibited persons and countries, we have not been able to guarantee, and cannot guarantee that the precautions we take will prevent all violations of export control and sanctions laws, including if purchasers of our products bring our products and services into sanctioned countries without our knowledge. Violations of U.S. sanctions or export control laws can result in significant fines or penalties and incarceration could be imposed on employees and managers for criminal violations of these laws.

Also, various countries, in addition to the United States, regulate the import and export of certain encryption and other technology, including import and export licensing requirements, and have enacted laws that could limit our ability to distribute our products and services or our end-users' ability to utilize our solutions in their countries. Changes in our products and services or changes in import and export regulations may create delays in the introduction of our products in international markets. Furthermore, actions by the current U.S. administration increasing duties on certain products imported from China may severely impact the price of our goods imported into the United States. It is uncertain how long these tariffs will apply. Further, other countries may follow suit and increase duties on goods produced in China.

Adverse action by any government agencies related to indirect tax laws could materially adversely affect our business, operating results and financial condition.

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.

Table of Contents

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

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

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

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

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

we fail to meet our customers' expectations. In addition, quality issues can impair our relationships with new or existing customers and adversely affect our brand and reputation, which could adversely affect our operating results.



## Table of Contents

We are currently involved in numerous litigation matters in the ordinary course and may in the future become involved in additional litigation, including litigation regarding intellectual property rights, consumer class actions and securities class actions, any of which could be costly and subject us to significant liability.

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

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

From time to time, we will undertake acquisitions to add new product lines and technologies, gain new sales channels or enter into new sales territories. For example, in August 2018, we acquired Meural Inc., a leader in digital platforms for visual art, to enhance our Connected Home product and service offerings. Acquisitions involve numerous risks and challenges, including but not limited to the following:

- integrating the companies, assets, systems, products, sales channels and personnel that we acquire;
- higher than anticipated acquisition and integration costs and expenses;

reliance on third parties to provide transition services for a period of time after closing to ensure an orderly transition of the business;

70

---

Table of Contents

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

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

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

We cannot ensure that we will be successful in selecting, executing and integrating acquisitions. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. In addition, if stock market analysts or our stockholders do not support or believe in the value of the acquisitions that we choose to undertake, our stock price may decline.

## Table of Contents

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

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

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

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

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

## Table of Contents

In addition to government regulations, many of our customers require us to comply with their own requirements regarding manufacturing, health and safety matters, corporate social responsibility, employee treatment, anti-corruption, use of materials and environmental concerns. Some customers may require us to periodically report on compliance with their unique requirements, and some customers reserve the right to audit our business for compliance. We are increasingly subject to requests for compliance with these customer requirements. For example, there has been significant focus from our customers as well as the press regarding corporate social responsibility policies. Recently, a number of jurisdictions have adopted public disclosure requirements on related topics, including labor practices and policies within companies' supply chains. We regularly audit our manufacturers; however, any deficiencies in compliance by our manufacturers may harm our business and our brand. In addition, we may not have the resources to maintain compliance with these customer requirements and failure to comply may result in decreased sales to these customers, which may have a material adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

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

be determined resulting in an adverse impact on our results of operations.

73

---

Table of Contents

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

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

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

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. A port worker strike, work slow-down or other transportation disruption in Long Beach, California, where we have a significant distribution center, could significantly disrupt our business. For example, a series of work stoppages and slow-downs arising from labor disputes at the Long Beach port and other West Coast ports, particularly in the first quarter of 2015, negatively impacted our ability to timely deliver certain product shipments to the United States and resulted in additional transportation expense. Our international freight is regularly subjected to inspection by governmental entities. If our delivery times increase unexpectedly for these or any other reasons, our ability to deliver products on time would be materially adversely affected and result in delayed or lost revenue as well as customer imposed penalties. In addition, if increases in fuel prices occur, our transportation costs would likely increase. Moreover, the cost of shipping our products by air freight is greater than other methods. From time to time in the past, we have shipped products using extensive air freight to meet unexpected spikes in demand, shifts in demand between product categories, to bring new product introductions to market quickly and to timely ship products previously ordered. If we rely more heavily upon air freight to deliver our products, our overall shipping costs will increase. A prolonged transportation disruption or a



significant increase in the cost of freight could severely disrupt our business and harm our operating results.

Table of Contents

Expansion of our operations and infrastructure may strain our operations and increase our operating expenses.

We have expanded our operations and are pursuing market opportunities both domestically and internationally in order to grow our sales. This expansion has required enhancements to our existing management information systems, and operational and financial controls. In addition, if we continue to grow, our expenditures would likely be significantly higher than our historical costs. We may not be able to install adequate controls in an efficient and timely manner as our business grows, and our current systems may not be adequate to support our future operations. The difficulties associated with installing and implementing new systems, procedures and controls may place a significant burden on our management, operational and financial resources. In addition, if we grow internationally, we will have to expand and enhance our communications infrastructure. If we fail to continue to improve our management information systems, procedures and financial controls or encounter unexpected difficulties during expansion and reorganization, our business could be harmed.

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

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

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

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.

Table of Contents

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 fully understand and use the source code, as we may not have the expertise to do so. We are increasingly exposed to these risks as we continue to develop and market more products containing third-party software, such as our TV connectivity, security and network attached storage products. If we are unable to license the necessary technology, we may be forced to acquire or develop alternative technology, which could be of lower quality or performance standards. The acquisition or development of alternative technology may limit and delay our ability to offer new or competitive products and services and increase our costs of production. As a result, our business, operating results and financial condition could be materially adversely 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 and technology. Despite efforts to protect our intellectual property, unauthorized third parties may attempt to design around, copy aspects of our product design or obtain and use technology or other intellectual property associated with our products. For example, one of our primary intellectual property assets is the NETGEAR name, trademark and logo. We may be unable to stop third parties from adopting similar names, trademarks and logos, particularly in those international markets where our intellectual property rights may be less protected. Furthermore, our competitors may independently develop similar technology or design around our intellectual property. Our inability to secure and protect our intellectual property rights could significantly harm our brand and business, operating results and financial condition.

Political events, war, terrorism, public health issues, natural disasters, sudden changes in trade and immigration policies, and other circumstances could materially adversely affect us.

Our corporate headquarters are located in Northern California and one of our warehouses is located in Southern California, both of which are regions known for seismic activity. Substantially all of our critical enterprise-wide information technology

Table of Contents

systems, including our main servers, are currently housed in colocation facilities in Mesa, Arizona. While our critical information technology systems are located at colocation facilities in a different geographic region in the United States, our headquarters and warehouses remain susceptible to seismic activity so long as they are located in California. In addition, the majority of our manufacturing occurs in mainland China and Southeast Asia, 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.

In addition, war, terrorism, geopolitical uncertainties, public health issues, sudden changes in trade and immigration policies (such as the higher tariffs on certain products imported from China enacted by the current U.S. administration), and other business interruptions have caused and could cause damage or disruption to international commerce and the global economy, and thus could have a strong negative effect on us, our suppliers, logistics providers, manufacturing vendors and customers. Our business operations are subject to interruption by natural disasters, fire, power shortages, terrorist attacks and other hostile acts, labor disputes, public health issues, and other events beyond our control. For example, labor disputes at manufacturing facilities in China have led to workers going on strike, and labor unrest could materially affect our third-party manufacturers' abilities to manufacture our products.

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

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

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

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

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



Table of Contents

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

(a) None.

(b) None.

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

Period	Total Number of Shares Purchased (2)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1)</sup>	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1, 2019 - January 27, 2019	142,800	\$ 33.91	142,800	1,342,084
January 28, 2019 - February 24, 2019	288,282	\$ 35.57	232,885	1,109,199
February 25, 2019 - March 31, 2019	94,519	\$ 34.34	60,220	1,048,979
Total	525,601	\$ 34.90	435,905	

(1) From time to time, our Board of Directors has authorized programs under which we may repurchase shares of our common stock, depending on market conditions, in the open market or through privately negotiated transactions. During the three months ended March 31, 2019, we repurchased and retired, reported based on the trade date, approximately shares of 0.4 million common stock at a cost of \$15.0 million under the authorizations.

(2) During the three months ended March 31, 2019, we repurchased, as reported based on trade date, approximately 89,000 shares of common stock at a cost of \$3.3 million to facilitate tax withholding for RSUs.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

Table of Contents

## Item 6. Exhibits

## Exhibit Index

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
<u>3.1</u>	<u>Amended and Restated Certificate of Incorporation of the registrant</u>	10-Q	8/4/2017	3.1	
<u>3.2</u>	<u>Amended and Restated Bylaws of the registrant</u>	8-K	4/20/2018	3.2	
<u>4.1</u>	<u>Form of registrant's common stock certificate</u>	S-1/A	7/14/2003	4.1	
<u>4.2</u>	<u>2016 Equity Incentive Plan, as amended and adjusted, and form agreements thereunder.</u>	S-8	2/22/2019	99.1	
<u>31.1</u>	<u>Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer</u>				X
<u>31.2</u>	<u>Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer</u>				X
<u>32.1#</u>	<u>Section 1350 Certification of Principal Executive Officer</u>				X
<u>32.2#</u>	<u>Section 1350 Certification of Principal Financial Officer</u>				X
101.INS	XBRL Instance Document				X
101.SCH	XBRL Taxonomy Extension Schema Document				X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document				X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document				X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document				X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document				X

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



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/ BRYAN D. MURRAY

Bryan D. Murray

Chief Financial Officer

(Principal Financial and Accounting Officer)

Date: May 3, 2019

80